



Bankruptcy laws: what is fair?

Current world conditions have demonstrated the interdependency of credit markets and bankruptcy laws. Market economies need a system of fair, predictable and consistently enforced laws and procedures to deal with financial failure. There are, however, no “right” and “wrong” answers to the question “What is a fair statutory scheme of bankruptcy laws and procedures”? The following article highlights a number of bankruptcy policy considerations for ascertaining fairness with respect to the treatment of secured creditors.

To non-insolvency specialists, bankruptcy law is not easily understood. Bankruptcy itself seems contrary to the notions of fair play and substantial justice. Specifically, bankruptcy laws often obliterate contractual bargains that were time-consuming to negotiate and implement. Plain and simple, bankruptcy means that creditors will not receive the benefit of their bargains and, in most cases, will lose money. To most, “bankruptcy fairness” is an oxymoron. How then can the fundamental fairness of bankruptcy laws be determined?

The short answer can be found within basic economic policy. In the abstract, bankruptcy laws are an amalgam of economic-based provisions designed to maximise values and fairness-based provisions that allocate those values. Put simply, economic policy dictates that a debtor, unable to pay its debts, either allocate the assets to creditors in a fair and proportionate manner or, if the enterprise value exceeds the asset value, restructure and reorganise its liabilities to a serviceable level.

Certainly, if people obtained goods and services only in exchange for cash or with comparable equivalents, as in a traditional barter system, there would be no debt and, therefore, no need for a bankruptcy system. In a communist regime, with only state-owned businesses and no market economy, there would also be little need for a bankruptcy system. However, market economies, by emphasising borrowing and credit, create the economic need for a bankruptcy system.

Once bankruptcy is put into an economic perspective and the “moral” dilemma of creating new bargains with the entity or representative of the entity that breached the original bargains is overcome, certain precepts should be considered. That is not to say that economic models are the only means for considering bankruptcy precepts and policies. Economic analysis focused on the debtor/creditor relationship alone is

fraught with problems. Community interests must also be considered. Moreover, there are inherent difficulties associated with economic modelling for bankruptcy, as expressed by Professor Elizabeth Warren of Harvard Law School:

To model improved systems that operate only in perfect markets, or to ignore the high costs of collection outside the bankruptcy system when critiquing the high costs of collection in bankruptcy, is to design an airplane that carries no payload, flies only in a gravity-free environment, and consumes no fuel. The exercise may be great fun, but it yields little that is useful for those who need to build planes that fly. It is important to separate debates about bankruptcy fancy from debates about bankruptcy policy.¹

Development of universal, international precepts and policies for bankruptcy laws is the current subject of The World Bank Insolvency Initiative. The World Bank, along with other international financial institutions (including the EBRD), is committed to identifying principles and guidelines for sound insolvency systems and related debtor-creditor rights.² Moreover, the legal department of the International Monetary Fund (IMF) has recently published a book on many of the general objectives and features of insolvency procedures.³

Unlike the IMF and certain other international development banks, the EBRD is extensively involved in project financing to promote and foster the transition of 26 countries in central and eastern Europe and the Commonwealth of Independent States (CIS) to market-orientated economies. The EBRD’s focus often translates into providing secured financing to private sector borrowers in the transition countries. By focusing on the application of a provision of the Russian Bankruptcy Law that strips secured creditors of their security in a bankruptcy proceeding, this article explores a number of bankruptcy policy considerations for secured lenders.

¹ Elizabeth Warren, “Bankruptcy Policymaking in an Imperfect World”, 92 *Michigan Law Review*, pp.336 and 386 (1993).

² Gordon W. Johnson, “Building Effective Insolvency Systems: Toward Principles and Guidelines”, A World Bank Background Paper (Working Draft 1999) (hereinafter referred to as “Principles and Guidelines”).

³ Legal Department, International Monetary Fund, “Orderly and Effective Insolvency Procedures: Key Issues” (1999) (hereinafter referred to as “Insolvency Procedures”).

An economic view of secured lending

Before venturing down the twisted road of bankruptcy policies for secured creditors, it is important to examine at least one important economic view of secured credit in market economies. In a market economy, a business often needs capital to expand production, develop products, provide requested services and otherwise meet the needs and expectations of its customers and constituency. Loans can rationally supply this capital to finance development, expansion or production if the expected revenues cover the cost of all inputs plus debt service. In theory, secured financing can lower the cost of debt service, thereby facilitating the financing of projects that otherwise could never get off the ground or expand. Secured lending may accomplish this by increasing the likelihood that a creditor will be able to recover its principal, through a transfer of property rights from the debtor to the creditor. This transfer of property rights gives the creditor access to assets which it may then use to discharge some or all of the debtor’s liability. This reduces risk, and hence the interest compensation the creditor requires for lending. Often, this reduction in risk is large enough to make available credit that would otherwise be non-existent.

Put differently, the freedom of the secured party to liquidate collateral upon default may liberalise interest rates or repayment terms. Efficient and effective remedies to recover collateral should reduce the risk

to the secured lender and invariably the cost of lending, thus reducing the interest rate charged. A junior lienholder or trade creditor knows or should know the priority of its position and the relative value of the collateral, and it should adjust the interest rate charged to reflect the appropriate risk factors.

The secured creditor certainly benefits from security and ease in recovering collateral after default. Obtaining a security interest is therefore one of the most basic and reliable ways for lenders to protect their own financial position. With the strongest possible legal rights, secured creditors are best able to recover their money when debtors become financially distressed. As a corollary, the debtor should benefit from secured credit in the form of wider credit availability as well as cheaper and better credit terms. In a microeconomic sense, therefore, the increased availability of debt financing and cheaper credit for longer terms should inevitably benefit the economy as a whole.

Treatment of secured creditors in bankruptcy

If the economic view of the efficacy of secured lending is accepted (any economic view is subject to debate),⁴ then the issue of the treatment of secured creditors in bankruptcy arises. In a bankruptcy system that obliterates the bargain of the secured creditor, the economic efficiencies of secured lending and the concomitant reduced cost of lending never materialise. On the other hand, strong policy arguments can be advanced that a secured creditor should share in some equitable fashion the losses with other creditors and, in a reorganisation scenario, the costs of restructuring. Unfortunately, there is no universal, international bankruptcy policy that can respond adequately to the competing issues of enforcement and equitable sharing. The following issues often arise with respect to secured credit in a bankruptcy proceeding:

- protection of collateral;
- compensation for depreciation;

- payment or accrual of interest;
- compensation for use of collateral;
- lifting of the stay for execution;
- the extent of any surcharge on the collateral; and
- priming of the security interest by other creditors.

Not all of these issues are addressed by bankruptcy legislation in each jurisdiction. Moreover, some jurisdictions limit or reduce the actual property rights granted to secured lenders under non-bankruptcy law.

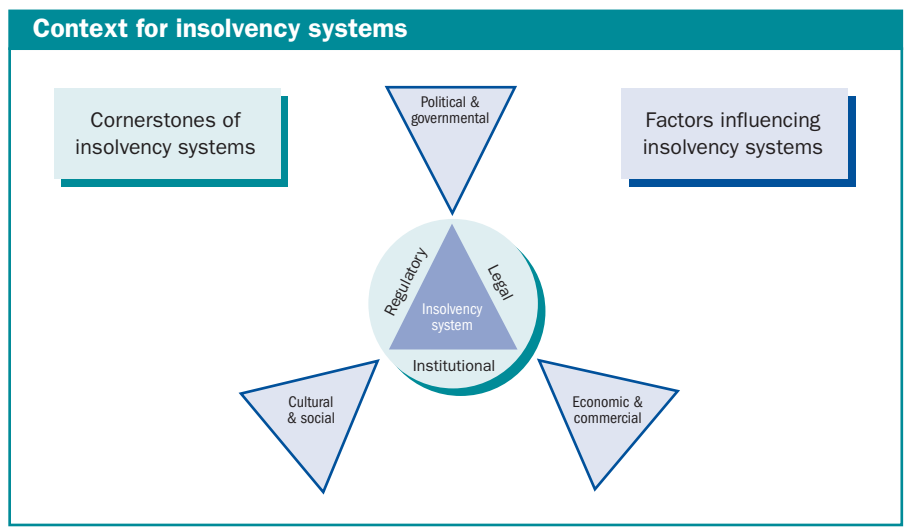
Bankruptcy laws must balance the goal of maximising the value of the debtor’s assets with the need to protect the interests of secured creditors. Put simply, one of the most difficult tasks in formulating bankruptcy laws is striking the balance between the important public policy of value maximisation and the public policy of maintaining the integrity of the debtor’s previous transactions with its creditors. Western laws traditionally protect the secured creditor’s interest in specific collateral through requirements of adequate protection, stay relief to enforce security interests on pledged assets, compensation for depreciation, interest accrual for the oversecured creditors and various other protections. Indeed, the IMF states that “[a]s a general principle, an insolvency law should...[protect] the value of [the secured lender’s] security – and, as a consequence,

the availability of credit is not eroded.”⁵ The World Bank also recognises the issue:

*An area of particular difficulty and contention is the extent to which the secured creditor should be allowed to assert its priority and enforce its security against the interests of the general body of creditors. The contest is between the individual interest of a particular creditor who has bargained for security and given value in reliance on it ... and the interest of unsecured creditors in the avoidance of precipitate action, such as the withdrawal of assets essential to the running of the business, which would damage or prevent the reorganization of the enterprise to the benefit of all creditors.*⁶

To address the issue, The World Bank notes the following approaches:

*One approach is to recognise the secured creditor’s rights but to restrict its remedies for a given period... Another approach might be to provide for arrangements under which secured creditors could be compelled to accept a change of status or a diminution of priority in the interests of the general body of creditors. The issue is part of a wider debate on the extent to which bankruptcy law should have a redistributive role which goes beyond the avoidance of suspect transactions and the conferment of super-priority for certain types of debt.*⁷



Source: The World Bank, 1999

As identified by The World Bank, bankruptcy laws are infinitely diverse. Bankruptcy tests the strengths and limits of property rights established by non-bankruptcy law. Although flexibility, transparency, and consistency are key components of effective bankruptcy laws, examination of at least a few of the underlying bankruptcy policies provides some insight into the fundamental fairness of a specific law. It is, therefore, a useful exercise to examine the specific and unusual treatment of secured creditors adopted by Russia where the security of a creditor is stripped by the bankruptcy. The Russian provision highlights and tests some of the esoteric bankruptcy policies.

Treatment of the secured creditor under Russian Federation insolvency laws (the stripping of security)

Once a borrower is declared bankrupt in the Russian Federation, secured creditors lose pledge rights *in rem* against specific assets of the debtor. In return, secured creditors receive a preferential right to recover ahead of general unsecured creditors but behind personal injury tort claims (capped at 10 years of periodic payments or until the claimant reaches 70 years of age) and wage claimants.⁸ Additionally, in the case of bankrupt banks, individual depositors are given priority over secured lenders. Moreover, all secured creditors participate in the distribution of bankruptcy proceeds on a *pro rata* basis, without regard as to whether the secured creditor had held primary or subsequent security interests in the specific property of the debtor. The amount of the third priority party's secured claim entitlement is generally thought to be limited to the value of the property originally subject to the creditors' pledge.⁹ Any excess claim amount would be treated as a fifth priority general unsecured claim (claims of the government are fourth priority). Finally, a secured creditor can vote the aggregate amount of its claim for various purposes (e.g., choice of the administrator in a bankruptcy proceeding and acceptance

of settlement proposals) and, if the aggregate claim is large enough, participate on the creditors' committee.¹⁰

The major obstacle for secured creditors is the stay on execution or enforcement, effective immediately on the acceptance of the bankruptcy petition.¹¹ Since security interests are stripped under the distribution scheme, there is no explicit provision for the lifting of the stay and no need to have such a provision. The provision relating to under-secured or partially secured claims is somewhat ambiguous. Because the secured creditor's security is stripped upon the bankruptcy filing, there are no explicit provisions relating to after-acquired property. Finally, the Russian bankruptcy laws provide for the accrual of post-petition interest in a manner provided by Article 395 of the Civil Code of the Russian Federation. The contractual rates of interest (both default and non-default rates) do not accrue.¹²

The Russian bankruptcy system adopts the second approach identified by The World Bank (quite different from the approach utilised by Western bankruptcy laws) by protecting the value of the secured claim through the provision giving secured claims priority over general unsecured claims. The disregard for the property interest in the collateral itself does not necessarily mean that the Russian law is unfair to secured lenders. That is, if applied consistently within the language of the law, the Russian system may result in the same or greater recovery for a secured creditor than results from many Western systems.

The loss of the property interest (pledged collateral) results in a reduced recovery for a secured creditor only if the payment of the priority administrative, wage, and tort claims reduces the amount distributable to secured creditors to less than the fair market value of the collateral. For example, assume that a secured creditor, owed US\$ 1,500, has a security interest encumbering all of the debtor's real property valued at US\$ 1,000. Assume further that the value of all of the

⁴ See Steven L. Schwarcz, "The Easy Case for the Priority of Secured Claims in Bankruptcy", 47 *Duke Law Journal* p.425 (1997), which offers an economic justification for secured debt; David Gray Carlson, "On the Efficiency of Secured Lending", 80 *Virginia Law Review* p.2179 (1994), which compellingly supports the theory that secured lending is efficient.

⁵ Insolvency Procedures, at p.33. To implement the principle, the IMF suggests that "[d]uring the period of the stay, a mechanism should exist that ensures that the interests of the secured creditor are adequately protected [which may include] giving the secured creditor a first-priority claim based on [the value of the collateral], plus a priority claim for regular payments of contractual default rate interest." *Id.* at p.34.

⁶ Principles and Guidelines at p.57-58.

⁷ Principles and Guidelines at p.58.

⁸ Article 106 (2) of the Russian Federation Federal Law on Insolvency (Bankruptcy) (hereinafter referred to as the "Russian Bankruptcy Laws") provides: Creditors' claims shall be satisfied according to the following order of priority: first, the claims of citizens to whom the debtor is liable for harm to life or health shall be satisfied by way of the capitalisation of the corresponding periodic payments; second, settlements shall be made for the payment of severance pay and wages with persons working under a labour agreement, including under contract, and for the payment of royalties under copyright agreements; third, creditors' claims for obligations secured by a pledge of property of the debtor shall be satisfied; fourth, claims for mandatory payments to the budget and for extra-budgetary funds shall be satisfied; fifth, settlements shall be made with other creditors.

⁹ Article 109, Creditors' Claims under Obligations Secured by a Pledge of the Debtor's Property: 1. The amount of a creditor's claim under an obligation secured by a pledge of the debtor's property shall be determined considering the portion of the debtor's indebtedness that is secured by the pledge. 2. The portion of the debtor's indebtedness not secured under a pledge of the debtor's property is considered as part of creditors' claims of the fifth priority. 3. Creditors' claims under obligations secured by a pledge of the debtor's property shall be subject to satisfaction out of all property of the debtor, including property that is not the subject of the said pledge.

¹⁰ Article 12 of the Russian Bankruptcy Laws.

¹¹ Article 11 (4) of the Russian Bankruptcy Laws provides that "[a]fter an Arbitration Court has accepted an application for the recognition of a debtor as bankrupt, creditors do not have the right to apply to the debtor for the purpose of satisfying their claims individually." Each successive stage of a bankruptcy has similar stay provisions. See Articles 57, 69, and 98 of the Russian Bankruptcy Laws.

¹² Article 70 of the Russian Bankruptcy Laws.

debtor's property (inclusive of the encumbered real property) is US\$ 1,200. Finally, assume that the priority administrative, wage, and tort claims are US\$ 100. The Russian system would strip the creditor's security and distribute the proceeds from the sale of all of the debtor's property in the following order: (i) priority administrative, wage, and tort claims would receive the first US\$ 100; (ii) the secured creditor would receive the next US\$ 1,000 (i.e., the value of the secured claim); and, assuming no government claims, (iii) the last US\$ 100 would be distributed to unsecured creditors on a *pro rata* basis (including the secured creditor's deficiency claim). Under the adequate protection scenarios provided by most Western bankruptcy laws, the secured creditor would receive US\$ 1,000 upon the sale of the encumbered real property and a deficiency claim of US\$ 500 that would be shared on a *pro rata* basis with the general unsecured creditors. Based on the assumed facts, the secured creditor may receive approximately the same treatment, albeit in a different manner, under both systems of bankruptcy laws. The result changes dramatically if: (i) the secured creditor has an "enterprise mortgage" encumbering all of the debtor's property; (ii) the priority claims are greater than US\$ 500; or (iii) junior secured creditors are added to the mix.

Do the differences make the treatment of secured claims under Russian laws unfair? Hardly! The answer is completely dependent on the application of a controlling bankruptcy policy. There is, however, no one correct policy and hence no deemed inherent unfairness to secured lenders.

Normative bankruptcy theories

To the extent possible, bankruptcy laws should be viewed in conjunction with normative bankruptcy principles. Unfortunately, there are no undisputed normative bankruptcy principles. There are, however, some theories worth noting.

Traditional public policies behind bankruptcy law

Bankruptcy law can be evaluated from the vantage point of three general public policies. Simply stated, they are: (i) allowing the unfortunate but honest debtor a fresh start free of the obligations and responsibilities consequent upon business misfortunes (the "Fresh Start Policy"); (ii) fostering the equitable distribution of a troubled debtor's assets through the equal sharing of losses by creditors of equal rank (the "Equity Policy");

and (iii) the restructuring and rehabilitation of a business to preserve jobs, pay creditors, produce a return for owners, and obtain the fruits of the enterprise (the "Rescue Policy"). With respect to the transition economies, (i.e., those countries that are shifting from communism to market economies), the Rescue Policy encompasses a transfer of assets to individuals or businesses that can more efficiently and effectively utilise those assets.

The application of these policies yields fair, practical, and predictable results. Take, for example, the debtor who lost a high-paying job and was not able to cut back on expenses before drowning in debt. The effect of the Fresh Start Policy of bankruptcy law is to insulate all (not just part) of the debtor's future income from creditors, provided that the debtor is honest in handling its affairs and turns over all non-exempt property for distribution to the debtor's creditors. Bankruptcy law allows creditors to scrutinise the debtor's affairs and, assuming no misbehavior, it provides the debtor with a fresh start – free from past debts.

The Equity Policy and the Rescue Policy are also easily understood. For example, a debtor having US\$ 10,000 in assets and ten creditors each owed US\$ 2,000 are subject to either or both the Equity Policy and/or the Rescue Policy. Specifically, it would be unjust for the debtor to satisfy five of the ten creditors and leave five to bear the full brunt of insolvency while the others are preferred. The Equity Policy provides that the debtor breach all ten of its obligations and have all ten creditors share the pain. Put differently, even though we are all taught to keep our promises, bankruptcy is a scenario in which honorable conduct consists not only of breaching obligations, but breaching all similar obligations so that the burdens are shared equitably. In this context, the Equity Policy provides that many wrongs do make a right.¹³



The Rescue Policy is also straightforward. Assume that the debtor's US\$ 10,000 of assets provides a net income generation of approximately US\$ 2,500 per year. Assume further that the US\$ 2,500 annual income is available only if the assets are left in the debtor's hands. Application of the Rescue Policy would allow creditors to be paid all or a portion of the US\$ 2,500 in annual income while keeping the assets intact. If assets generate an enterprise value in excess of liquidation value, the Rescue Policy is served by allowing the business to continue as a going concern. Here, the assets will generate sufficient income to allow creditors to receive a substantial distribution over time in excess of what such creditors would receive in liquidation. Thus, the Rescue Policy is served by permitting the debtor to operate as a going concern. Put differently, the Rescue Policy is founded on the assumption that creditors and society would be better off by allowing the continuation of a "going concern", as opposed to a piecemeal liquidation. Deploying assets to maximise their value is the foundation of the Rescue Policy.

The Russian bankruptcy scheme of stripping a secured creditor's security interest does not violate any of the traditional bankruptcy policies. For example, the Equity Policy is not disturbed because all similarly situated creditors are receiving the same treatment. This is provided, however, that junior and undersecured creditors are treated as unsecured creditors to the extent that the value of the collateral is less than the amount of the debt and senior secured creditors are paid before junior creditors holding security interests on the same collateral.¹⁴ Moreover, the Rescue Policy may actually be enhanced by the Russian bankruptcy treatment of secured creditors. Releasing obligations on specific assets may allow the use of those unencumbered assets to rescue the business and maximise the value for all creditors. Hence, it may foster reorganisation and rehabilitation.

Structured bargaining

Bargaining concerns what people do with rights. In markets, people exchange property rights. They bargain over the price and the bundle of rights to be transferred from one to another. For example, in a lending transaction, a borrower will bargain for immediately available cash at as low a cost as possible and the lender will negotiate for security (property of the borrower that may be liquidated to satisfy the indebtedness). This bargaining presupposes a set of legal rules, and the bargaining occurs within the legal framework. Even bargaining that does not directly use the law nevertheless occurs within its shadow.

Lenders need certainty in both the laws and the implementation of the laws. Defining the risks and making them predictable permits lenders to price loans and make financing available. Uncertainty, on the other hand, not only raises the cost of capital but also limits the availability of capital. For secured lenders, certainty of the law and its implementation through the established systems may not be sufficient to lower interest rates and transaction costs. Reduced interest rates and secured lending transaction costs require efficient laws and legal systems in addition to predictability and certainty.¹⁵

Bankruptcy law can be viewed as creating a baseline. It enables the affected parties in distressed situations to negotiate out-of-court restructurings because each party can assess whether the consensual treatment of its position is better than bankruptcy. Indeed, in an environment with clear bankruptcy rules and procedures that are uniformly and transparently enforced, the bulk of debtor/creditor financial issues should be resolved through bargaining and consensus, not through litigation in the courts.

The bankruptcy laws and their enforcement must also be predictable. Individual countries can and do make different choices

¹³ See Martin J. Bienenstock, "Bankruptcy Reorganization", p.3 (PLI 1987).

¹⁴ This view is contrary to the explicit language of Article 114, point 3 (creditors in each priority ranking share *pro rata* the amount of their claims if liquidation proceeds are insufficient to pay them off in full). Notably, however, Article 114 conflicts with the priority ranking rule set forth in Article 342, point 1 of the Civil Code (laying down "first in time, first in right" priority rule).

¹⁵ See generally, Model Law on Secured Transactions (EBRD, 1994), which defines a set of 10 core principles for secured transactions.

¹⁶ In his article in the focus section of this issue, "The Role of the Judicial System: How to Achieve Consistency in Bankruptcy Cases," United States Bankruptcy Judge Steven A. Felsenthal addresses the institutional framework necessary to achieve effective, efficient, fair, and consistent results from the application of the law.

as to how insolvency laws will allocate risk among creditors and equity holders. The choices could be based on a hypothetical creditors' bargain (described below), the interests of the community (also described below), the successful implementation of a system in another country, or on some other basis. Regardless of the choice, the rules should be clearly stated and consistently applied in a system that is transparent and open.¹⁶

Once the rules are known and consistently applied, creditors can make business decisions on the extension of credit in any particular country. Risks can be evaluated when the environment is stable and ascertainable. In this context, the treatment of secured claims under Russian bankruptcy law may be fair as long as the rules (and their application) can be determined in advance of the loan. One objective problem with the Russian system is that the risk of administrative and priority claims may not be ascertained with any certainty. As third priority creditors, secured creditors would have the discomfort of not knowing the amount of claims that may precede them in priority.

The creditors' bargain

In 1979, Professors Thomas Jackson and Anthony Kronman created a new law-and-economic analysis of US Bankruptcy laws.¹⁷ Soon thereafter, the “creditors’ bargain” model was developed by Professor Jackson. The model, in simplest terms, was utilised to analyse almost any bankruptcy issue by asking one theoretical question: What would creditors have agreed to if they had been asked in advance of insolvency? Professor Jackson argued that normative bankruptcy principles should be viewed as resolving a limited common-pool problem caused by the execution and enforcement of individual creditor remedies when the debtor has insufficient assets to satisfy all claims. A collection of assets can be more valuable when held together than it would be if the assets were immediately divided and distributed. A compulsory, collective proceeding, like bankruptcy, provides a mechanism to maximise the value of the assets of the common pool. The creditors’ bargain, in sum, asks what the creditors would agree to in advance to maximise returns from a limited pool of assets if they knew that individual creditors’ rights could not be enforced and that they would be forced into a collective proceeding like bankruptcy.

Notwithstanding the collective norm embodied in the creditors’ bargain, Professors Thomas Jackson and Douglas Baird argue that bankruptcy law should not alter the pre-bankruptcy entitlements among creditors.¹⁸ Most likely, the treatment of secured lenders under the Russian bankruptcy laws (i.e., the loss of the security interest on specifically pledged collateral) would shock Jackson and Baird (and most Western lawyers and bankers for that matter). Baird and Jackson would contend that the retention and foreclosure of collateral does not impair the value-maximisation goal in any meaningful manner. Moreover, they would argue that a bankruptcy rule that avoids a non-bankruptcy law entitlement, otherwise valid against unsecured creditors, provides a perverse

incentive to general creditors to file a bankruptcy petition.

On the other hand, it could be argued that the Russian bankruptcy system adequately addresses the creditors’ bargain and common pool issues. Specifically, the stripping of security interests permits the efficient liquidation of assets and may thereby maximise the common pool for all creditors. Moreover, the security interest stripping may enhance the prospect of a successful reorganisation of the debtor. Replacing the secured creditors’ security interests with a priority over general unsecured claims (at least with respect to the value of the collateral) represents the type of bargain creditors may have reached in advance of an insolvency.

There is, perhaps, another way to view the role of bankruptcy law in the non-bankruptcy relationship of creditors. Specifically, there are two major characteristics governing the non-bankruptcy relationship between secured and unsecured creditors that deserves enforcement in bankruptcy. First, secured creditors are entitled to the value of the pledged assets to the full extent of the security interest. This entitlement, of course, does not allow the secured creditor to receive more than the value of the security. Secondly, unsecured creditors are entitled to the value of the pledged assets in excess of what is necessary to compensate the secured party. Enforcing this “bargain” under non-bankruptcy law is next to impossible. Absent a collective proceeding like bankruptcy, unsecured creditors are generally not entitled to notice of forced sales. Even if so notified, they would be in the awkward position of either bidding at the execution sale or losing the equity. It is therefore appropriate for bankruptcy policy to enforce the foregoing bargain on creditors in a collective proceeding.

The human and cultural predicament

Most people assume that bankruptcy is all about money. It is not. How a society treats

individual and corporate debtors depends, in part, on what a particular culture believes underlies the financial failure. Cultural beliefs about human nature and property rights influence how any particular society wants to treat creditors and bankrupt debtors. The culture helps explain why in certain societies some creditors and/or debtors are considered more deserving than others. These beliefs justify the redistributive effects that consideration of cultural values imposes on other interests.

Bankruptcy laws are generally viewed from either a creditor’s perspective or a debtor’s perspective. These dual perspectives, however, fail to provide a complete picture. The interests of the community must also be considered. Bankruptcy touches on many community interests, and those interests should be considered in evaluating the underlying fairness of any bankruptcy law. For example, the closure and liquidation of a factory would cause people in the community to lose jobs, surrounding businesses to lose customers, the tax base of the community to diminish, and so on. If bankruptcy causes a business to relocate, there would be a similar negative ripple effect in the community losing the business and, perhaps, a positive ripple effect in the community gaining the business. What motivates and justifies the interests of the debtor and its creditors may be far different from the interests of the community.¹⁹

In the United States, chapter 11 (the reorganisation chapter of the United States’ Bankruptcy Code) has been the subject of immense criticism,²⁰ which may result from the failure of chapter 11 to take into account the interests of the community. For example, A.H. Robbins used chapter 11 in an attempt to eliminate its Dalkon Shield liability; Manville did the same for present and future asbestos claims; Continental Airlines, Wilson Foods, and Buildisco used chapter 11 to extricate themselves from agreements with the unions; and LTV tried chapter 11 to escape pension liabilities. During the time these cases were pending, chapter 11


was used as a basis for restructuring the debts of companies whose balance sheets were re-created during the leveraged buy-out craze of the 1980s. Public bondholders often received little or nothing while Wall Street investment banks received windfalls. Clearly the social issues involved in the cases impacted communities, not just debtors and creditors. The failure of chapter 11 to address the community issues justifies criticism.

In addition to collateral, secured lenders have a further advantage over most other creditors. Secured lenders repeatedly play the game of financial risk, consistently assuming the creditor position. Other creditors (workers and tort claimants) are generally not in the game of financial risk. In Russia, the scheme of distribution set forth in the Law on Bankruptcy suggests that the policy of the law is to limit freedom of contract by preferring the interests of certain classes of creditors – tort claimants and wage creditors – regardless of what a security agreement may provide. This policy has deep roots in both Russian and Soviet civil law and Russian society based on the paternalistic policies established by the Tsars and followed by the protective communist state. The fact that it does not accord with Western notions of security or of the nature of bankruptcy does not mean that it is “wrong,” “unfair,” or even inappropriate in a market economy.

Bankruptcy addresses failures. A given society’s mechanism for addressing these failures becomes the prism for viewing a society’s most weighty problems. Notions of community, therefore, must be included when considering the fairness of bankruptcy laws.

Conclusion

Bankruptcy is a defining characteristic of a market economy. It establishes the limits and priority of credit extension and entrepreneurial venture capital and allocates risk. Empirical evidence has shown that social progress takes a toll in the form of bankruptcies and insolvencies.²¹ Dealing with bankruptcy and insolvency through a web of economics-based laws is certainly a Herculean task in and of itself. The addition of cultural and human factors makes it that much more difficult to formulate “fair” bankruptcy laws. Nonetheless, fair bankruptcy laws are a necessity for a smoothly performing market economy. Of course, beauty is in the eye of the bondholder (or secured debt holder). Accordingly, the final determination of fairness may ultimately depend on the perception of third-party lenders and investors regardless of the policies served and/or community needs met.

For its part, the EBRD will continue to support and participate in multilateral efforts to establish global principles and guidelines for building effective insolvency systems. While policy issues are clearly the province of national governments, governments of transition countries must recognise the issues and make a deliberate choice of which policies to promote. In addition, through its role as a prominent investor, the EBRD will continue to reinforce the need to have systems in the EBRD’s countries of operations that apply “fair” laws in a consistent, predictable, and uncorrupted manner. Finally, through systematic monitoring of progress in bankruptcy/insolvency law in its countries of operations, the EBRD will evaluate and publicise the legal reform efforts of transition countries as they grapple with choosing and implementing “fair” bankruptcy systems. 

¹⁷ Thomas H. Jackson and Anthony T. Kronman, “Secured Financing and Priorities Among Creditors”, 88 *Yale Law Journal*, p.1143 (1979).

¹⁸ Douglas G. Baird and Thomas H. Jackson, “Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy”, 51 *University of Chicago Law Review*, pp.97 and 103 (1984).

¹⁹ Karen Gross, “Failure and Forgiveness: Rebalancing the Bankruptcy System”, p.193 *et. seq.* (1997).

²⁰ See e.g., Barry E. Adler, “Financial and Political Theories of American Corporate Bankruptcy”, 45 *Stanford Law Review* p.311 (1993); Lucian A. Bebchuk, “A New Approach to Corporate Reorganizations”, 101 *Harvard Law Review* p.775 (1988); Douglas G. Baird, “The Uneasy Case for Corporate Reorganizations”, 15 *Journal of Legal Studies*, p.127 (1986).

²¹ One empirical study suggests that 50 per cent of all new business formations in America fail. Sullivan, T.A., Warren, E., and Westbrook, J.L., “As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America”, p.124 (Oxford University Press 1989).

* **Craig H. Averch**
Counsel
Office of the General Counsel
European Bank for Reconstruction
and Development
One Exchange Square
London EC2A 2JN
United Kingdom
Tel: +44 20 7338 6779
Fax: +44 20 7338 6150
E-mail: averchc@ebrd.com