

Chapter 3

Constitutions and Crises: Balancing Insolvency and Social Policy through the Lens of Comparative Legal History

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1. Introduction

The economic and financial crises of the last decade have led to massive changes in economic, social, banking, and employment policies throughout the world. However, both the United States and the United Kingdom have generally maintained more static in relation to their overall status quo regarding insolvency and social policy, in stark contrast to the reactions of most continental European nations. Taken together with the sovereign debt crisis that plagued many continental European nations beginning in 2010, it may be somewhat surprising that the United Kingdom has not adjusted its policies to any greater degree than it has. Rather, it is continental Europe that has moved more or less *en masse* toward the lower common denominator of the United Kingdom, at least in terms of social and employment protection. In addition, many peripheral or less economically developed European nations have achieved some inadvertent legal benefits from the crises of the last decade in the reform or creation of more robust insolvency and corporate rescue systems.

The purpose of this paper is to explore the historical and constitutional underpinnings of the US and the UK, within the context of the European Union when required, in order to identify important differences in legal development and divergence from a common legal ancestry in approaches to insolvency, in particular corporate rescue procedures such as Chapter 11 and administration

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under the Insolvency Act 1986, and the social policy issues related to it. By identifying points of divergence situated within the historical context in which it arose, a more detailed, path dependent observation may reveal deeply seated differences that can explain why the US and the UK have often relied upon different foundational philosophies in the development of legal systems in insolvency and social policy. While the UK and the US are often compared in a positive light, as being more closely aligned than other European nations and the UK, their differences continue to persist, despite EU influence, and indeed, at times, in spite of it.

2 Comparative History of Insolvency and Corporate Rescue in UK and USA

Insolvency law draws together a number of different legal areas that interact in a complex balancing act, one that has sometimes been skewed due to constitutional restrictions and other legal and policy related roadblocks. The complex intermingling of insolvency law with, in particular, the law of contract, with what one might normally view as the defining parameters of the American Constitution, contrasted with the decisions of individual state courts, illustrates how this area has been problematic. The United Kingdom has not faced similar obstacles for a number of centuries, which, while reducing the competing factors that might be encountered by legislators in this area, has not prevented a slow evolution of insolvency systems, as opposed to the more rapid and holistic changes that has historically characterised insolvency in the US.

2.1 Divergence from a Common Past

The Statute of Anne that was in place in the American colonies at the time of the American Revolution, exporting the stigma that remains attached to indebtedness today in the UK given the fact that one was “liable” to bankruptcy, rather than benefitting from it.¹ This law is

¹ S.J. Lubben, “A New Understanding of the Bankruptcy Clause”, (2013) 64(2) Case Western Reserve Law Review 319, pp. 337.

often portrayed as the beginning of a modern, enlightened bankruptcy practice because it introduced the possibility of being discharged from debt, though exceedingly difficult and restricted only to traders.² Even prior to the passing of the Statute of Anne various states of America had created their own ways of dealing with bankruptcy, with Maryland formulating the first true bankruptcy law on the American continent in 1638, though it tracked existing English law at the time. Pennsylvania, New York, and Massachusetts followed suit with their own versions, all of which varied in description, scope, and purpose. Between 1755 and 1770 New York expanded a system for the release of impoverished debtors from prison to include the ability to bind holdout creditors to a workout agreed by a majority of creditors. Thus, the US began to diverge from the norms of British bankruptcy law even prior to the Revolution, developing a number of procedures that were often labelled as something else and private bills that eventually came together to provide an early system of bankruptcy relief. While it relied heavily on English practice in the earliest days, the tendency of the colonial law makers were to concentrate on the plight of imprisoned debtors rather than the punishment of them.³

In the early 1770s, the US continued to attempt to provide better and greater relief via bankruptcy provisions. One of the major issues encountered by colonial legislators was the requirement that any commercial legislation must obtain approval of Britain's Privy Council. In 1771, New York attempted to further expand their system relating to the release of imprisoned debtors to also protect the debtor's property acquired following release from prison, but Britain refused to approve it.⁴ Thus not only did the Revolution successfully separate the American nation from the patriarchy of English rule, it freed their ability to legislate to create systems suited to the social, cultural, and economic circumstances that characterised the pioneering spirit

² *Ibid.*, pp. 336-337.

³ *Ibid.*, pp. 338-339.

⁴ *Ibid.*, p. 339.

of the new American nation. Following the American Revolution, the first constitutional document, the Articles of Confederation, failed to provide for a national bankruptcy law, thus the states had to continue to legislate in this area without any continuity that might have been possible with some federal coordination.⁵

The US Constitution provided the framework for the power relationship between the States and the Federal Government. Due to competing views on what level of power the federal government should wield over the states, the Federal Government was given enumerated powers that limited its competences to govern the states.⁶ These enumerated powers included a Bankruptcy Clause, which gave the federal government the apparent power to enact “uniform laws on the subject of bankruptcies throughout the United States.”⁷ This should have heralded the commencement of a senatorial drafting of a unifying bankruptcy act that would have consolidated and simplified bankruptcy throughout the entire nation. However, such was not to be for nearly two centuries due to fundamental differences in governance philosophies between Federalists and Republicans, the competing political parties of the day.⁸ Thus, the states remained free to enact the insolvency laws they deemed appropriate and the Federal Government was acquiescent, leaving individual states responsible for providing the means to resolve financial distress despite the apparent constitutional power of the Bankruptcy Clause,⁹ with only a few largely failed interventions by the Federal Government.¹⁰

⁵ *Ibid.*, p. 340.

⁶ M.H. Redish, “Doing it with Mirror: *New York v United States* and Constitutional Limitations of Federal Power to Require State Legislation”, (1993-1994) 21 *Hastings Const LQ* 593, pp. 594-596.

⁷ US Constitution, article I paragraph 8 clause 4.

⁸ R. Sylla, R.E. Wright and D.J. Cowen, “Alexander Hamilton, Central Banker: Crisis Management during the US Financial Panic of 1792”, (2009) 83 *Business History Review*, pp. 62-63.

⁹ Lubben, above note 1, 341-342.

¹⁰ The Bankruptcy Act of 1800, Act of Apr 4, 1800, ch 19, 2 Stat 19 (repealed 1803); The Bankruptcy Act of 1841, Act of Aug 19, 1841, ch 5 Stat 440 (repealed

In 1874, a predecessor of the debtor in possession provision of Chapter 11 was introduced in a composition procedure that formed a part of massive reforms made to the Bankruptcy Act of 1867.¹¹ The composition provision allowed a debtor to remain in possession of his property if a sufficient number of creditors accepted the composition proposal, which would then be binding on all unsecured creditors, while those creditors who dissented were paid according to a “best interests” test based on liquidation outcomes. While this law lasted longer than those attempts made previously by the federal government, the economic problems encountered by the South following the Civil War led to the repeal of the federal bankruptcy legislation.¹²

2.2 British Insolvency: Slow Escape from the Debt Stigmata

During period between the passing of the Statute of Anne and the commencement of hostilities with the American colonies, Britain also had developments in its bankruptcy system, but in a fashion that focussed on maximising the returns to creditors rather than alleviating the burden of debtors to any significant degree. In 1732, a consolidating act¹³ was passed that became the statutory basis for bankruptcy law for the rest of the eighteenth century. As the eighteenth century progressed, the number of insolvencies increased, revealing weaknesses in the system illuminated by the burden placed upon it.¹⁴

Throughout the nineteenth century, insolvency law in the UK evolved in order to avoid fraudulent activities common in the earlier regimes.

1843); The Bankruptcy Act of 1867, Act of Mar 2, 1867, ch 176, 14 Stat 517 (repealed 1878).

¹¹ Act of Jun 22, 1874, ch 390, 18 Stat 178 (amending and supplementing an act entitled “an act to establish a uniform system of bankruptcy throughout the United States).

¹² Lubben, above note 1, 377.

¹³ An Act Preventing the Committing of Frauds by Bankrupts 1732 (5 Geo 2 c 30).

¹⁴ V.M. Lester, *Victorian Insolvency* (1995, Oxford University Press, Oxford), pp. 18-21.

While *laissez-faire* economics was the preferred approach during this period, government intervention¹⁵ was justified due to the growing influence of the business community,¹⁶ particularly following the introduction of the joint-stock companies.¹⁷ While an early composition procedure was also available,¹⁸ the stigma associated with debt and bankruptcy remained resilient, as well as the focus on creditors.¹⁹ The focus on fault and creditor satisfaction indicates a close tie to the prevailing moral perception of bankrupts and the Victorian values of thrift, self-help, and individual effort.²⁰

A number of Acts²¹ introduced and reinforced modern concepts of insolvency, such as the statutory regime for preferential debts; the *pari passu* principle; separate judicial and administrative functions; and the public examination of those at fault for creditor losses.²² Some of these were influenced by the recognition that some species of public good was both desirable and could be achieved by providing a means of collective action in the liquidation and distribution of bankrupt estates.²³ However, the quantity of bankruptcy reforms during the nineteenth and early twentieth century resulted in layers of law that were difficult to operate and prone to manipulation and

¹⁵ Bankruptcy Court (England) Act 1831 (1 & 2 Will 4 c 56).

¹⁶ Lester, above note 14, pp. 40-48.

¹⁷ Joint Stock Companies Act 1844 (7&8 Vict c 110); a winding-up was introduced at the same time in the Act Facilitating the Winding Up of Affairs of Joint Stock Companies Unable to Meet Their Pecuniary Engagements 1844 (7&8 Vict c111).

¹⁸ Bankrupts (England) Act 1825 (6 Geo 4 c16).

¹⁹ Lester, above note 14, 21-37 & 53-64.

²⁰ R. Bellamy, *Victorian Liberalism: Nineteenth Century Political Thought and Practice* (1988, Routledge, London), p. 7.

²¹ The Joint Stock Companies Winding-Up Act 1844 (7&8 Vict c111); Bankruptcy Act 1883 (46&47 Vict c52); Bankruptcy Act 1914 (4&5 Geo 5 c59); and The Companies Act (25 & 26 Vict c89).

²² R. Goode, *Principles of Corporate Insolvency Law*, Student edn, (2005, Sweet and Maxwell, London) 6-9 and Lester, above note 14, p. 227.

²³ Lester, above note 14, pp. 293-294.

would attract the attention of reformers in the 1970s,²⁴ but it would not be until the Insolvency Act of 1986 that a true species of corporate rescue would be legislated,²⁵ partly due to the desire of the UK to join the European Community.²⁶

The Cork Report preceded the passage of the Insolvency Act 1986.²⁷ An entirely new approach and perception of the aims of insolvency law in the UK was adopted, including a truly social message that was recommended to be incorporated in the imminent reforms.²⁸ The Cork Report recognised and formulated the concept of a rescue culture, stating that given that the failure of commercial enterprises has wide repercussions for a variety of stakeholders, including but not limited to creditors, shareholders, employees, suppliers, and others who would be adversely affected by business failure. A legitimate aim of insolvency laws should be to have concern for the livelihood and well-being of those dependent upon an enterprise.²⁹ In the view of Cork Committee, the rescue culture would manifest itself in policies directed at the more benevolent treatment of insolvent legal entities as well as the more draconian treatment of the unscrupulous abusers of the system. It would also mean the steady removal of the stigmatising effect of bankruptcy.³⁰ Though beneficent in their view of what the future should hold for insolvency, the Cork Committee's more socially oriented recommendations would not find immediate

²⁴ V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, 2nd edn (2009, CUP, Cambridge), pp. 12-13.

²⁵ 1986 c 45 (hereafter referred to as the IA1986); M. Hunter, "The Nature and Functions of the Rescue Culture" (1999) November JBL 426, p. 455.

²⁶ Hereafter referred to as the "EC".

²⁷ Hunter, above note 25.

²⁸ K. Cork, Sir (Chairman), *Insolvency Law and Practice: Report of the Review Committee* (Cmnd 8558 1982) ch 4 para 203-204.

²⁹ *Ibid.*

³⁰ Hunter, above note 25, p. 26.

implementation, however, more recent reforms³¹ as well as the influence of the EU have seen many of the social objectives of insolvency law incorporated into the British insolvency system, including a preference for rescue over simple liquidation.³²

The changes made to insolvency law in the last fifteen years demonstrate that the policy of corporate rescue is now being given precedence over traditional creditor wealth maximisation and debt recovery.³³ Rescue strategies supported by the current legislation are based upon a utilitarian approach, predicated on the premise that the interests of the few are outweighed by the needs of the many. The interests represented now also include the wider community, as well as social and political objectives of full employment. These interests can often be better served though the rescue of a business than asset realisations followed by *pari passu* distributions of what remains after secured creditors and liquidators are paid their share.³⁴

2.3 The American Way: A Constitutional Conundrum

The presence of the Bankruptcy Clause in the American Constitution crossed with the existence of a myriad of State authored bankruptcy laws caused a number of problems for state courts. Some held insolvency codes to be unconstitutional, on the interpretation of the Bankruptcy Clause as having left Congress with the sole power to legislate in this area. Focused on the existence of the discharge, it was held that

“a law discharging a debtor from his debts, without payment, if not a bankrupt law, is a law impairing the law

³¹ The Enterprise Act 2002 c 40 (hereafter referred to as the “EA”).

³² See the Insolvency Act 1986 sch B1 para 3.

³³ D. Milman, “Moratoria on Enforcement Rights: Revisiting Corporate Rescue” (2004) March/April *Conveyancer and Property Law Journal* 89, p. 104.

³⁴ *Ibid.*

of contracts, the power of making which is, by the said Constitution, expressly forbidden to individual states.”³⁵

Thus it was not only the Bankruptcy Clause, the ignoring of which was beginning to create uncertainty, but also implicated the Contracts Clause, given the effect on contracts that a discharge post-bankruptcy would have. By allowing a discharge, bankruptcy law was viewed as interfering with the integrity of contracts by facilitating a breach in discharging the obligation to pay the full consideration agreed by the contracting parties.³⁶

The constitutionality of state authored bankruptcy law was assessed in *Sturges v Crownshield*³⁷ in 1819. Crownshield sought relief by way of bankruptcy and discharge under the New York statute. It was argued by his creditor that the Bankruptcy Clause prevented states from legislating in this area and that, therefore, the New York statute and the discharge it afforded was unconstitutional. The Supreme Court failed to state definitively the position of state insolvency law with regard to the Bankruptcy Clause; rather, the Court inferred a broader reading of the Clause, ruling that the states had the power to legislate in this area in the absence of Congressional action, and that such laws would be constitutional as long as they were not applied to contracts arising prior to the promulgation of the law.³⁸ By not weighing in definitively on what likely should have been the federal nature of bankruptcy under the Bankruptcy Clause of the US Constitution, the Supreme Court allowed the States to take the ambiguous judgment in *Crownshield* and apply it to their own bankruptcy cases with an extraordinarily diverse effect, creating a great deal of uncertainty in relation to the applicability and

³⁵ *Olden v Hallet* 4 NJ 466, 469 (NJ 1819).

³⁶ Lubben, above note 1, 349-350.

³⁷ *Sturges v Crownshield* 17 US (4 Wheat) 122 (1819).

³⁸ Lubben, above note 1, 352-353.

effectiveness of bankruptcy laws among the states, as well as the validity of any discharges that were given.³⁹

State insolvency laws met their end in the final years of the nineteenth century with the passing of the Bankruptcy Act of 1898.⁴⁰ The Act was a clear break from the English inspired, creditor controlled systems that were tried earlier in the century, providing discharge post liquidation and the option of compositions with creditors. When challenged in the Supreme Court, the Bankruptcy Clause finally left dormancy as bankruptcy became the province of the federal government.⁴¹ Its boundaries were tested in the 1930s and corporate reorganisations were federalised in the Chandler Act. Following the Act, a group of specialised bankruptcy professionals developed, who would be important characters for the procedures introduced in the 1978 Act when the referees under the previous act became bankruptcy judges.⁴²

3 Aims of Insolvency: An Anglo-American Rift

American Bankruptcy Law evolved following the Revolution in a piecemeal fashion among individual states with a focus on how to provide relief for debtors while also treating creditors as fairly as possible under the circumstances. A Maryland bankruptcy statute encapsulates the concept of discharge:

“The great principle upon which it is founded, is, that the debtor shall surrender *all* his property for the common benefit of *all* his creditors. He can only obtain his discharge on complying with this requisite, and some

³⁹ Joshua M. Van Cott, “A General Bankrupt Law” (1841) 4 *Merchant’s Magazine and Commercial Review* 22.

⁴⁰ Act of July 1, 1898, Ch 541 30 Stat 544 (repealed 1978); SJ Lubben, “A New Understanding of the Bankruptcy Clause” (2013) 64(2) *Case Western Reserve Law Review* 319, 383-384.

⁴¹ Lubben, above note 1, 388-389.

⁴² *Cent Va Cmty Coll v Katz*, 546 US 356, 373 (2006).

others of an inferior nature. When he *has* complied, then he is entitled to his discharge.”⁴³

The idea of a “fresh start” attracted dozens of bankrupts to apply to the court in Baltimore. Further, the concept of a fresh start is a fundamental characteristic of the modern American bankruptcy system. It was recognised that it was important for the entrepreneurial spirit of the country that relief should be made available to honest but unfortunate debtors.⁴⁴ Thus the purpose of bankruptcy in the American system has evolved with the foundational principle of aiding the unfortunate but honest debtor.⁴⁵

English bankruptcy was quite different due to the historic relationship with debt which characterised debtors as anti-social and immoral by causing difficulty for one’s creditors and failing to adhere to bargains struck. While the unforgiving nature of English bankruptcy law has changed over time to a degree, financial failure is still considered a character weakness and business failure is generally an embarrassment.⁴⁶ The opposing character of American bankruptcy law could be attributed to the draconian treatment of debtors in the English legal system. A large proportion of settlers in the eighteenth century were convicts who had been imprisoned for debt, so it is not surprising that the American approach to bankruptcy would be potentially quite different from the old country. In addition, the nature of economic growth in America had to be rapid in order to cope with competing industrialising nations in Europe; as such, early bankruptcy laws had the flavour of promoting commerce, which meant encouraging entrepreneurialism and the risk taking that was inherently associated with it.⁴⁷ Debt forgiveness was therefore critical to a strong American economy.⁴⁸

⁴³ *In Re Stewart*, 2 Am LJ 184, 186 (Md Ch 1809).

⁴⁴ *In Re Brown*, 1 Mart (os) 158, 159 (Orleans 1810).

⁴⁵ *Stellwagen v Clum*, 245 US 605, 617 (1918).

⁴⁶ N. Martin, “Common-Law Bankruptcy Systems: Similarities and Differences” (2003) 11 Am Bankr Inst L Rev 367, pp. 371-374.

⁴⁷ *Ibid*, p 370.

⁴⁸ *Ibid.*, p. 403.

There is also a cultural aspect of the American people that helps to explain the focus on debt forgiveness and reorganisation over liquidation and punishment. Money and consumerism are particularly strong forces in American society. Losing money equates to losing independence and independence is a fundamental facet of the American psyche.⁴⁹ In addition, business failure is often viewed as a product of misfortune rather than wrong doing. Given the pioneering character of the US historically, risk-taking is expected and respected, while creditors are at times perceived as being greedy.⁵⁰

The Chapter 11 procedure today continues to adhere to aims of rescue and reorganisation over liquidation with the debtor-friendly aspect of early bankruptcy laws evident in the “debtor in possession” nature of the procedure. Reorganisation has been prioritised because it was viewed that allowing assets to be utilised as intended with the benefit of preserving jobs was preferred over the destruction of valuable firm specific assets.⁵¹ Thus not only is the old focus on discharge still present, which places the plight of the honest debtor ideologically above the position of creditors, but the focus on rescue over liquidation is clear in the preference that managers often have for the former given the presumption favouring the continued control of management. The structure of the procedure provides an incentive for managers given the latitude corporate debtors have regarding the treatment of creditors and the fact that the managers can control what is done with that freedom.⁵² The underpinning philosophy is to balance the desires of creditor and debtor groups while promoting commerce, which was not aligned with the English system’s

⁴⁹ G. McCormack, “Control and Corporate Rescue – an Anglo-American Evaluation” (2007) 56(3) *International and Comparative Law Quarterly* 515, p. 525.

⁵⁰ G. Moss, “Comparative Bankruptcy Cultures: Rescue or Liquidations? Comparisons of Trends in National Law—England” (1997) 23 *Brooklyn Journal of International Law* 115.

⁵¹ M. Bradley and M. Rosenwig, “The Untenable Case for Chapter 11” (1992) 101(5) *The Yale Law Journal* 1043, pp. 1043-1044.

⁵² *Ibid.*, 1045

unforgiving and highly administrative bankruptcy process.⁵³ It did not take long to shed the stigma of the more punitive English system.

Prior to the introduction of the concept of corporate rescue in the United Kingdom, the purpose of insolvency was based primarily on a collective regime aimed at achieving the best possible outcome for creditors.⁵⁴ The purpose of insolvency law was predicated on the assumption that if a company encounters financial difficulty, it is probably due to the failure of management. Thus, unlike the American system, it is viewed as contrary to the aims of insolvency to allow the management to retain control.⁵⁵ Further, the British system tends to favour financiers as bankers seem to have acquired respectability while entrepreneurs who take business risks have not.⁵⁶ The English judiciary also tend to be inclined to be sympathetic to insolvency practitioners rather than debtors as practitioners are professionals known to the court, whereas the debtor's fall into insolvency tends to be treated as a basis for suspicion.⁵⁷

Although insolvency law has traditionally aimed to satisfy more economic interests in the UK, issues of fairness have now been accepted as necessary considerations in the UK insolvency system. Among these considerations are the ranking of wages as preferential debts, access to social security for repayment of arrears, rules dealing with continuity of employment, and laws stipulating the mandatory transfer of contracts on the transfer of a business as a going concern.⁵⁸ In this area, the UK has expanded beyond the social considerations taken in relation to corporate rescue than has the US, which is again influenced by the constitutional and legal history of both jurisdictions, as well as the approach to social policy that each country takes. It is to the concept of social policy as it relates to insolvency that this paper now turns.

⁵³ Martin, above note 46, pp. 367-368.

⁵⁴ Goode, above note 22, p. 5.

⁵⁵ McCormack, above note 49, p. 522.

⁵⁶ Moss, above note 50.

⁵⁷ McCormack, above note 49, p. 525.

⁵⁸ Finch, above note 24, p.15.

4 Employees in Insolvency: Issues of Job Security and Social Policy

From its peak following the New Deal era,⁵⁹ much of the welfare state programmes have been retrenched in the US with policy changes that either cut social expenditure, restructure welfare state programs to conform more closely to the residual welfare state model, or alter the political environment in ways that enhance the probability of such outcomes in the future.⁶⁰ In addition, social policy retrenchment is highly path dependent, thus social policy choices tend to create strong vested interests and expectations, which are difficult to dislodge. As the risks have risen due to increased income inequality, growing instability of income over time, increased employment in less structured services and part time roles, and increased structural unemployment, social protections have been eroded rather than enhanced.⁶¹ The US has an uneasy partnership with welfare state ideals. The purpose of welfare considerations undermines that central theme of independence and the individual responsibility that is connected to it. This approach to matching reforms to social changes is also evident in the American approach to employment issues arising out of corporate rescue.

While the UK tends toward a modest liberal market ideology, its welfare state model tends to be far more progressive than the US model. Among most welfare states apart from the US, core programmes are broadly cherished, rather than regarded with suspicion.⁶² However, the financial crisis and sovereign debt crisis precipitated a review of such programmes throughout the world's

⁵⁹ The New Deal was a series of federal programs, public works projects, and financial reforms and regulations enacted in the United States during the 1930s in response to the Great Depression.

⁶⁰ P. Pierson, *Dismantling the Welfare State* (1995, CUP, Cambridge), p. 17.

⁶¹ J.S. Hacker, "Privatizing Risk without Privatizing the Welfare State: The Hidden Politics of Social Policy Retrenchment in the United States" (2004) 98(2) *The American Political Science Review* 243, pp. 245-249.

⁶² B. Vis, K. van Kersbergen and T. Hylands, "To What Extent Did the Financial Crisis Intensify the Pressure to Reform the Welfare State" (2011) 45(4) *Social Policy & Administration* 338, p. 341.

welfare states, including the UK. A number of social protections have been undermined, including employment protection and job security, despite public outcry and resistance. In fact, public support for the welfare state has increased following the crises, despite mounting financial constraints that have limited the extent to which governments can meet such demands. The UK, however, has scaled back far more welfare support than has its European counterparts,⁶³ though the nature of social policy remains far more central and important in the UK than the position it occupies in the US.

4.1 Social Policy and Insolvency in the United States: A Dire WARNING

Until World War I, State law was the primary source of employment law, but these regulatory frameworks were heavily tempered by the concept of individual liberty. State laws generally tended to uphold rights to freely enter contracts for the hiring of services.⁶⁴ The American employment system is thus characterised by the concept of “at-will” employment in which employers possessed the legal authority to determine unilaterally the terms and conditions of an employment relationship.⁶⁵ This rule gained the ultimate authority in 1908 when the Supreme Court provided a constitutional basis for the doctrine.⁶⁶ Essentially the doctrine means that both the employer and employee are engaged in a relationship that is at the will of either of them, thus the employee can leave at any time and the employer can dismiss him, unless there is a contractual provision in place to the contrary.⁶⁷ The at will doctrine is universally accepted in the US, having been described as the “very foundation of the free enterprise

⁶³ *Ibid.*, 342.

⁶⁴ C.A. Scott, “Money Talks: The Influence of Economic Power on the Employment Laws and Policies in the United States and France” (2006) 7 San Diego Int’l LJ 341, pp. 350-351.

⁶⁵ S.F. Befort, “Labour and Employment Law at the Millennium: a Historical Review and Critical Assessment” (2001) 43 B C L Rev 460, pp. 355-375.

⁶⁶ *Adair v United States*, 208 US 161 (1908).

⁶⁷ Scott, above note 64, 351.

system.”⁶⁸ Some states have enacted legislation placing limitations on the at-will doctrine; however, broadly speaking it is still in place.⁶⁹ The lack of employment protection for American workers is not helped by the lack of federal power to control social policy in this area in any fundamental way due to the fact that contract law, of which employment law is a subset, is governed by individual state legal systems.

While the Bankruptcy Clause provides the US Federal Government with the power to legislate in relation to insolvency and corporate rescue,⁷⁰ the same does not apply to contract law and other domestic state concerns. Certain rights are now guaranteed for employees in the US, but these rights do not derive from any specific constitutional article or amendment implementing social policy objectives on a federal level. Rather, they derive from various articles and amendments to the Constitution that have been used to justify their existence. Notably, employee rights such as minimum wage, working hours, health and safety, equal pay, and even civil rights issues such as affirmative action⁷¹ have been justified as being covered by the Commerce Clause,⁷² which allows the federal government to regulate business conducted across state lines. There is also a “necessary and proper” clause providing Congress with a significant degree of flexibility in the invocation of its enumerated powers, though this flexibility has been continuously mitigated by a focus on the

⁶⁸ D.B. Shine, “An Analysis of the Terms and Level of Implementation of the European Union’s Collective Dismissal Directive and the United States WARN ACT. Another Example for the European Union on the Relative Merits of Political Federation over Confederation” (1998) 12 Fla J Int’l L 183, p. 185.

⁶⁹ Known as “whistle-blowing” in the UK which as a reason for discharge is now prohibited in a number of American states; see Befort, above note 65, 385-393.

⁷⁰ Article 1 Section 8 Clause 4 states that Congresses enumerated powers include the power to establish a uniform rule of naturalisation and uniform laws on the subject of bankruptcies throughout the US.

⁷¹ Although the groundwork for these were laid by the 13th amendment abolishing slavery, the 14th amendment prohibiting discrimination in the right to vote based on race and the 15th amendment giving women the right to vote laid the groundwork for these laws.

⁷² Article 1 Section 8 of the Preamble to the US Constitution

limitations on the federal government set out with some specificity in the Constitution.⁷³ The context of US social policy thus differs significantly from EU social policy, which figures quite prominently in most Member States through the implementation of social policy directives having legal basis set out in the Social Chapter of the EU Treaty.

Although there are certain employee rights available under Chapter 11, these do not always adequately protect employees who might be subject to drastic reductions in the workforce, pensions and other employee benefits. As these are not protected in any way by statute, and in the absence of any protection from collective agreements, employees may get notification of redundancies but will essentially just have to suffer the loss of their jobs and associated benefits. These drastic reductions often occur at the beginning of a reorganisation process, which is then sometimes followed by the payment of massive retention bonuses to upper management in order to keep them “on the job.”⁷⁴ Thus, there is often a great divide between the treatment of managers as opposed to workers and employees in the context of Chapter 11 restructurings.⁷⁵ In addition, collective agreements and employment contracts can be summarily terminated under the Bankruptcy Code.⁷⁶ The persistence of the “at will” doctrine means that employees in these situations will have recourse to legal protection in only limited circumstances.

⁷³ Redish, above note 6, p. 604.

⁷⁴ See for example *Re Eastman Kodak Co. et al*, Voluntary Petition for Chapter 11 Bankruptcy, Case No 12-10202, So, Dist. NY (2012) available from http://bankrupt.com/misc/Kodak_StipSpectra073013.pdf accessed 30 October 2014.

⁷⁵ J. Berry, “Different Playing Fields: What Affect Does Chapter 11 Bankruptcy Have on Employees of the Debtor and Why do, These Affects Drive Companies to Bankruptcy?” (2012) Social Sciences Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2139062> accessed 30 October 2014.

⁷⁶ P.A. Susser, A.M. Weber and S.J. Friedman, “Employment and Employee Benefits in the US: Overview” (2014) Practical Law Multi-Jurisdictional Guide on Employment and Employee Benefits <<http://global.practicallaw.com/1-503-3486>> accessed 28 October 2014.

Employee claims occurring prior to the petition for Chapter 11 rank fourth in priority under the US Bankruptcy Code and are limited in time and amount.⁷⁷ While such claims carry priority, this is only after administrative expenses and secured claims have been paid.⁷⁸ Following the petition for bankruptcy, those employees that have been assumed by the debtor are assured of being paid for services rendered during the reorganisation. These rank as an administrative expense and are given first priority, though it is rare that such a claim will arise as a debtor will be sure to continue to pay such administrative debts as they fall due or risk not completing reorganisation.⁷⁹ In any event, while priority exists, it falls short of the priority given to employees in similar situations in EU countries as employees with pre-petition claims essentially rank equally with unsecured creditors and are limited in time and amount claimable.

In terms of the employment protection regulation available to employees during the insolvency of their employer, the “at-will” doctrine continues to apply in the United States. An employee does not have the right to be transferred with a business to which he is associated and if he is, there is no continuity of employment between the previous employer and the new one. Essentially, this relies on basic laws of contract that once governed the whole of employment law in the UK, though this is now mitigated by employment protection regulation aimed at correcting the power imbalance in the employment relationship. There are no statutory notice periods, requirements for severance, or redundancy pay, or procedural requirements for dismissal. For any of these to apply, they would have to be included in a collective agreement or perhaps an employee handbook. Employers can lay-off employees for any reason that does

⁷⁷ Pensions refers only to retirement income while welfare benefits refer to medical, health, accident, disability or death benefits, severance pay, training, apprenticeship programmes, day care and prepaid legal services.

⁷⁸ P.M. Secunda, “An Analysis of the Treatment of Employee Pension and Wage Claims in Insolvency and Under Guarantee Schemes in OECD Countries: Comparative Law Lessons for Detroit and the US” (2014) XLI *Fordham Urban Law Journal* 867, 898 and D R Korobkin, “Employee Interests in Bankruptcy” (1996) 4 *Am Bankr Inst L Rev* 5, pp. 8-9.

⁷⁹ Korobkin, above note 78, pp. 14-15.

not violate anti-discrimination statutes or that constitute an act of bad faith.⁸⁰

There are some limited protections available to employees affected by an employer's insolvency. The Worker Adjustment and Retraining Notification Act,⁸¹ a statute requiring advance notice if collective redundancies were envisaged, was passed to mitigate some of the issues surrounding large scale bankruptcies.⁸² If the WARN Act is engaged, the employer must provide written notice to representatives and employees affected by the action. The WARN Act applies to business enterprises of a certain size and composition in the event of a mass layoff,⁸³ however, the threshold for a mass layoff is relatively high compared to the Collective Redundancies Directive. The WARN Act does not require consultation, merely 60 days advance notice in employers having over 100 employees, though it excludes several categories of workers, including those engaging in collective action at the time of the notice.⁸⁴ There is also no provision for transferring employment contracts. Employees will only transfer if the transferee formally offers them employment and continuity of employment is not guaranteed.⁸⁵ Compared with the protections available to employees affected by the insolvency of their employer in the UK and other EU countries, the WARN Act merely recognises that employees are affected, but offers very little in terms of real security or protection. This is where the protections provided to American employees in the event of an insolvency ends.

4.2 Social Policy and Insolvency in the United Kingdom: An EU Imperative

⁸⁰ Susser, Weber and Friedman, above note 76.

⁸¹ An Act to require advance notification of plant closings and mass layoffs, and for other purposes (the "WARN" Act) enacted by the 100th United States Congress, Pub. L. 100-379 102 Stat 890.

⁸² Susser, Weber and Friedman, above note 76.

⁸³ Scott, above note 64, pp. 373-374.

⁸⁴ Council Directive 98/59/EC of 20 July 1998 on the approximation of the laws of the Member States relating to collective redundancies.

⁸⁵ Scott, above note 76, p. 377.

The British employment relationship is based on a ‘master and servant’ model connected to the early legal form of social relations, which was a statutory and hierarchical paradigm rather than contractual and common law. The master and servant form of employment relationship relied upon a command relation with an open ended duty of obedience imposed on the worker, reserving far-reaching disciplinary powers to the employer.⁸⁶ Even once the employment relationship had been given contractual status, imposing certain civil obligations, the hierarchical characteristic of the traditional master and servant model has been carried over into the modern contractual employment relationship to some extent.⁸⁷ Legal terminology and the old assumptions of unmediated control continued to be applied by the courts as they developed the common law of employment. The advent of the welfare state and the extension of collective bargaining caused employment law to change direction, but the traditional hierarchy of employer and employee remained difficult to dislodge from the British legal psyche.⁸⁸ While this has been tempered since the 1940s and given legal status following the introduction of the Employment Rights Act of 1996, as well as other more progressive employment oriented legislation, the master and servant approach is still evident in Britain’s regulatory approach to employment law.⁸⁹ This has been displaced to some extent by the application of EU law through a number of social policy directives.

After decades of slow but progressive changes to employment rights and protections within the EU, all Member States are now bound by the EU Charter of Fundamental Rights⁹⁰ and the Social Chapter of

⁸⁶ S. Deakin and W. Njoya, “The Legal Framework of Employment Relations” (2007) Centre for Business Research, University of Cambridge, Working Paper no. 349, p 7.

⁸⁷ Lord Wedderburn of Charlton, “The Social Charter in Britain: Labour Law and Labour Courts?” (1991) 54(1) MLR 35, p. 6.

⁸⁸ Deakin and Njoya, above note 86, p. 7.

⁸⁹ Lord Wedderburn of Charlton, above note 87, p. 6.

⁹⁰ Charter of Fundamental Rights of the European Union OJ 2000/C 364/1 of 18 December 2000.

the EU Treaty,⁹¹ with some narrow derogative options.⁹² However, EU social policy remains within the domain of Member States to determine, requiring unanimous decision making in legislative proposals falling under its definition.⁹³ As social institutions are deeply embedded in each country's larger societal framework and history, they cannot be easily aligned⁹⁴ as can be seen by the diverse ways in which social policy related directives are implemented in Member States.

The approach to social policy differs significantly from the more closely coordinated action taken by the EU in matters of insolvency. The cooperation of European countries in matters of insolvency has a long history. The project has been in progress for over 40 years within the EU, evolving in complexity and increasing in cooperation as the EU has expanded and changed.⁹⁵ The culmination of this cooperation was the EU Insolvency Regulation.⁹⁶ While this does not implement an EU wide insolvency system, the aims and outcomes of corporate rescue mechanisms throughout the EU do not have the same variance that social policy regulation does. This could be explained by the fact that insolvency, as a corporate law matter, has a more international influence given the globalised marketplace in which most businesses now exist. A closer alignment of insolvency mechanisms is logical, therefore, as it makes cross-border business less complicated. This may also explain the EU approach to a cross-border insolvency regulation, rather than trying to implement an EU wide insolvency system. There is perhaps a more natural tendency to

⁹¹ The Treaty on European Union OJ C/191/01 of 29 July 1992 (the Maastricht Treaty).

⁹² The Treaty of Amsterdam incorporated the provisions of the Social Chapter directly in 1997.

⁹³ N. Esenturk, "EU Social Policy: Progressive Development in Legal and Governance Aspects" (2010) UK Social Policy Association <<http://www.social-policy.org.uk/lincoln/Esenturk.pdf>> accessed 17 November 2012, 2-3.

⁹⁴ P. Kettunen and C. Wolff, "Europeanisation through the Back Door: EU Social Policy and the Member States" (2010) 47(5) *Politicka misao* 146, p.148.

⁹⁵ P. Omar, *European Insolvency Law* (Ashgate 2004), p. 49.

⁹⁶ Council Regulation (EC) No. 1346/2000 of 29 May 2000 on Insolvency Proceedings (OJ 2000/L160/1) (hereafter referred to as the "EIR").

align systems that are forced to interact regularly in the common and international markets.⁹⁷

This same idea can explain to a certain extent why it is that Member State employment regulations have not seen the same kind of convergence or direct regulation by the EU. Workers are generally less mobile with the consequence that differences in preferences can lead to differences in employment law systems. Also, the political context of business versus labour is specifically a domestic concern; as such, the conflicting pressure may steer different countries in different directions.⁹⁸ This also offers justification for legislating in this area with directives, which are binding only as to the result to be achieved. There are a number of EU directives that serve to further preserve employment and workers' rights in insolvency situations in relation to collective redundancies,⁹⁹ transfers of undertakings¹⁰⁰ and state guarantee funds for employee wages and other compensation.¹⁰¹ Member States have taken varied approaches to the implementation of these directives¹⁰² as derogations are available that have been

⁹⁷ See M. Siems, "Shareholder, Creditor and Worker Protection: Time Series Evidence about the Differences between French, German, Indian, UK and US Law" (2012) Centre for Business Research, University of Cambridge, Working Paper No 381 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1329997> accessed September 2013.

⁹⁸ *Ibid.*, 20-21.

⁹⁹ Council Directive 98/59/EC of 20 July 1998 on the approximation of the laws of the Member States relating to collective redundancies, OJ L 255 provides standards to be used when an employer is contemplating collective dismissals which must be applied in a situation that involves dismissing 20 employees over a period of 90 days or the lesser of 10% or 30 employees over 30 days.

¹⁰⁰ Council Directive 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses, OJ L 82 - provides for specific protections for employees subject to business transfers requiring the transfer of their employment contracts with continuity of employment, but allows for specific derogations in insolvency situations.

¹⁰¹ Council Directive 80/987/EEC of 20 October 1980 on the approximation of the laws of the Member States relating to the protection of employees in the event of the insolvency of their employer, OJ L 283.

¹⁰² Ius Laboris, Collective Redundancy Guide (2009).

implemented differently among the Member States owing to the endogenous factors of culture, legal tradition and domestic social policy.¹⁰³ While social policy directives and their implementation among Member States provide a minimum level of protection for employees affected by their employer's insolvency, the position following the financial crisis has seen a retrenchment of social policy issues throughout the EU.

In the UK there are a number of protections in place for employees affected by the insolvency of their employer. While employees are still generally considered unsecured creditors of the employer with the usual rights of a normal contracting party,¹⁰⁴ their position is protected in relation to up to four months wages occurring prior to the insolvency, ranking as a preferential debt subject to a maximum amount of £800, an amount set in 1986¹⁰⁵ and, to date, unchanged. Employee claims beyond the preferred portion rank equally to that of other unsecured creditors. An employee also has the right to claim some amounts due from the Secretary of State, which is paid out of the National Insurance Fund.¹⁰⁶ In the event the business continues, an insolvency practitioner steps into the role of the employer and must deal with the adopted employment contracts appropriately. Where the business is sold, provisions apply that will transfer employment contracts to the purchaser.¹⁰⁷ This was a huge change for the UK system, which relied on a fundamental value of freedom of contract. The first UK legislation conferring continuity of

<http://www.iuslaboris.com/files/documents/Public%20Files/Publications/2009_Publications/collective-redundancies-guide.pdf> first accessed 2013.

¹⁰³ Ius Laboris, Guide on Transfer of Undertakings, available from http://www.iuslaboris.com/files/documents/Public%20Files/Publications/2008_Publications/transfers-of-undertaking.pdf first accessed 2012.

¹⁰⁴ D. Pollard, *Corporate Insolvency: Employment and Pension Rights*, 4th edn, (2009, Bloomsbury Professional Limited, Haywards Heath), p. 1.

¹⁰⁵ SI 1986 No. 1996 The Insolvency Proceedings (Monetary Limits) Order 1986 para 4.

¹⁰⁶ D. Baker and I. Smith, *Smith & Woods Employment Law*, 10th edn, (2010, OUP, Oxford), pp. 202-203.

¹⁰⁷ Pollard, above note 104, p. 1.

employment on a business transfer¹⁰⁸ only applied if the employees were voluntarily retained by the purchasing firm. There was no concept of automatic transfer as this would conflict with the fundamental freedom of contract.¹⁰⁹

In terms of dismissals associated with corporate rescue procedures, there are a number of protections in place. Unfair dismissal legislation¹¹⁰ generally will protect employees from dismissals that have not been justified if an employee has worked at an establishment for at least two years. Redundancy¹¹¹ is also regulated, which is the most likely method of dismissal to occur in the event of an employer's insolvency. Like unfair dismissal, an employee must also have two years of continuous employment. If eligible, then employees may also be due a statutory redundancy payment¹¹² calculated according to the length of time an employee has worked for the employer. In the event of collective redundancies, the Collective Redundancies Directive¹¹³ may apply, which requires consultation and information obligations provided to employees by the employer. Thus there are a number of provisions available to employees affected by the insolvency of their employer, unlike the limited protections available under the US system.

5 Constitutional Matters: Bankruptcy and Social Policy – a Question of Federalism?

The UK and US have developed insolvency and social policy regulation in a fairly opposing manner. Despite the fact that parallels are often drawn between the UK and the US due to their generally shared views of a neo-liberal economy, the underpinning philosophies that inform regulatory choices are diametrically opposing. This can be attributed to the staid and steady UK culture

¹⁰⁸ Contracts of Employment Act 1963.

¹⁰⁹ Baker and Smith, above note 106, p. 541.

¹¹⁰ S98 Employment Rights Act 1996 c 18 (hereafter referred to as the "ERA").

¹¹¹ S139 ERA.

¹¹² S162 ERA.

¹¹³ S188 Trade Union and Labour Relations (Consolidation) Act 1992 c 52.

and history juxtaposed against the fast growing, risk taking, and pioneering spirit that formed the backbone of the US. The American spirit of entrepreneurialism and independence continues today and is evident in its approach to both insolvency and social policy. The independence factor tends to both impede progress in the area of social policy due to the suspicion with which any paternalistic activism is viewed, while the same independence has imbued itself in the US insolvency system by making it possible for debtors to be freed from the shackles of debt without the same stigma that often accompanies debt discharge in the UK. Seeking to balance the earnest businessman's need to take risks to capture economic progress with the need to satisfy the obligations owed to creditors under contract law, the US created a system that allowed for bankruptcy discharge and an emphasis on rescue and restructuring. These aspects of the American culture are deeply imbedded in its history, colouring much of the policies still held today.

Applying in a shallow manner the theory of path dependence to the social policy of the US, it is clear that given the American emphasis on individuality and independence, and the restrictions that it has created in relation to offering more robust protections to individuals who find themselves in difficulty due to their employers' insolvency or other aspect of the lack of job security that is generally characteristic of the American employment market, it is clear that without some kind of "revolutionary" change, incremental changes are unlikely to achieve any significant shifts in relation to the protections available in such circumstances. While progressive ideas have recently found their way into common discourse, particularly in light of the current political debate, it remains uncertain whether the current system of governance is equipped to deal with such fundamental changes. The path dependent obstacles standing in the way of change in this area may require a federal approach that is potentially unachievable given the lack of firm constitutional basis to make unilateral change in the area of social policy. A similar structure can be observed in the way that social policy matters tend to be left to the prevue of the Member States of the EU, however, despite this fact, it appears that the EU has been able to influence

individual states in a far more significant manner than the US has for the States. However, it is questionable whether such intervention is something that is within the ideological capacity of the American system in any event.

While the power of the US Federal Government to legislate with regard to bankruptcy law forms a part of the very first Article of the Constitution, any federal intervention in labour or employment have had to find their justification in clauses and amendments that may or may not provide enough muster to pass Supreme Court analysis. This seems directly opposed to the way in which insolvency and social policy are regulated within the EU. The European Insolvency Regulation only goes so far as to regulate in matters of cross-border insolvencies, leaving member state procedures autonomous, while the social chapter has given the EU wide powers to legislate in matters of employment and labour regulation. While true that there the EU Commission has issued a recommendation introducing a new approach to business failure and insolvency that shifts the focus from liquidation to encouraging the early restructuring of viable businesses,¹¹⁴ this is merely exhortation and an invitation to reform, non-binding on the Member States. However, in areas of social policy, EU influence is far more heavily felt, despite the fact that legislation is only in the form of Directives, which are binding only to the achievement of the intended results. The constitutional framework of the EU also seems far more flexible than the US, having directly interfered with Member State sovereignty in the area of social policy through a number of directives requiring implementation.

What, then, is the final analysis that provides a rationale for the foregoing investigation? Despite the fact that the US and the UK are in theory aligned in economic and social policy to a significantly high degree compared to the rest of the EU, their underpinning values vary due to historical influences that have created very different contexts of legal development. It has been said that the US and the UK are two

¹¹⁴ See the Commission Recommendation of 12.03.2014 on a new approach to business failure and insolvency

countries divided by a common language, but it seems that in terms of the philosophical foundations of both insolvency and social policy, in spite of an apparent cohesiveness, the truth of the matter is that the underpinning values vary to such an extent that they may not be reconcilable. This helps to explain why a debtor in possession model has not been tried in any meaningful way in the UK as it is contrary to the fault-based ideology underpinning insolvency theory. It explains why the at-will doctrine continues to find favour in the US among individuals, companies, and governmental organisations alike due to the focus on independence and freedom to contract. While in reality such freedom does not exist due to the imbalance in bargaining power in the employment relationship, the belief in freedom and independence is such that applying paternalistic employment policies, such as those present in the UK and throughout the EU, which provide basic job security and employee protection, would be unacceptable to many Americans.

Even the more progressive nature of the Democratic party today tends to be tempered by some adherence to American values of independence and freedom, although the current climate is introducing extraordinary innovation that tempers those values with some social democratic ideas. The 2016 presidential election had the potential to break new ground that has the potential to dislodge some of the path dependent ideals that continue to inform both social policy and bankruptcy policy decisions, and the first year of the current presidency has seen significant attempts to “buck the trend” of progress. In a similar vein, the upcoming spectre of Brexit is raising serious questions about the direction that the UK will take in the future. The direction taken will inevitably influence the path of the law.