

Sultan Qaboos University
Journal of Arts & Social Sciences



جامعة السلطان قابوس
مجلة الآداب والعلوم الاجتماعية

An Assessment of Various Theoretical Approaches to Bankruptcy Law

Saleh Al-Barashdi

Assistant Professor
College of Law
Sultan Qaboos University
sinaw814@squ.edu.om

Horace Yeung

Lecturer
University of Leicester, UK
horace.yeung@le.ac.uk

Date received: 15/11/2016

Date of acceptance: 19/12/2017

An Assessment of Various Theoretical Approaches to Bankruptcy Law

Saleh Al-Barashdi and Horace Yeung

Abstract:

A broad diversity of interests could be affected by the bankruptcy of companies. If a company is bankrupt, a question on whether the main goal of bankruptcy rules should be to protect the interests of creditors or it should create a balance between the interests of creditors as well as non-creditors, e.g., employees, suppliers, and third parties. A number of theories on the policy underpinning bankruptcy law exist.. These theories can be, in general, categorized into two main groups: i) the first theory is of the view that the main objective of bankruptcy law should be merely to maximize the collective returns to creditors, ii) the second theory is to create a balance between the rules protecting creditors versus others, as bankruptcy creates a community of parties who are affected by the debtor's financial distress beside creditors such as employees, customers, supplier, and local authority. The purpose of this article is to analyze, compare, and evaluate the theories underpinning bankruptcy law.

Keywords: bankruptcy/insolvency law, creditors' bargain theory, communitarian theory, multiple values theory, explicit value theory.

تحليل الاتجاهات الفقهية لقانون الإفلاس

صالح البراشدي وهورس يونج

الملخص:

تتأثر عدد كبير من المصالح نتيجة لإفلاس الشركات، والتي بدورها تثير مجموعة من الأسئلة منها: هل ينبغي أن تكون غاية قانون الإفلاس تعظيم العائد المادي للدائنين وحماية حقوقهم؟ أم أن الهدف ينبغي أن يكون لحماية مصالح الدائنين إلى جانب حماية مصالح غير الدائنين، كالعاملين بالشركة، الموردين، والمجتمع بشكل عام؟ هل ينبغي أن يصاغ قانون الإفلاس بشكل يخلق توازن بين حقوق المدينين والدائنين وغير الدائنين؟ للإجابة على هكذا أسئلة، ظهرت عدة نظريات تحمل في طياتها وجهات نظر مختلفة. يمكن تقسيم هذه النظريات لمجموعتين رئيسيتين: المجموعة الأولى والتي ترى بأن الغرض الرئيس لقانون الإفلاس يجب أن يوجه لتعظيم العائد المالي للدائنين. بينما ترى المجموعة الثانية بأنه يترتب على إفلاس الشركة نشوء عدة مراكز قانونية تتأثر من جراء الإفلاس، وهكذا مراكز تشمل إلى جانب الدائنين، العاملين، الزبائن، الموردين، والمجتمع المحلي. الغرض من هذه الورقة تسليط الضوء على أهم النظريات التي ظهرت وإبداء وجهة النظر حولها.

الكلمات المفتاحية: قانون الإفلاس، نظرية الدائنين، النظرية المجتمعية، نظرية القيم المختلفة.

1. Introduction

A broad range of interests would be affected by the insolvency¹ of a company, such as the interests of the secured creditors, unsecured creditors and employees. Investors may lose their money, creditors may not be given their money in full, suppliers might be brought into bankruptcy, government may not be able to levy due tax revenue, and employees may lose their jobs. As a consequence, if a company becomes insolvent, a number of questions arise on whether the main goal of insolvency rules should be protecting creditors only or creating a balance between the interests of creditors as well as non-creditors such as employees and other third parties affected by the insolvency of the company.

In an attempt to address the above issue on the protection of interests affected by insolvency, a number of theories have emerged. These theories include: i) the creditors' bargain theory (e.g. Jackson, 1986; Jackson and Scott, 1989; Baird and Jackson, 1988), ii) the communitarian theory (e.g. Gross, 1994; Gross, 1999; Keay, 2000), iii) the multiple values approach (e.g. Warren, 1987; Korobkin, 1991), and iv) the explicit value approach (e.g. Finch, 2009). As Walton (2011) rightly stated, there are almost as many theories as there are writers in this particular area. However, it has been said that the very center of the whole debate on insolvency theories involves deciding who and what is to be protected and recognized by insolvency law (Keay and Walton, 2003: 25).

The aim of this article is to explore some of the theories underpinning insolvency law. The creditors' bargain theory, which is considered to be the most debatable theory, will be discussed. Mokal (2005: 33) stated "that there is no doubt that insolvency law scholarship has long been dominated by the creditors' bargain theory. For almost two decades, insolvency scholars have either argued within its assumptions, or have proceeded by making it their first (and often primary) target". Then, the communitarian theory and multiple values theory will be dealt with. Further, the alternative approach to those existing theories promoted by Finch (2009) in terms of the explicit value theory will be discussed. Finally, this article will conclude by giving further remarks on those normative theories.

2. Creditors' Bargain Theory

Creditors' bargain theory or creditor wealth maximization theory is the most widely debated insolvency law theory (Mokal, 2005, p.33; Keay and Walton, 2003:25). This theory was proposed by Thomas Jack-

son (1986) through his lectures and writing in the 1980s. Subsequently, Douglas Baird and Robert Scott joined him as the main supporters of the creditors' bargain theory (Baird and Jackson, 1988; Jackson and Scott, 1989). The premises of this theory are derived from the general principles advocated by the contractarian theory² and, more particularly, influenced prominently by the law and economics movement which was born in the United States in the mid- 1970s and which had a substantial impact on scholarship, not only in the United States, but also in the UK and around the world (Keay and Walton, 2003: 25). This section starts with the main principals of the Creditors' bargain theory and then explains the pros and cons of the theory.

2.1 Principles of the Theory

Jackson (1986), followed by his supporters, argued that the main role and objective of insolvency law should be to maximise the collective returns to the creditors' of the insolvent debtor. Insolvency law is concerned with neither the interests of the debtor nor the interests of the community. Insolvency law, based on Jackson's view, is a collective debt-collection device and it only deals with the rights of creditors of the insolvent company. This theory does not recognise reorganisation of the distressed enterprise as a legitimate objective of insolvency law unless, to the extent, that it is intended to maximise returns to the existing creditors. Thus, according to Jackson (1986), insolvency law should help a firm stay in operation when it is worth more to its creditors alive than dead. Even though it should help a firm to continue its business if it is worth more to the debtor's creditors as a going concern than selling it piecemeal. "Rehabilitation per se should not be an independent policy because it does little to reconcile the diverse interests of creditors."

The creditors' bargain theory contradicts with the idea that insolvency law should take into account the interests of the substantial numbers of public rights (Keay, 2000; Veach, 1997). It is stated that it is not within the policy of insolvency law to take into consideration the interests of others who have no claims against the assets of the insolvent company. Baird (1987: 822) stated that:

"Legal rights should turn as little as possible on the forum in which one person or another seeks to vindicate them...whenever we must have a legal rule to distribute losses in [insolvency], we must also have a legal rule that distributes the same loss outside of [in-

solvency].

Baird questioned why an insolvent company should have a special obligation to protect its employees. If social policy rationally favors workers, legislation could favour workers in all businesses not just those that are unable to meet their debt obligation or find themselves insolvent for some other reasons. If some interests are in need of such protection, it is better to tackle this problem and provide protection within the whole legal system in order to provide a uniform and certain protection (Baird and Jackson, 1984: 102-103). Thus, according to the Creditors' bargain theory theory, protecting the rights of employees, local suppliers, environmental costs, and community rights, under insolvency law is inappropriate (Goode, 2011: 72-73). Jackson (1991: 860) viewed insolvency as a system designed to mirror the agreement one would expect the creditors to reach among themselves (*ex ante*) were they to have the opportunity to negotiate such agreement before entering into a transaction with the debtor. Jackson claims this theory is an application of the famous Rawlsian³ notion of bargaining from behind a "veil of ignorance". This theory reflects the hypothetical agreement that creditors would reach if they had the chance before (*ex ante*) extending credit to the insolvent debtor. Although the bargain is hypothetical, the creditors have the attributes that creditors in real world transactions possess, as it is claimed, that "The hypothetical bargain analysis provides indirect evidence of what real world parties would, in fact, agree to" (Jackson and Scott, 1989: 160).

According to Jackson, insolvency law is a response to a 'common pool' problem arising when diverse co-owners affirm rights against a common pool of assets. Similarly, Baird clarified the same by maintaining that self-interest of creditors leads to a collective action problem, and a legal instrument in place is required to ensure that the self-interest of individuals does not conflict with the interests of the group. In order to tackle such a problem, this theory suggests that there should be a compulsory collective system where the law "must usurp individual creditor remedies in order to make the claimants act in an altruistic and cooperative way" and all debtors' creditors should be bound to it (Jackson, 1986: 17).

Other scholars such add that there are two principles that must be satisfied if the aim of collective asset maximisation is to be achieved (Goode, 2011: 42). Priority rule, that stockholders obtain nothing until creditors have been paid in full, should apply. Also, insolvency law must respect the pre-insolvency ordering

of entitlements by translating pre-insolvency assets and liabilities into the insolvency pool with nominal displacement.

To sum up, according to this theory insolvency creates a "common pool problem" which insolvency law addresses by providing a mandatory mechanism of debt collection instead of the individual debt collection scheme that is in place outside insolvency law (Jackson, 1991: 862). That is why a "stay on creditors" is considered to be an integral part of the compulsory debt collection scheme.

2.2 Strengths of the Theory

This theory is claimed to justify the compulsory collectivist device of insolvency law on the grounds that where creditors are free to agree on the forms of enforcement of their claims (*ex ante*), they would agree to collectivist arrangement rather than procedures of individual action or partial collectivism (Jackson, 1986). Jackson (1991: 861) argued that having such a system will help in reducing the cost of debt collection, help in maximising an aggregate pool of assets and it is considered as administratively effective. Paterson (2016: 723) observed that traditionally the central objective of the US law has been to impose a stay on individual creditor action, so that the business and assets can be kept together.

It is further claimed that a collective debt-collection system would reduce the "first in time, first in priority" which is considered to be a "race to the court-house" between creditors. Without having such a compulsory system, the creditors will have to spend time and money monitoring each of their debtors' assets; and once insolvency is suspected to take action to win the race to enforce their debt more quickly than the other creditors. According to Jackson (1991: 862), mandatory insolvency procedures will help in avoiding "the prisoner's dilemma"⁴ for creditors. He stated that the fundamental feature of a prisoner's dilemma is rational individual behaviour that, in absence of cooperation with other individuals, leads to a sub-optimal decision when viewed collectively. Hence, having in place a compulsory debt collection scheme will prohibit this kind of discrimination among creditors and, accordingly, will overcome creditors' co-ordination problems regarding the common pool of assets.

Jackson also claims that having a compulsory collective debt-collection system will help in increasing the return for creditors (Jackson, 1986, pp.14-16; Jackson, 1991: 864). More generally, Estrin and colleagues (2017) drew on previous literature and contended

further that insolvency laws that are more creditor friendly are likely to encourage the provision of finance and may thereby relax financing constraints for entrepreneurs. In the absence of such a compulsory system, creditors will waste assets in order to seize their security or to obtain a judgment against the debtor and that is what is described as a 'race to the courthouse' between creditors. However, this kind of race by creditors to be first may lead to the dismantlement of the debtor's assets and to a loss of value for all creditors if the debtor's assets are worth more as a whole than as a collection of pieces (Jackson, 1991, p.867; Aghion et al., 1992). This is derived, according to Jackson (1986: 14), "From a commonplace notion that a collection of assets is sometimes more valuable together than the same assets would be if spread to the winds. It is often referred to as the surplus of a going-concern value over a liquidation value".

Further, Jackson (1991: 866-868) sees the collectivist compulsory system as administratively efficient. Issues such as the detailed amount of the debtor's assets and the nature and quantity of secured claims must be solved in almost every collection procedure. Also, a single inquiry into frequent collection questions is likely to be less expensive than the multiple inquiries necessary in an individualistic remedies scheme. Hence, based on this theory, a single compulsory collective debt system is administratively efficient in avoiding these kinds of unnecessary procedures. However, Jackson acknowledged that even though it would be in the interest of all creditors, no single creditor would accept to be bound to a collective process unless it were a compulsory system binding all other creditors. Therefore, he argued that in order to tackle this problem, it is necessary to establish a federal bankruptcy rule by making available a mandatory collective system after insolvency has occurred.

2.3 Criticisms of the Theory

This theory which has been developed into very well-designed and sophisticated theories of insolvency law based on the concept of the creditors' bargain has not been passed without criticisms (Goode, 1991:43; Finch, 2009: 36-37; Westbrook, 1989: 337; Newborn, 1994: 112-114; Bruckner, 2013: 245-248). The creditors' bargain theory implies that insolvency law should be seen as a system designed to mirror the contract one would expect creditors to reach were they able to negotiate such agreement *ex ante* from behind the veil of ignorance. However, it has been argued that to presume that creditors in the bargain are capable of

reaching a united agreement is to stand against reality, since in practice real parties are diverse in their legal perception and power (Carlson, 1987: 1349; Korobkin, 1993: 555). This theory treats creditors as if they are all equal in terms of their knowledge, experience and power, and focuses, merely, on voluntary creditors who are able to bargain freely in their contracts with the insolvent debtor. Carlson (1987) and Finch (2009: 36) argued that creditors normally differ in their leverage and knowledge, their skills in obtaining payment or liens, and their opportunity costs of litigating. Finch argued that the assumption that powerful creditors would agree to a collective process is highly questionable. In addition, secured creditors who are powerful *vis-à-vis* other unsecured creditors would not agree to give up power to "weaklings" unless proper compensation has been provided (Carlson, 1987: 1349). In her article, Finch (1997: 233) stated that:

"Employee creditors who face displacement costs separate from their claims for back wages might not agree to creditor equality because they consider such costs should be reflected in a higher priority for their back wages claims".

Therefore, what creditors would agree if they had a chance to bargain *ex ante* might reflect the inequalities in rights, authority and practical benefit that shape their perspectives (Korobkin, 1993: 552).

Further, the idea that a race between various creditors is costly and, as a consequence, a compulsory debt collection system will help in reducing such costs, is subject to criticism. In response to this assertion, Carlson (1987: 1350) stated that "Rights are always 'costly' to enforce, but if an investment in enforcement promises a gigantic return, mere costliness will not persuade a creditor to give up profitable rights. All gains come at the expense of some investment. You cannot plead the fact that investment requires capital in support of the view that investors would prefer not to invest".

The argument, which is made by Jackson and Baird (1984; 1988), that the interests of non-creditors should be protected outside insolvency law also faced critiques from a number of scholars. Goode (2011:73) and Gross (1994: 1031), for example, stated that there are other values to be safeguarded that go beyond the interests of existing creditors. Among these interests, according to them, are the interests of shareholders in the preservation of their future expectations, as well as the interests of the community at large, for instance in the continuation of the business. Goode (2011), further, claimed that to focus solely on max-

imising returns to debtor's creditors, is to ignore the fact that there may be different means of protecting creditors, some of which will also benefit other interests such as those of employees, suppliers, shareholders and the local community, and in so doing may even advance creditors' interests. In other words, it is suggested that rehabilitation may benefit all creditors, secured and unsecured, in the long term as well. The supporters of the creditors' bargain wealth theory, nevertheless, have asserted that the aim of insolvency law should be, merely, at maximising the interests of the debtors' creditors⁵. However, Goode (2011: 73-74) has described such an assertion as "neat but ultimately unpersuasive" for a number of reasons. First, the creditors' bargain theory never takes into account that there are certain confronting claimants outside the common pool creditors arising specifically because of the debtor's insolvency and for no other reason. He stated, for example, that the Labour Law in England already gives rights and remedies to employees who are wrongly or unfairly dismissed, but in pursuit of these remedies against a solvent firm the former employees are not competing with other creditors, for there are by definition enough assets to meet all claims. According to him, there is no scope for the general law to prescribe priority for employees or tort claimants; as a result, such a priority rule would make no sense except in the context of insolvency law. Secondly, he continued by stating that to treat insolvency law as exclusively for creditors' confronting the common pool problem is certainly prejudging the very question at issue, it being incompatible with insolvency laws around the world which incorporate provisions for claimants outside the common pool creditors.

3. Communitarian Theory

Unlike the creditors' bargain theory that focuses only on the rights of creditors, the communitarian theory seeks to balance a wide range of interests and take into account the welfare of the community at large (Gross, 1994). Deakin and colleagues (2017: 364) observed that whilst insolvency law tends to be defined in terms of creditor wealth maximization, other values can be found underlying insolvency laws of different countries or the same country at different times.

3.1 Principles of the Theory

According to this theory, not only should the interests of the creditors of the debtor be taken into account in the case of insolvency, but the interests of other

stakeholders, who are also affected by the insolvency of the debtor. The list of these stakeholders is long and includes, for example, employees, suppliers, customers, government and the local community in which an enterprise operates (Symes, 2008: 63). There is no complete list of non-stakeholders. Gross (1999:205) argued that some interests, besides those of the creditors, might be worth considering. Even though he acknowledged the fact that interests such as community interests are extremely difficult to quantify, difficulty alone is not justification of exclusion from an economic theory of insolvency.

However, there is no explicit definition of what is meant by "community" or what amounts to public interests (Gross, 1994: 1031-1032). Similarly, Keay (2000: 523-525) stated that when it comes to the question of public interest, it is challenging to reach consensus. Nonetheless, he advocated that instead of trying to formulate an inclusive definition of the public interest, it is appropriate to say, for the purposes of insolvency law, that the public interest involves taking into consideration interests for which society has regard and which are broader than the interests of those parties directly involved in any given insolvency situation. In order that insolvency law acts to benefit the community at large, communitarianism appears to favour the survival of companies where there it is viable, as well as orderly winding up when reorganisation is not a viable option (Finch, 2009: 41).

3.2 Criticisms of the Theory

In criticizing the communitarian theory, Finch (2009:42) argued that the problem is not just that community interest is difficult to identify but that there are so many expected interests in any insolvency and that selection of interests worthy of legal protection is likely to give rise to substantial disagreement. Further, it is difficult to define community since in each insolvency there may be many community interests at stake in each geographical boundary (Schermer, 1994). For example, Schermer (1994: 1051) rightly stated that:

"if the community interests were defined as that portion of the citizenry that is affected by a debtor's business, the breadth of the community could reach a potentially infinite number, since almost anyone, from local employee to distant supplier, can claim some remote loss due to the failure of a once-viable local business." Hence, the problem is not just that community interest cannot be articulated, but there are many potential interests in each insolvency case.

Further, he argued that even though some community interests could be defined, there is a problem with application. As there are so many community interests in each insolvency case, there will inevitably be conflicts between those interests that would need to be considered. Nonetheless, it might be argued that it is the role of the relevant court to create a balance (Keay and Walton, 2003: 28). In return, Schermer (1994) stated that an insolvency court should not decide upon any community interest investigation. According to him, an insolvency court cannot weigh, for example, a local community's interests in maintaining its employment base against possible long term environmental damage. Further, an insolvency court is not necessarily qualified to decide what should, or what should not, be considered a community problem, or what should be in society's interests. Thus, based on Schermer's view, insolvency judges should not be involved in investigating so many community interests since it is difficult to quantify such interests. However, it might be asserted by the communitarians that courts usually and in all sectors of the law take into account public and community interest and, as a result, that should be the case of insolvency law (Finch, 2009: 43).

4. Multiple Values Theory

Warren (1987), supported by Korobkin (1991), offered the "dirty, complex, elastic, interconnected" vision of insolvency law from which neither outcomes can be predicted nor does it "even necessarily fully articulate all the factors relevant to a policy decision".

4.1 Principles of the Theory

The approach taken by Warren overlaps, to some extent, with the communitarian theory discussed above, in asserting that besides considering creditor interests there is a need to take into consideration other values that are also affected by the insolvency of the debtor (Gross, 1994, 1999; Warren, 1987). In summarizing her approach, Warren (1987: 777) stated that:

I see bankruptcy as an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors. Bankruptcy encompasses a number of competing - and sometimes conflicting- values in this distribution. As I see it, no one value dominates, so that bankruptcy policy becomes a composite of factors that bear on a better answer to the question, how shall the losses be distributed?

The multiple values approach is in stark contrast with

the creditors' bargain theory, which provides a "narrow" justification and denies a realistic evaluation of the insolvency system (Warren, 1993: 338). Warren's view is that insolvency law serves a series of values that cannot be organised into "neat priorities". She claimed that the creditor wealth maximization theory cannot sufficiently explain the purpose of insolvency law (Warren, 1987: 812). However, economic value enhancement is only part of the goal of insolvency law. Thus, Warren (1987: 800) accepted the fact that collectivism offers a useful means to examine some insolvency problems because having a compulsory collective debt system will help in reducing the cost of debt collection and prevent multiple individual actions. Nonetheless, she argued that this collectivism cannot be used to justify the whole insolvency system. Further, Warren advanced a case for consideration of broader interests that include employees, customers, and suppliers. She stated that insolvency law is "a more complex and ultimately less confined process" than supporters of the creditor wealth maximisation theory such as Jackson, Scott and Baird might view it (Warren, 1987: 778).

In an attempt to formulate the aims of insolvency law, Warren (1993: 368) has identified four principal goals of the insolvency system. She stated that to deal with failing firms, the insolvency system offers a number of potential advantages. First, "It fosters substantial enhancement of the value of the debtor", so the stakeholders obtain more than they would have under an alternative collective debt system. Secondly, such a collective system will help in distributing the assets of the debtor "according to a deliberate scheme" to secure protection to a number of deserving parties who would otherwise receive little or nothing. In addition, one of the principal goals of the insolvency system is to "force parties who deal with the debtor to bear the burden of their losses without externalizing them to others". Finally, one of the most crucial features of the insolvency system is to have in place an effective mechanism in order to "bring the system into play at the appropriate time". Notwithstanding, based on her view, the insolvency regime only protects the interests of parties without formal legal rights. It does this mainly through provisions that allow firms to reorganize instead of being wound up by a few anxious creditors (McCormack, 2008: 34).

Korobkin (1991: 762-768) asserted that the economic approach is incapable of recognising non-economic values such as moral, political, social and personal consideration following business failure. He stated

that insolvency law is not merely a response to the problem of debt collection rather it is a distinct system for responding to the problem of financial distress. It is argued that in dealing with financial distress, insolvency law should and must modify rights recognised under substantive non-insolvency law. Korobkin asserted (1991: 768) that “This is not a prohibited act”, as the economic theorists allege, it is an “essential and inevitable part of a full response to the problem of financial distress”. Further, he stated that insolvency law is distinct because it requires the discourse of the financial distress of the business. Thus, according to Korobkin (1991: 789), the goal of insolvency law should be to address the problem of financial distress and to create “conditions for a discourse in which values of participants may be rehabilitated into a coherent and informed vision of what the enterprise shall exist to do”.

4.2 Criticisms of the Theory

The multiple values or eclectic theory of insolvency law has not escaped criticisms, particularly from the proponents of the creditors’ bargain theory. According to this theory, assessing the impact of business failure a number of values, including moral, political and social values, need to be taken into account by insolvency law (Korobkin, 1991: 781). However, the main criticism of such an approach is that it does not offer clear and straightforward guidance to the decision-makers on the controlling of tensions and conflicts between the numerous values being affected by the debtor’s insolvency (Warren, 1987; Finch, 2009; Keay and Walton, 2003). Since there are no central principles developed to guide judges to determine trade-off or to establish weightings, this theory is accused of being ambiguous leading to uncertainty and indeterminacy. As a consequence, it might lead to lacking and confusion results (Finch, 2009: 48; McCormack, 2008: 35). Thus, it is difficult to employ insolvency law to offer protection to various values since it is difficult to identify the value of the interests held by the community and it is even unclear which kind of community interests should be protected.

Further, Warren (1987: 796) asserted that one of the central concerns of insolvency law should be to distribute losses that flow from the failure of businesses. In doing so insolvency law should contain wealth redistribution provisions and favour those who are least able to bear the costs of such a failure. Nonetheless, Baird (1987: 819) challenged such assertion by stating that “such a conception of bankruptcy would be so

foreign that it would be hard to call it bankruptcy”. He argued that the failure of the business is not necessarily linked with default and “default itself is not necessarily connected with bankruptcy”. Baird (1987:817), in addition, argued that redistributing losses in insolvency is the same as outside insolvency and as a result distribution of losses is not an insolvency concern rather it is a non-insolvency problem. Thus, if there is a need to protect some values, he argued, it is adequate to protect them within the context of the whole legal system instead of within insolvency law. However, as a response to this claim, Goode (2011:73-74) argued that there is no scope for the non-insolvency law to prescribe priorities for other values, including employees and tort claimants since such issues arise specifically because of the business failure. As a result, inserting such a priority rule makes no sense except in the context of insolvency law.

5. Explicit Value Theory

Having examined and critiqued various theories of insolvency law, Finch (1997, 2009) promoted her approach towards insolvency law. She termed her theory “Explicit Value Approach” and it is considered to be one of the theories that offers an alternative approach to the existing theories. She asserts that even though various theories of insolvency law highlight different aspects of corporate insolvency law’s role, they fail in providing “a complete view of the appropriate measures of bankruptcy law”.

5.1 Principles of the Theory

Finch (2009: 49) explained that it is important to investigate “the purpose of a quest for benchmarks” for insolvency law. In doing so two questions should be asked, namely: what is being measured by previous theories, and whether it is possible to vindicate insolvency law and its procedures given present approaches. Reference should be made to the fundamental rules of company law, particularly in regard to the question of how corporate managerial power is legitimated.

Since company law was said to be about “the legitimation of managerial power in the hands of directors” (Stokes, 1986: 155), Finch (2009: 52-53) stated that the insolvency process is more complicated since power is normally taken out of the hands of management and given to different parties. Further, she argued that an insolvency regime needs this kind of legitimation since insolvency processes affect both public and private interests. It affects public inter-

est because decisions are made about the future of the firms and such decisions have an impact on livelihood and communities. Insolvency processes also impact private rights in that securities can be frozen and individual attempts to impose other legal rights are, usually, stayed. She, therefore, argued that “the broad bankruptcy process in all its dimensions and with its variety of actors requires legitimation” and such legitimation should take into account both public and private interests (Finch, 2009: 52-53). Accordingly, Finch (2009: 53) expressed the view that “The attribution of legitimacy should not be based merely on communitarian approaches or the creditors’ bargain approach”. Therefore, “the powers involved” in insolvency processes “can be seen as calling for strong justification”. However, in searching for the measures of insolvency law, various theories of insolvency law can be seen as incorporating a number of important legitimating rationales for insolvency processes. Thus, relying on some of the concepts underpinning these theories. Finch (2009: 52) attempted to suggest an approach in which the right balance between different legitimating rationales, public and private, can be achieved.

In her view, assessing the legitimacy of an insolvency process differs from merely expressing political opinion on the topic. Such an assessment “involves a stepping back and reference, not to personal preferences or visions, but to values enjoying broad acceptance” as relevant (Finch, 2009: 55-56). Accordingly, she argued that the legitimacy of the processes and principles of insolvency law can be established by reference to four values or “benchmarks”. These benchmarks are: Efficiency which “looks to the securing of democratically mandated ends at lowest cost”; Expertise “refers to the allocation of decision and policy functions to properly competent persons”; Accountability “looks to the control of insolvency participants by democratic bodies or courts or through the openness of processes and their amenability to representations”; and Fairness “considers issues of justice and propensities to respect the interests of affected parties by allowing such parties access to, and respect, within decision and policy processes” (Finch, 2009, p.56). Hence, in measuring the legitimacy of such rules or procedures under these legitimating headings reference to a number of questions should be made. Examples of such questions are whether this is a process that permits Parliament’s (Congress) desires to be effectively implemented? Are levels of accountability satisfactory? Can the proposed procedures be

considered fair as giving due access to and respect for the interests of affected parties?

Further, Finch (2009: 57) argued that transparency in relation to the measures of insolvency law can be seen as clarity regarding values that can be served by such laws. Nonetheless, she indicated that such clarity does not offer complete answers on whether a particular balance between, for example, protection for secured creditors and for employees is desirable or not. In addition, she stated that “the rightness and wrongness of particular trade-offs can only be argued for by giving weightings or priorities to the protection of different values or interests”. Such weightings and priorities presume “substantive visions of the just society” and, therefore, individuals of diverse “political persuasions” might be expected to vary on the “right balancing” of different interests in insolvency. Nevertheless, she asserted that such disagreement in striking the right balance between various conflicting values would disappear by final political judgments.

The efficiency of a statutory mandate, as viewed by Finch (2009: 59), is one of the benchmarks of insolvency processes or decisions. Having a clear mandate on the ground, therefore, offers a very compelling yardstick for measuring an insolvency process or decision. However, Finch argued that statutory mandates in insolvency laws are often unclear or even lacking. In this case, she stated that in order to legitimate such processes or decisions a reference should be made to the expertise, accountability and fairness justifications.

In describing her approach, Finch (2009: 58) acknowledged that the “explicit value approach” provides no ultimate vision aimed at worldwide subscription however “a means of bringing a degree of clarity to evaluate discussions” while accepting that we may all be different in our notions of “the just society” or “the just distribution of rights” in insolvency. Nonetheless, she claimed that unlike the eclectic and communitarian theories, her approach is limited in so far as relevant legitimating arguments are established under the four benchmarks headings, namely efficiency, expertise, accountability and fairness, and arguments. Outside of such headings are consequently not to be considered as relevant for purposes of legitimation (Finch, 2009: 64-65). Thus, judges and decision-makers are invited to reason with reference to these benchmarks instead of relying on a single theory of insolvency law.

5.2 Criticisms of the Theory

The above explicit value theory has been criticized by

Mokal (2003), one of the supporters of the insolvency choice theory. Having examined the benchmarks underpinning the explicit value theory, Mokal stated that Finch's argument fails to make a distinction between the "diverse natures of her benchmarks" and she does not reveal the principles governing them, nor the factors which differentiates between them (Mokal, 2003, pp.460-462). First, he argued that even though Finch stated that the efficiency benchmark employs different notions of efficiency, Finch does not explain why she simply picks one of them and rejects the others. In examining the efficiency benchmark, Finch (2009, pp.62-63) stated that "technical efficiency" is concerned "with achieving the objectives being pursued by Parliament" with the minimal use of resources and costs and with the minimal waste of effort. However, Mokal (2003: 460) argued that Finch did not state exactly what sort of costs are desired to be avoided here and how effort may be wasted. Further, he raised a number of other concerns. For example, since legitimacy is considered to be a moral concept, do the results that efficiency wishes to achieve at the lowest cost also need to satisfy certain moral obligations. As a consequence, he argued that ignoring such concerns causes the explicit value approach to be "both incomplete and internally inconsistent". In addition, based on Finch's view, the justification of insolvency processes cannot be merely dependent on the efficient pursuit of mandates but it should also be dependent on the degree of expertise exercised by relevant parties, the adequacy of control and accountability schemes and the procedural fairness that is shown in dealing with the affected parties' interests (Finch, 2009: 44). However, this benchmarking theory has been critiqued because it arguably fails in making a distinction between substantive and procedural goals (Mokal, 2003: 457). Substantive goals are those "which justify the existence of this part of the law by showing it in its best light, by demonstrating why it is worth having it" whereas, procedural goals are "about how the law goes about attaining its substantive goals". To simplify, a distinction should be made between the ultimate ends of the law, and the methods that the law adopts in order to achieve those aims. "Once a set of substantive goals has been exogenously specified (e.g. using a theory of justice) efficiency can be used to judge between various proposed schemes for implementing it." (Mokal, 2003:457) Nevertheless, Mokal (2003: 458) argued that efficiency can neither be a substantive goal of any area of the law nor confer justification on any part of it. However, it can be

used to judge between various proposed schemes in order to implement only a specific substantive goal by choosing the method which is less costly to implement. Thus, he stated that efficiency in itself does not provide a goal that any area of the law should aim at since it creates no sufficient reason for the law to be one way rather than another. Furthermore, fairness benchmark is utilised throughout Finch's book in the analysis of the legitimacy of various parts of the law (Finch, 2009). Mokal (2003: 458) argued that "There is no general or abstract statement or theory of what Finch understands by 'fairness'. For example, Mokal (2003: 464) stated that Finch appears to condemn the institution as 'unfair' because, among other things, the floating charge holder does not have an obligation to take into account the interests of any other parties, and could take decisions affecting their interests without their consent. However, even though we assume that fairness requires the consent of those affected by a decision or a process, Finch did not explain how such consent might appropriately be obtained.

6. Concluding Remarks

The above-discussed theories highlight the different roles that might be played by insolvency law and, as a result, each of them has its own merits. In this regard, while the creditors' bargain theory highlights the importance of establishing a compulsory debt collection system, the multiple values theory stresses the significance of a redistributive role of insolvency laws. Hence, it is useful for the decision makers to have recourse to these normative theories when considering further development of particular insolvency laws because these various theories incorporate a number of important justifications for insolvency law and its processes. For instance, even though the main deficiency of the creditors' bargain theory is that it merely focuses on the interests of secured creditors, this theory underscores the importance of having in place a mechanism whereby all creditors' claims are stayed during the process. Further, while the communitarian and multiple values theories take the view that, besides protecting the interests of secured creditors, insolvency law should take into account other interests, Finch (2009), through her explicit value theory, argues that insolvency law should strike a balance between various stakeholders. In order to strike such a balance, in the US, for instance, the rescue plan will not be imposed over the wishes of objecting creditors unless they are sufficiently protected (Klee, 1979:156). This is similar to the case in England (O'Dea, 2009). How-

ever, whereas in England the court is given total discretion in determining whether dissenting creditors are crammed-down or not, in the US there are statutory provisions that should be met before imposing the rescue plan over the wishes of dissenting creditors. As observed by Paterson (2016: 723), in general, market changes have brought the two jurisdictions closer together for their law in action, rather than growing apart.

Based on the above discussion, this article argues that insolvency law should be designed in a way that leads to the achievement of a number of ends. Estrin and colleagues (2017: 981) on the one hand recognized the benefits of a creditor friendly regime. On the other hand, they observed that countries where bankruptcy laws are more debtor friendly are likely to have more entrepreneurs. In this regard, this article argues that insolvency law should aim to achieve a number of goals. First, maximising the welfare of debtors and all creditors, secured and unsecured, through encouraging the rehabilitation of viable businesses and liquidating the unviable businesses should be one of the objectives of insolvency law. This is due to that fact that including the possibility of rehabilitation of distressed debtors as an alternative to liquidation might mean that jobs will be preserved, secured creditors might receive better returns and suppliers may opt for continuing their relationship with the distressed debtor. Thus, immediately liquidating viable businesses without giving them a chance to be rehabilitated means that jobs will not be preserved, and shareholders might receive little or nothing⁶. Secondly, one of the aims of insolvency law should be to establish a collective debt-collection system in which all claims must be stayed during insolvency proceedings. The aim of this system is to reduce the cost of debt collection in order to maximise the aggregate pool of assets. Establishing a collective debt-collection system means that all creditors' actions are stayed to protect the assets of the debtor from hostile and damaging actions by creditors (Milman, 2003). However, since secured creditors are most particularly burdened by the imposition of such a stay, there should be a mechanism whereby secured creditors are given the necessary legal right to seek the lifting of the stay (McCormack, 2008)⁷. Thirdly, one of the objectives of insolvency law should be to redistribute losses in insolvency by containing wealth redistribution provisions. Such readjustment and modification is necessary to promote the concept of rescue culture. For instance, in order to encourage existing lenders or new lenders to provide

the necessary funding to the distressed debtor, it is important for insolvency laws to offer them sufficient guarantee that they will be paid. This might include adjusting pre-insolvency entitlements by granting a post-petition lender a super priority status over pre-petition secured creditors⁸. However, this does not mean to leave secured creditors unprotected. Such a super priority status should not be granted unless it is proven that there is adequate value in the collateral to protect pre-petition secured creditors.

In the event of insolvency, one of the concerns raised is whose interests should be protected by insolvency law. Should insolvency law be designed merely to maximise the interests of creditors or should other interests be taken into account by policy makers, such as the interest of employees, customers, and local community? In determining the aims and policies underpinning insolvency law, a number of theories/theories having different views have been developed. However, as discussed above, even though all the above discussed theories have not escaped criticisms, each of them has its own merits which is worthy of consideration. This, as a result, led the authors of this article to argue that it is essential for policy makers to resort to these normative theories in designing and developing insolvency laws.

Endnotes:

1- It is necessary at the onset of a study of this kind to attain clarity in the terminology used. As legal terms, the meaning of 'bankruptcy' and 'insolvency' vary from one country to another. For instance, in England the term 'insolvency' applies to companies and 'bankruptcy' applies to individuals. In the United States, the term 'bankruptcy' applies for both individuals and corporations. In Oman, the term 'bankruptcy' applies to traders which include commercial companies and the term 'insolvency' applies to individuals. In the interest of simplicity, however, this study will use both terms 'bankruptcy' and 'insolvency' as synonyms and both of them will be used interchangeably. Thus, both 'bankruptcy' and 'insolvency' extend to traders which covers companies and individuals that carry out commercial activities.

2- Contractarian seek to construct moral and political principles on the basis of rational agreement from a coercion-free starting point (Gauthier, 1986). In explaining the principle of this theory, Cudd (2013) stated that: 'Contractarian theory has two fundamental elements from which it derives its moral and political principles: a characterization of the initial situation,

and a characterization of the parties to the contract, particularly in terms of their rationality and motivation to come to agreement. The initial situation posits what in bargaining theory is called the 'no agreement position', the situation to which the individuals return in case of failure to make an agreement or contract. This situation is what would obtain in the absence of rules of justice, and it is the starting point for making agreements. The second element of a contractarian theory characterizes the potential contractors' practical rationality. There are two parts to this. First, contractarian (as opposed to contractualist) theories take persons to be self-interested in order to justify rules of justice as rational self-interest, and avoid assuming that persons have preferences for moral behavior as such in order to derive morality from prudence. Persons are assumed to have given preference and interests that do not necessarily include the well-being of others, because interests in the well-being of others are taken to be moral preferences and as such not prior to morality. Self-interest need not be selfish or self-centered, but it may be; self-interest simply entails that the motivation to act is one's own. Secondly, persons are presumed to understand and desire the instrumental benefits of social interaction if they can be had without sacrificing individual self-interest. Contractarians characterize practical rationality instrumentally, subjectively, and preferentially: acting rationally entails maximizing satisfaction of one's own subjective preferences. Contractarian argument relies on the crucial fact about humans that we are able to cooperate to produce more than each working or acting alone, thus making it rational to cooperate under at least some terms. The desire to benefit from cooperation in turn makes persons rationally concerned about their reputations for adhering to the moral norms that make cooperation possible and rational.'

3- Jackson (1986) claimed that he bases his theory on Rawls concepts of "original position" behind a "veil of ignorance". See also Rawls (1980).

4- A "prisoner's dilemma" rests (as does a common pool problem) on three essential premises. First, the participants are unable to get together and make a collective decision. Secondly, the participants are selfish and not altruistic. Thirdly, the result reached by individual action is worse than a cooperative solution.

5- See discussions above.

6- Many countries in the European Union have reformed their insolvency legislations (for example, France, Germany, the UK, Spain, Finland) and the goal of such reforms was to have in place a insolvency leg-

islation that includes both reorganization and liquidation chapters.

7- See e.g. sections 10 & 11 of the UK Insolvency Act 1986; section 362 (a) of the US Bankruptcy Code; The leading case on the approach of the court in exercising its discretionary power to grant permission to the lifting of the moratorium is *Re Atlantic Computer Systems plc* [1992] Ch 505.

8- This is the case in the US: section 364 (d) (1) of the US Bankruptcy Code imposes three requirements for authorising post- petition financing; e.g. pre-petition securities adequately protected and getting the approval of the court.

References

- Aghion, P., O. Hart, and J. Moore. 1992. The economics of bankruptcy reform. *Journal of Law, Economics and Organization* 8, pp. 523-546.
- Baird, D. and T. Jackson. 1984. Corporate reorganization and the treatment of diverse ownership interests: a comment on adequate protection of secured creditors in bankruptcy', *University of Chicago Law Review* 51, pp. 97-130.
- Baird, D. 1987. Loss distribution, forum shopping, and bankruptcy: a reply to Warren. *54 University of Chicago Law Review* 54, pp. 815-834.
- Baird, D. 1987a. World without bankruptcy. *Law and Contemporary Problems* 50, pp. 173-193.
- Baird, D. and T. Jackson. 1988. Bargaining after the fall and the contours of the absolute priority rule. *University of Chicago Law Review* 55, pp. 738-789.
- Bruckner, M. 2013. The virtue in bankruptcy. *Loyola University Chicago Law Journal* 45, pp. 233-286.
- Carlson, D.G. 1987. Philosophy in bankruptcy. *Modern Law Review* 85, pp. 1341-1389.
- Cudd, A. 2013. Justice, rights, and bailouts: a contractarian approach to corporate bailout. *Georgetown Journal of Law and Public Policy* 11, pp. 283-300.
- Deakin, S., Mollica, V. and Sarkar, P. 2017. Varieties of creditor protection: insolvency law reform and credit expansion in developed market economies. *Socio-Economic Review* 15, pp. 359-384.

- Estrin, S., Mickiewicz, T. and Rebmann, A. 2017. Prospect theory and the effects of bankruptcy laws on entrepreneurial aspirations. *Small Business Economics* 48, pp. 977-997.
- Finch, V. 1997. The measures of bankruptcy. *Oxford Journal Legal Studies* 17, pp. 227-251.
- Finch, V. 2009. *Corporate insolvency law: perspectives and principles*. Cambridge University Press, Cambridge.
- Gauthier, D. 1986. *Morals by agreement*. Oxford University Press, Oxford.
- Goode, R. 2011. *Principles of corporate insolvency law*. Sweet and Maxwell, London.
- Gross, K. 1994. Taking community interests into account in bankruptcy. *Washington University Law Quarterly* 72, pp. 1031-1048,
- Gross, K. 1999. *Failure and forgiveness: rebalancing the bankruptcy system*. Yale University Press, New Haven.
- Jackson, T. 1986. *The logic and limits of bankruptcy law*. Harvard University Press, Cambridge.
- Jackson, T. 1991. Bankruptcy, non-bankruptcy entitlement, and the creditors' bargain. *Yale Law Journal* 91, pp. 857-907.
- Jackson, T. and R. Scott. 1989. On the nature of bankruptcy: an essay on bankruptcy sharing and the creditors' bargain. *Virginia Law Review* 75, pp. 155-204.
- Keay, A. 2000. Insolvency law: a matter of public interest. *Northern Ireland Legal Quarterly* 51, pp. 509-534.
- Keay, A. and P. Walton. 2003. *Insolvency law: corporate and personal*. Longman, Harlow.
- Klee, K. 1979. All you ever wanted to know about cram down under the new bankruptcy code. *American Bankruptcy Law Journal* 53, pp. 133-171.
- Korobkin, D. 1991. Rehabilitating values: a jurisprudence of bankruptcy. *Columbia Law Review* 91, pp. 717- 789.
- Korobkin, D. 1993. Contractarianism and the normative foundations of bankruptcy law. *Texas Law Review* 71, pp. 541-630.
- McCormack, G. 2008. *Corporate rescue law - an Anglo-American perspective*. Edward Elgar Publishing, Cheltenham.
- Milman, D. 2003. Winding up of companies: recent litigation and legislative development. *Insolvency Lawyer* 4, 157-161.
- Mokal, R. 2003. On fairness and efficiency. *Modern Law Review* 66, pp. 452-467.
- Mokal, R. 2005. *Corporate insolvency law: theory and application*. Oxford University Press, Oxford.
- Newborn, M. 1994. The new Rawlsian theory of bankruptcy ethics. *Cardozo Law Review* 16, 111-146.
- O'Dea, G. 2009. Craving a cram-down: why English insolvency law needs reforming. *Butterworths Journal of International Banking and Financial Law* 24, pp. 583-589.
- Paterson, S. 2016. Rethinking corporate bankruptcy theory in the twenty-first century. *Oxford Journal of Legal Studies* 36, pp. 697-723.
- Rawls, J. 1980. Kantian constructivism in moral theory. *Journal of Philosophy* 77, pp. 515-572.
- Schermer, B. 1994. Response to Professor Gross: taking the interests of the community into account in bankruptcy. *Washington University Law Quarterly* 72, pp. 1049-1054.
- Stokes, M. 1986. Company law and legal theory. In W. Twining (ed.). *Legal theory and common law*. pp. 155-183. Blackwell, Oxford.
- Symes, C. 2008. *Statutory priorities in corporate insolvency law: an analysis of preferred creditor status*. Ashgate, Aldershot.
- Veach, J. 1997. On considering the public interest in bankruptcy: looking to the railroad for answers. *Indiana Law Journal* 72, pp. 1211-1230.
- Walton, P. 2011. When is pre-packaged administration appropriate? A theoretical consideration. Nottingham

Law Journal 20, pp. 1-13.

Warren, E. 1987. Bankruptcy policy. *University of Chicago Law Review* 54, pp. 755-814.

Warren, E. 1993. Bankruptcy policymaking in an imperfect. *Modern Law Review* 92, pp. 336-387.

Westbrook, J.L. 1989. A functional analysis of executory contracts. *Minnesota Law Review*, 47, pp. 227-338.