Paradigm Academic Press
Law and Economy
ISSN 2788-7049
DEC. 2022 VOL.1 NO.5

An Analysis of the Multiple Aims of Insolvency Law: From the Internal and External Perspectives

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doi:10.56397/LE.2022.12.04

Abstract

With the development of the insolvency legal system, protecting creditors' rights and interests is no longer the sole purpose of insolvency law. Conversely, the aims of insolvency law have shown a trend of diversified development. In contrast to the traditional view that the sole purpose of insolvency law is to protect the rights and interests of creditors, this paper argues that each of the multiple purposes of insolvency law has a distinct value and is not a by-product of the primary purpose of protecting creditors. This article groups the aims of insolvency law into two categories: internal and external. The insolvency law's internal purposes include establishing the insolvency system's commercial and legal attributes, protecting the rights and interests of creditors, and establishing an effective mechanism for assessing the viability of a business. The insolvency law's external purposes include protecting employees' rights and ensuring the rational allocation of resources to avoid creating plenty of zombie companies. These various aims of insolvency contribute to improving the insolvency system, demonstrating the legislative purpose and the response of insolvency law to judicial practice.

Keywords: creditors, internal and external aims, viability, employees

1. Introduction

The aims of insolvency law reflect the legislator's value orientation. The aims guide practice for specific institutional amendments and practical applications of insolvency law. Over time, the aims of insolvency law have evolved from using criminal penalties to punish insolvent debtors, imposing a profound stigma on debtors at the moral level, and focusing on protecting creditors' rights. In the context of the pandemic, countless enterprises have been severely impacted, pendulum of the purpose of bankruptcy law began to swing from liquidation to rescue. With the deepening of theoretical research and the understanding of insolvency law, the aims of insolvency law have shown a trend of pluralism. Warren articulated the multi-objective theory, she suggested that bankruptcy processes aim to protect or maximize the value of the insolvent business and strive to defend the rights of secured creditors, general creditors, tax creditors, employees, and other groups (Elizabeth Warren, 1987). The purpose of insolvency law is also to protect enterprise employees' interests and ensure the rational allocation of resources. These diverse aims follow two main lines: insolvency law's internal and external purposes. This paper divides the purpose of bankruptcy law into internal and external purposes and elaborates the aims of insolvency law at two different levels.

2. Internal Aims of the Insolvency Law

The internal aims of insolvency law embody the essential nature of the insolvency system. These purposes can be expressed directly in the legal relationship of insolvency and are the core tasks of insolvency law. The internal purposes of insolvency law include consolidating the commercial attributes of insolvency and eliminating stigma, maximizing the interests of creditors, and establishing an effective mechanism for assessing the viability of a business.

2.1 Establishing the Commercial Attributes of the Insolvency Law: Decriminalization and De-Stigmatization of the Insolvency Law

In contemporary society, insolvency is a purely commercial and legal system, where people are more concerned with maximizing their interests. Except for malicious fraud involving property crimes, one can hardly imagine insolvency being associated with crime and stigma. However, historically insolvent debtors have been repeatedly subjected to penalties. For centuries debtors in the United Kingdom could be found languishing in prisons. For instance, Charles Dickens poignantly depicted the plight of those confined in an English debtors' prison in his 1857 novel titled Little Dorrit.[1]

Even when insolvency was subsequently decriminalized, it was still difficult for people to escape the stigma associated with the severe penalties imposed on insolvent debtors. Multiple restrictions on the capacity to engage in trade tended to reinforce stigmas associated with default. (Edited by Paul J. Omar & Jennifer L.L. Gant (eds), 2021) The default is not entirely due to the subjective fault of the debtor, and in many cases of debt default, the creditor is not even at fault. For instance, external events can put a business holder out of his or her business, such as the war in Ukraine and the pandemic. The fear of stigma has led many debtors to prefer to remain with a non-viable company rather than seek insolvency. This approach of barely maintaining a non-viable company is unsustainable. It can even result in a company that had a chance to be rescued missing the best opportunity for rescue and eventually becoming utterly economic non-viable for rescue. Even today, this misconception still exists in the minds of many business holders. Insolvency is not a moral system but a commercial and legal system that is not essentially distinct from legal relationships such as guarantees and lending. Tying ethics to insolvency only leads to irreversible consequences for the debtor, based on a false perception of insolvency results that put the debtor in a problematic situation and damage the rights and interests of creditors and shareholders, ultimately leading to a loss of interest for all. Thus, one of the aims of contemporary insolvency law is to consolidate the commercial and legal attributes of the insolvency system in order to mitigate the harm caused to debtors, creditors and others by the insolvency stigma.

2.2 Creditors' Bargaining Theory: From Individualistic Creditors' Remedy System to the Collective System

Protection of creditor rights and maximization of creditor returns are indisputable purposes of bankruptcy law. It is necessary to recognize that enterprises should pay their debts efficiently and fairly. (Royston Miles Goode, 2011) In the beginning, creditors were more concerned with ensuring that debtors could repay them as soon as possible. Hence, they preferred to dismantle and liquidate businesses quickly. When the debtor is unable to repay the debt sufficiently by the due date, some creditors will attempt to maximize their interests by engaging in opportunistic behaviours to obtain their money back while damaging other creditors' interests. Furthermore, the unjustified demands by creditors might result in disruption and even unlawful and criminal behaviour. (Michael Murray & Jason Harris, 2018) However, it was soon realized that this disorderly scramble to maximize creditors' returns would not ultimately lead to maximum returns for creditors but instead to chaos and hardship. When insolvency was in its infancy during the Middle Ages, debtors had few choices. Once creditors determined in multi-dimensional zero-sum game analysis, possibly based on perceived information asymmetry, that cooperation was preferable to competition and piecemeal dismemberment of the debtor's property, the *fallimento* or *faillite* was conceived as an insolvency procedure for traders. (Edited by Paul J. Omar & Jennifer L.L. Gant (eds), 2021)

In his creditors' bargaining theory, Jackson introduced a set of concepts: individualistic creditors' remedy system versus collective system, which corresponds to creditors' individual action and collective action. Jackson graphically likens the basis of the individualistic creditors' remedy system to a prisoner's dilemma. Assuming that the debtor's remaining assets are not sufficient to efficiently repay all creditors, creditors can only maximize their rights on a first come, first be repaid basis, which leads to a tendency for all creditors to act early to avoid the disadvantage of falling behind other creditors. (Jackson, T H, 1982) For instance, the insolvent debtor has only $600,000 in property and unsecured creditors A and B have a claim against the debtor for $500,000, respectively. If there is no prior agreement between the two creditors, then perhaps the creditor, who claims first will get the full repayment of $500,000, and the creditor who claims second will only get $100,000. But no one can guarantee that he or she will always be the first assert a claim and win in every game of prisoner's dilemma. However, suppose all creditors prefer to use the individualistic remedy. In that case, it may result in a piecemeal dismantling of the debtor's company, which can lead to a devaluation of the debtor's assets, resulting in a decrease in the aggregate pool of funds in insolvency.[2] But if creditors tend to choose the collective system to realize their claims, then either through liquidation or reorganization, which may increase the aggregate pool in insolvency, it is in the best interest of the creditors as a group to use the collective system instead of individualistic remedies.[3]

It is evident that the ultimate goal of this collective system of ex-ante creditor bargaining is to maximize the interests of creditors. It helps creditors eliminate their risks by reaching a second-best solution, which is

acceptable among creditors in advance. Jackson also sees that the decrease of uncertainty would be considered a virtue by creditors.[4] In a prisoner's dilemma, winning is not sustainable, so this pre-agreed second-best solution for creditors is the best solution if it is based on a risk management perspective and the purpose of maximizing creditors' rights in each insolvency.

Casey argues that the theory of ex-ante creditor bargaining exists only in a hypothetical world with perfect information, zero transaction costs, and rational behaviour; these conditions do not exist in the real world; based on the uncertainty, in reality, parties cannot write a perfect contract. (Anthony J. Casey, 2020) Therefore, it is unrealistic that the creditors' bargaining theory assumes that creditors can reach an early agreement on the distribution of the bankruptcy estate. But the creditors' bargaining theory at least provides us with a perspective that creditors as a group engage in orderly actions that may protect the rights and interests of each creditor to the greatest extent possible. Whether or not the ex-ante bargaining by creditors leads to agreement, the collective action system demonstrates, at least theoretically, significant advantages over the individualistic creditors' remedy system in reducing strategic expenditures, aggregate pool of assets, and improving administrative efficiency, all of which are critical to maximizing creditor rights and return.

In summary, maximizing the rights and interests of creditors is one of the critical goals of insolvency law. Throughout the history of bankruptcy law, creditors have experienced a transformation from individual action to collective action to achieve this goal. The collective system centred on ex-ante bargaining has fully demonstrated its advantages in maximizing creditors' rights and interests, despite facing practical tests, but it embodies the goal of bankruptcy law on maximizing creditors' rights and interests sufficiently.

2.3 Between Liquidation and Rescue: Establishing an Effective Viability Assessment Mechanism

Liquidation and rescue are two critical tools for solving insolvency problems. When an enterprise is in financial distress, the task of bankruptcy law is to choose between liquidation and rescue. However, corporate bankruptcy law can be highly arbitrary without an efficient assessment tool applying to liquidation versus rescue due to the wide range of company conditions. Therefore, the purpose of insolvency law is not merely to select between liquidation and rescue but rather to develop an effective viability assessment mechanism that evaluates the status of the insolvent business and determines whether to liquidate or rescue the enterprise. Lydia Tsioli argues that distinguishing viable debtors from non-viable debtors is at the heart of corporate insolvency law. (Lydia Tsioli, 2010) In this context, one of the most critical tasks for legislators is to develop frameworks that promote the reorganization of financially troubled but viable enterprises while simultaneously filtering out non-viable companies for liquidation.[5]

First, not all companies in distress are because they are no longer commercially viable; changes in external circumstances can significantly impact a company's business conditions. During the COVID-19 period, people were less willing to spend, sales decreased and became uncertain, and companies invested less. (Arnold & Martin, 2020) Therefore, companies in distress are likely to have deteriorated their business situations due to the changes in the external environment. The company's innovative capabilities, core technologies, and business value have not been intrinsically affected. For such companies with depleted cash flow, due to changes in the external environment, the traditional business viability assessment mechanism will assess them as financially inviable, meaning that the value of the business itself is greater than the value of the assets after liquidation and that if the business is rescued through proper procedures, then the cash flow of the business will return to normal, and the company will revive latter. The advantage of the rescue for financial inviable business is that the survival of the business resulting from the rescue will not only maximize the return to creditors, but also safeguard the market dynamics compared to the direct dismantling of the business. But not all companies deserve to be rescued. In the context of the pandemic, governments have adopted plenty of rescue policies for companies, resulting in the retention of many companies that are not innovative and commercially viable. These businesses belong to the category of economic viability, meaning that the value of the business itself is less than the pool of assets by liquidation. For these businesses, liquidation is apparently the best way to proceed.

However, due to the complexity of the business situation, establishing a sound feasibility assessment mechanism is not an easy task. A prior viability assessment mechanism establishes a relatively straightforward and well-defined assessment system, to determine whether a business should be liquidated or saved based on the business's cash flow, the assets after liquidation, and a prediction of the post-recovery condition of the business. A previous viability evaluation method establishes a relatively straightforward and well-defined assessment way of deciding whether a company should be liquidated or rescued depending on the business's cash flow, the assets after liquidation, and a forecast of the business's post-recovery circumstance. In general, the insolvency law aims to build a more effective assessment mechanism and determine whether a business should be liquidated or rescued.

3. External Aims of the Insolvency Law

Since the traditional purpose of insolvency law is to protect the interests of creditors, people tend to focus on the legal relationship between creditors and debtors for this purpose. The external aims of insolvency law have specific social attributes and characteristics of plurality, so it is challenging to discover the external aims of bankruptcy law from the traditional lens. Based on the multi-objective theory, this paper argues that the external aims of insolvency law include protecting employees' rights and interests, promoting the sound development of capital markets, and reducing the costs and geographical barriers to insolvency.

3.1 Protection of Employees' Rights in Particular

In a business context, the interdependence of employers and employees is evident. The most immediate consequence of an enterprise's insolvency and liquidation is job losing of employees. Employees, as particular creditors of the enterprise, are more vulnerable than other ordinary creditors. The insolvency's impact on employees and their families is significantly harsher than on other creditors. If the labor provided by employees to their employers is considered an investment, then employees differ from other creditors because their investments are extremely undiversified (Jay Lawrence Westbrook, 2009), facing greater risk.

Within the bankruptcy creditors category, many jurisdictions have already acknowledged the importance of employees by granting them a higher position than other creditors. This elevated status, commonly known as that of preferential creditors, guarantees that employee claims are frequently satisfied before those of other creditors. [6]

This priority of employee creditors is embodied in legislation and case laws. 433 of *Corporations Act 2001* provides that the proceeds from the sale of assets must be distributed to employees before secured creditors[7]. Likewises, 561 provided that liquidators make the same prioritized payment. Priority can be given to paying employee salary, pension contributions, and superannuation guarantee charges[8]. In legal practice, in the case of *Carter Holt Harvey Woodproducts Australia Pty Ltd v The Commonwealth of Australia* in 2019, the High Court of Australia's judgment confirmed that employee salary paid by the corporate should take precedence over other creditors[9].

Protecting employees' rights is not only a by-product of the purpose of insolvency law. Conversely, it has an independent significance of insolvency law. The vulnerability of employees as particular creditors makes it difficult for employees to survive in bankruptcy. The special protection of employees under bankruptcy law can minimize the disastrous consequences of employees' vulnerability, reflecting the fairness of the purpose of bankruptcy law.

3.2 Ensuring Capital is Allocated Appropriately and Avoiding the Massive Emergence of Zombie Companies

Zombie enterprises are those that have lost the ability to repair themselves and must rely on non-market resources, for instance, government subsidies and renewed loans from state banks, to stay in a corporation. In an entirely free competitive market, zombie firms would exit Automatically due to their low competitiveness. (Yanan Lu & Ya Zuo, 2016)

Not only does insolvency law play the role of adjusting the relationship between creditors and debtors, but it also undertakes the task of guaranteeing the healthy operation of the capital market. As a matter of fact, blind rescue is not the purpose of insolvency law, which will lead to some enterprises that should be liquidated to remain in the capital market, and the resources occupied by these enterprises cannot be used efficiently.

Instead, one of the purposes of insolvency law is to create a free market with fair and sufficient competition to eliminate those businesses that lack competitiveness and commercial value. In an ideal free competitive market, those companies that can use resources efficiently will dominate and obtain more capital to expand reproduction. These competitive businesses actively participate in market competition, thereby increasing the level of resource utilization in the entire society, and businesses can use limited resources to create more profits and provide more jobs.

In a capital market where capital is precious, insolvency law must ensure that resources or assets can be allocated appropriately through liquidation. The purpose of insolvency is to end the waste of capital resulting from an irrational allocation of resources and avoid the loss or degradation of any value. And zombie companies are the product of irrational capital allocation, which is mainly caused by government-led intervention policies. Lam suggested that zombie companies in China are strongly associated with state-owned enterprises (SOEs), and that zombie companies share similar characteristics with some SOEs, namely involving debt vulnerability and low productivity. (Stacey Steele, 2016) In the post-pandemic era, it was realized that the excessive rescue policies adopted by governments at the beginning of the pandemic to avoid a wave of bankruptcies undermined the self-regulatory function of capital markets, which in turn led to the emergence of a large number of zombie companies. Mr. Sewing also warned that using government subsidies to keep companies viable would prevent creative destruction, the process described by economist Joseph Schumpeter in which bankrupt companies make way for healthier new ones. (Arnold & Martin, 2020) Therefore, combined with the internal purpose of the

insolvency law, it is necessary to establish a reasonable enterprise viability evaluation mechanism to avoid excessive intervention in the capital market for the purpose of extreme rescue, which leads to the emergence of a large number of zombie enterprises.

4. Conclusion

Based on the multi-objective theory of insolvency law, this study analyzes the tendency of pluralistic insolvency law aims in the new era, structurally divides the aims of insolvency law into two levels and illustrates the role and significance of different aims of insolvency law employing a hierarchical elaboration. Starting from stigma, the moral ghost that has plagued the insolvency system for a long time, this paper creatively proposes that eliminating stigma and consolidating the commercial and legal attributes of insolvency law should be an essential purpose of insolvency law, which is also a prerequisite for many purposes of insolvency law. In addition, this paper analyzes the collective system under Thomas' creditor bargaining theory from the traditional aim of bankruptcy law—maximizing creditors' rights and interests and argues that the collective system is an effective way to maximize creditors' rights. In terms of the external aims of insolvency law, this paper focuses on protecting employees' rights and promoting the rational allocation of capital. This study does not go into enough detail regarding the interplay and interaction between the internal and external purposes of insolvency law, and there is potential for further research in these areas.

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[1] Charles Dickens, Little Dorrit (Bradbury and Evans, 1857). See, eg, Hussain v Vaswani [2020] EWCA Civ 1216 (Hussain), [22] (Arnold LJ, Baker LJ agreeing). See further, eg, Cork Report (n 11) 17 [41].

[2] Ibid 864.

[3] Ibid 864.

[4] Ibid 863.

[5] Ibid.

[6] Ibid 184.

[7] *Corporations Act 2001* (Cth) s 433.

[8] Ibid, s561.

[9] *Carter Holt Harvey Woodproducts Australia Pty Ltd v Commonwealth*, (2019). 268 CLR 524, 569 [98].