THE AIMS AND POLICY OF INSOLVENCY LAW

1 These notes, prepared hurriedly, are intended to serve as a basis for a discussion about the general principles and philosophy of Insolvency Law. The aim should perhaps be to provide a set of main and subsidiary guidelines to develop a system or code for dealing with insolvency matters which is in tune with the likely needs of the last two decades of this century and the early part of the next.

2 There has been no recent analysis of any real weight in England of the fundamental principles of insolvency. The material discussed below has been derived in part from sources which are not generally available in this country but it is intended to produce as soon as possible a comprehensive bibliography of the subject. It is believed that the Law Commission in Edinburgh possesses the most detailed lists of books and articles on insolvency throughout the world available in the United Kingdom.

HISTORICAL

3 The debtor's lot in primitive times was not a happy one. There was no exception to the rule that he must pay his debts in full. If he couldn't pay with his property, he paid with his person; he was either killed, made a slave, imprisoned or exiled. Gradually this inhumane and harsh approach was alleviated and a system whereby the assets of an insolvent debtor were compulsorily assigned to a representative of his creditors was developed - the cessio bonorum. This was an embryonic form of bankruptcy.

4 The derivation of the word "bankruptcy" has been the subject of much debate. One colourful theory is that it is derived from Italian sources and from the words "banca" and "ruptus". When in mediaeval times Italian moneylenders or bankers defaulted on their obligations, the bench or stall from which they carried on their activities was broken. This signified not only that in practical terms their business had been closed down but also carried with it the notion of the public recognition of the debtor's financial incompetence and ineptitude. The disgrace for the debtor by the imposition upon him of "the stigma of bankruptcy" was motivated by a desire to police the commercial community with a view to maintaining acceptable business standards. If a debtor fell below those standards he not only suffered with regard to his livelihood but in time also had to suffer a considerable diminution in his civil rights to participate in public life.

5 Another important element of the system of humiliating the debtor was the need to condemn those persons who by their business activities, particularly if dishonest, had abused the privileges of the commercial society in which they lived in the sense that the structure of that society was put at risk if a trader did not fulfill his commitments. The chain reaction upon other members of the society, such as fellow traders, apprentices or employees, not to speak of the family dependants, was such that any dislocation to the system required more or less severe measures of punishment as a deterrent to other traders.

6 The old English common law adopted a robust approach to the subject. It appears, for example from a law of 1352, that a creditor was obliged to

resort to a very expensive, lengthy and cumbersome procedure to obtain an attachment of his debtor's property. Execution against the debtor's entire estate could not be obtained but only against the property described in the writ. If there were several creditors, they took the debtor's property in the order of their attachment. The race was to the swift. The rule was "first come, first served".

7 The first inroad on the common law principle was introduced by Henry VIII in 1542 in the first English Bankruptcy Act which contained provisions for involuntary procedures directed against the dishonest and absconding debtor who, upon petition of his creditors, could be divested of his property by the Lord Chancellor who would distribute the proceeds amongst them. The law of 1571, under Elizabeth I, made the real foundations for the present law, it introduced the concept of acts of bankruptcy, thought its provisions were limited to merchants.

8 The restriction of the benefits of the bankruptcy laws to traders continued until 1861 and the philosophy underlining the exclusion of non-traders was summed up by Blackstone, in the mid eighteenth century as follows:

> "The laws of England allow the benefit of the laws of bankruptcy to none but actual traders; since that set of men are, generally speaking, the only persons liable to accidental losses, and to an inability of paying their debts, without any fault of their own. If persons in other situations of life

run in debt without the power of payment, they must take the consequences of their own indiscretion, even though they may meet with sudden accidents that may reduce their fortunes: for the law holds it to be an unjustifiable practice, for any person but a tradesman to encumber himself with debts of any considerable value. If a gentleman, or one in a liberal profession, at a time of contracting his debts, has a sufficient fund to pay them, the delay of payment is a species of dishonesty, and a temporary injustice to his creditor: and if, at such time he has no sufficient fund, the dishonesty and the injustice is the greater. He cannot, therefore, murmur, if he suffers the punishment which he has voluntarily drawn upon himself but in merchant transactions the case is otherwise. Trade cannot be carried on without mutual credit on both sides: the contracting of debts is therefore here not only justifiable, but necessary. And if by accidental calamities, as by the loss of a ship in a tempest, the failure of brother traders, or by the non-payment of persons out of trade, a merchant or tradesman becomes incapable of discharging his own debt, it is his misfortune and not his fault. To the misfortunes, therefore, of debtors, the law had given a compassionate remedy, but denied it to their faults: since at the same time that it provides for the security of commerce, by enacting that every considerable trader may be declared a bankrupt, for the benefit of his creditors as well as himself, it has also, to discourage

> extravagance, declared that no-one shall be capable of being made a bankrupt, but only a trader, not capable of receiving the full benefit of the statutes, but only an industrious trader."

9 It was not until 1831 that a court of bankruptcy as such was established. It introduced new administrative machinery in the shape of "official assignees". These officers were required to be merchants, brokers or accountants, or persons who were, or had been, engaged in trade, one of them was appointed to act in each bankruptcy, and the bankrupt's estate was vested in the official assignee on whom fell the real burden of administering the estate. The next landmark was the Bankruptcy Act of 1849 which was greeted with great expectations because of the increased powers it gave to deal with fraud and dishonesty on the part of bankrupts. It also contained provisions intended to facilitate arrangements without a bankruptcy. However, the high hopes for the Act were disappointed. Although there were a great number of arrangements by deed, the problem was that they did not usually find dissenting creditors.

10 The next great overhaul of the law came with the Bankruptcy Act 1869 which was prompted, in part, by a desire to remodel the system of arrangements between a debtor and his creditors, so as to give greater protection for the creditors and to ensure that the creditors be invested with a greater and more direct control over the bankruptcy proceedings. It is not uninteresting to note that the Scots bankruptcy law, which had recently been amended, was thought in this country to have had a successful and beneficial operation in Scotland and was generally regarded as the model to which the English law should

be reformed.

11 Whatever may have been the true model for the Act of 1869 it was very quickly found to have considerable defects. The Act contained special provisions for regulating the liquidation by arrangement of the affairs of debtors, and compositions with their creditors, without resort to bankruptcy. However, these provisions were found not to work at all well in practice, owing greatly to the abuse of the use of proxies, and the inertness of creditors in looking after their own interests, which frequently let to the adoption of inadequate compositions through the influence of the debtor's friends; and in a great measure, also, owing to the exemption of the trustees in such cases from those provisions in the Act which enabled the court to exercise control over trustees in bankruptcy.

12 The history of bankruptcy reform in the 19th century reveals much experimentation concerning who should liquidate and supervise an estate:

(i) In 1831 provision was made for the joint administration by official assignees and assignees chosen by the creditors;

(ii) in 1869 the system of administration, at the insistence of the trading community, reverted to a system of creditor liquidation; the creditors chose the trustee who was supervised by a committee of inspectors also chosen by the creditors. However abuses arose, particularly in regard to the solicitation of proxies, which

often permitted a minority of creditors to control and manipulate the administration of an estate in their interests to the prejudice of the majority of creditors.

(iii) the system adopted in 1883 and continued in the Act of 1914 was one of joint official and creditor control.

13 Perhaps the greatest novelties contained in the Act of 1883 were the introduction of the Board of Trade as a factor in the administration of the estates of bankrupts, the creation of the new officer, the Official Receiver, and the introduction of the receiving order as a preliminary step under a bankruptcy petition.

14 In introducing the Act of 1883 the President of the Board of Trade, Joseph Chamberlain, suggested that there were two main, but quite distinct, objects of any good bankruptcy law:

(i) the need for the honest administration of bankrupt estates, with a view to the fair and speedy distribution of the assets amongst the creditors, whose property they were;

(ii) following the idea that prevention is better than cure, to improve the general tone of commercial morality, to promote honest trading and to lessen the number of failures.

15 It is quite likely that the repeated emphasis on the need for honesty was made in response to the many

scandals which appear to have taken place in relation to the administration of insolvent estates during the previous decade. The theme of the legislation was summed up when the President stated that Parliament must endeavour, as far as possible "to protect the salvage, and also to diminish the number of wrecks".

16 The only way to achieve those two objectives was by securing an independent and impartial examination into the circumstances of each case:

> "What happened when a bankruptcy took place which might easily cause misery to thousands of people and bring ruin on many homes? It was treated as if it were entirely a matter of private concern, and allowed to become a scramble between the debtor and his advisors - who are often his confederates - on the one hand, and the creditors of the other. Meanwhile, the great public interests at stake in all these questions were entirely and absolutely ignored, as there was nobody to represent them, and the practice which was followed in the case of other calamities was, in this case, entirely absent. In the case of accidents by sea and by land - railway accidents, for instance - it was incumbent upon a government department to institute an inquiry. There were inquiries in the case of accidents in mines, and of boiler explosions, and sad as those disasters were, they did not, in the majority of cases, cause so much misery as a bad bankruptcy, which brought ruin to many families by carrying off the fruits of their labour and industry . . ."

17 The system created by the Act of 1883 might fairly be called a system of official inquiry. It was considered that without some such "limited officialism" as that introduced by the Act, any satisfactory inquiry was impossible. No investigation could be worth anything unless it was conducted by an independent and impartial officer.

18 The basic questions facing us today are the extent to which the different criteria or guidelines which can be seen to emerge from the foregoing analysis, continue to have any validity in the context of the vastly changed structure of political, economic and social life which has taken place this century. Furthermore, are there new criteria which call to be taken into account and, in any event, what is the relative importance as between each consideration in today's conditions or the weight or priority which should be given to them. In striking the new balance it may well be necessary to modify old attitudes and concepts or even to discard them altogether; however, it is suggested that no such alteration should be countenanced unless a strong and solid case for reform has been made out. The essence of English law has been one of gradual organic growth and there should be a reluctance to introduce radical new approaches unless present methods are quite unacceptable and entirely beyond overhaul and modernisation.

19 The law regarding the winding-up and liquidation of companies has a much shorter ancestry. It really only began to play an important role after the industrial revolution and in particular with the railway boom in the 1830's. It appears that until about 1849 the winding-up of corporations or companies was dealt with in the Chancery Courts in much the same way as the winding-up of a partnership. The increasing

incidents of company failures appears to have led to a demand for a more self-contained code and procedure and this is reflected by the Companies Act of 1862. The machinery for dealing with failed companies appears to have been a mixture of the methods available for dealing with individual traders, ie, the involuntary winding-up or the voluntary system, akin to the liquidating debtor who at that time put himself in the hands of his creditors without resort to bankruptcy. At some stage the system was considerably improved by the introduction of machinery for imposing schemes of arrangement or reconstruction upon dissenting creditors in a manner which, since 1883, has had no place in bankruptcy, except, unsatisfactorily, through the deed of arrangement, which for many years fell almost into disuse.

20 The law relating to receiverships is essentially based on general principles of equity law with certain recent statutory encrustaceons.

THE GUIDING PRINCIPLES

21 The following is an attempt to stimulate discussion and must not be treated as by any means comprehensive or, indeed, supported by sufficient arguments.

THE NATURE OF INSOLVENCY LAW

22 (i) The laws governing insolvency matters should be, as far as possible, clear, concise and free from doubt as well as being readily accessible and understandable to all those directly or indirectly affected by them;

(ii) the law should aim at striking a fair and reasonable balance between the many

competing interests which exist when insolvencies occur;

(iii) the law should be sufficiently adaptable and flexible to take account of changing circumstances without the need for too frequent overhaul by parliament.

23 (i) The aim should be to achieve, as speedily and as cheaply as possible, a fair and equitable realisation and distribution of the insolvents' assets amongst the various classes of his creditors - the system must, in short, promote equity;

(ii) there should be an inquisitorial aspect of insolvency law to enable society to judge the degree of seriousness to be attributed to particular failures and to decide upon the consequences which should be visited upon the perpetrators;

(iii) the system must facilitate the rehabilitation of the perpetrators, whether individual debtors or directors of companies;

(iv) it must be acknowledged that in a host of respects the community has a considerable direct and indirect interest in the avoidance of insolvency situations, as well as the manner in which they are disposed of and those interests should be identified with

some precision;

(v) the generally accepted fabric of commercial life should be adequately protected and high standards of commercial morality should be promoted; the system should be sufficiently frightening or inconvenient so that the threat of resorting to it might constitute a measure for persuading those who can to pay their debts otherwise than through the insolvency machinery.

24 It is suggested that the present system has grown up haphazardly, as particular needs of the time demanded, and that it comprises a jumble and hodge-podge of different measures of varying degrees of effectiveness. The following modes of administration can be mentioned at a brief glance:

Bankruptcy
Criminal Bankruptcy
Deeds of Arrangement
Administration Orders for small debtors
Receiverships
Voluntary Winding-Up
Compulsory Winding-Up
Schemes of Arrangement

25 The list is not endless, but there is no doubt that the situation is, to say the least, confusing. A creditor in a straight bankruptcy or his representative, the trustee, is at a disadvantage as compared with the creditors and trustee in a criminal bankruptcy; creditors in a bankruptcy are entitled to statutory interest on their debts; not so in winding-up; the doctrine of reputed

ownership is applicable in bankruptcy but not in winding-up. There is not the space for me to catalogue what is likely to be an immense list of anomalies but it is suggested that "a book of anomalies" should be maintained by the secretariat to help identify the various areas of reforms to be considered.

26 The trading community, as well as the professional practitioners, are handicapped, with so many different systems with varying degrees of differences between them, in deciding what is the most prudent course to be adopted in the face of insolvency proceedings or a potential insolvency problem. Commercial documents, for example, frequently provide what is to happen in a wide range of insolvency situations but usually on a more or less hit or miss basis. It cannot be stressed enough that this confusion has been aggravated by the introduction and proliferation of so many new techniques for financing businesses and supplying goods and services during the last 50 years or so; many have been designed, not so much to improve economic efficiency, but as a response to the introduction of the Moneylenders Act in 1900 and as a means of circumventing their strict provisions. With the dismantling in due course of the whole apparatus of the Moneylenders Acts, the Bills of Sale Acts and other measures designed to protect certain classes of creditors from the depredations of "greedy capitalists", which will be effected when the Consumer Credit Act 1974 is finally in force, a fresh approach may well be required by the insolvency code.

27 The most glaring anomaly and divergence of approach is exemplified by the concept of the "act of bankruptcy" which, in bankruptcy, is in essentials based on the 1572 Act: see above. The concept is expressed somewhat differently in the Companies Acts and the European Convention as a yet further approach through the doctrine

of "cessation of payments". The subject is of such fundamental importance to a true understanding of the impact and consequences of insolvency law that further detailed study will have to be given to it, probably, at an early stage.

28 Certain aspects of commercial law, such as the Sale of Goods Act and the Bills of Exchange Act, were intended to codify the old common law and law merchant and they have in fact stood the test of time remarkably well. Even if it is not possible to assimilate entirely the many disparate elements of our present insolvency laws into one unified code, it may, nonetheless, be possible to identify a sufficient body of common principles as to form the nucleus of a general insolvency act which may have to contain separate sections for particular situations, such as individual debtors, small companies, large companies, deceased insolvents' estates, to name but a few.

THE CONCEPT OF EQUALITY

29 The trend of recent case law has been to exhibit a tug of war between the interests of the general body of creditors on the one hand and individual creditors claiming through their security or "snatch-back" rights to queue jump, not to speak of the overriding rights of preferential creditors which even in the last few years have proliferated, usually in favour of the Crown of Social Security authorities; the attempts of employees to obtain a super-preferential status in the 1973 Bill did not succeed.

30 The House of Lords in the British Eagle case reaffirmed the principle of equality between unsecured creditors and struck down the validity of the airlines clearing house in the context of a liquidation. That decision is probably against the trend which is more

and more to recognise the validity of security interests, eg Romalpa and the pernicious effect of the Yeovil Glove case in 1963 as regards the "washing" of floating charges. It seems that the farsighted provider of credit or supplier of goods (but not services) can with not too much ingenuity queue jump quite legitimately, as indeed can a judgment creditor resorting to executions fairly late in the day (see the recent Boston case). Likewise there seems to be a trend in the courts to protect the "public" if possible, eg the acceptance in Kayford (1975) that deposits paid late in the day to a mail order business were capable of being treated as trust monies. Likewise, in the travel industry, the size and extent of recent failures was such that the public consumer interest was sufficiently vocal to require to be given some safeguards against insolvency, eg the bonding system and statutory help from the government.

31 The moral is that if you have sufficient economic clout or exert sufficient pressure, with luck, you need not find yourself in the ranks of the unsecured. The unsophisticated and naive trader who extends credit is more likely to be the person who will get hurt, as well as, so it is said, the gullible average member of the public.

32 It may be desirable to underline the necessity for a fair and equitable realisation of the debtor's assets, as well as a fair distribution of the proceeds. Restrictions as to the mode and manner of realisation are all very well, but to what extent can they easily be circumvented. Likewise, it may be asked, whether it is really desirable that sales should be advertised of "bankrupt and liquidation stocks". The public may get a bargain, but at the end of the day the unsecured creditors are presumably disadvantaged.

33 The hierarchy of rules for distributing the assets amongst the various creditors was essentially developed prior to the end of the 19th century and the question is to what extent the balance really is correct in today's conditions. It is too early even to hazard a new solution but it may be as well to bear in mind that the courts have recently become much more concerned for the supplier of goods at a late stage, eg in the Texaco case (1973) where petrol was delivered to the debtor before the advertisement of the receiving order and it was held that the trustee could not have the benefit of the petrol without paying for it.

34 In an insolvency situation for every person or group who receives more or fares better, another person or group may receive less or fare not so well. Bankruptcy has been said to be an example in which the general welfare of the community is achieved by mutual sacrifices of various groups in it. It is important, therefore, that the system should be fair and equitable in the demands it makes and the settlements it imposes.

35 If the arrangements for dealing with an insolvency situation are to be fair but are also to be seen to be fair and to command the maximum of support and respect, the need for participation in the working out of the process by creditors or their representatives and the representatives of other interested groups begins to be seen as an important feature. Whether the rules for creditor participation evolved in the 19th century, before the age of mass communication, photocopying machines and a much lower standard of general education are valid today, is, it is suggested, an important question.

36 It is possible that if this question is faced fairly and squarely in the context of something analogous

to "democracy for creditors" it might be much easier to devise a system for imposing a scheme of arrangement or reconstruction upon dissentient creditors and to considerably simplify the present cumbersome machinery (eg under section 206 of the Companies Act) for obtaining court approval to a scheme, even assuming a court approval is always to be a requisite necessity in the absence of unanimity on the part of all concerned.

REHABILITATION

37 Is it sufficient to relieve a debtor of the burden of his debts and allow him either at once or within a reasonable period of time to resume his full place and status in society, leaving the punishment of his misdeeds, if any, to the sanctions of the ordinary criminal law? It is surely anamolous that if my local sweet shop is run by an individual, he can be made bankrupt; if, on the other hand, he is operated through a small company (in the absence of guarantees) he cannot be, assuming no misfeasance or dishonesty. If the two classes of entrepreneur were equated, what should society's attitude to them be? Do they deserve "the stigma of bankruptcy" in any shape or form and should not this ugly phrase be banished from the language, except for fraudsmen?

38 This does not mean to say that a rehabilitation process is not desirable with a view to enabling the debtor to avoid some of his previous mistakes. This is surely of particular relevance to the submerged mass of debtors who do not normally fall into the net of bankruptcy at all but whose cases are dealt with through the machinery of the debt collecting sessions in the county court. A greater degree of training at school about the handling of household budgets could possibly reduce the numbers of these cases a little, but there

is still the problem of the feckless or indolent and the need to provide accountancy advice of a rudimentary nature for them: see the Payne Report in 1969 and the Justice Report.

THE NON-CREDITOR INTEREST DIRECTLY OR INDIRECTLY AFFECTED BY A BANKRUPTCY

39 These include the State (other than in its capacity as a creditor for taxes and in respect of Social Security matters) and society generally which may have an overriding public interest which is expressed on the levels of social and economic concern. In the first place of all the resources the country possesses, its human resources are the most valuable. Secondly, it is recognised that the growth of the country's economic productivity and institutions depends, to a large measure, on the successful resolution of conflicts stemming from the financial difficulties of its citizens. In addition, once it has been accepted then it is in the interests of the country to establish a fair and equitable system for the adjustment of the conflicts between a debtor and his creditors and to relieve and rehabilitate the over-burdened debtor, there is a public interest that the system be not abused.

40 It is possible to develop other more specific interest groups such as employees, their dependants and persons whose livelihood depends on the prosperity of a particular area. The Companies Bill of 1973 expressly recognised some of these interests and it may be desirable to adopt this approach in new insolvency legislation.

41 The need to promote improved standards of commercial morality is recognised in the Bankruptcy Act, eg with regard to the necessity to keep books of account, and there is a catalogue of crimes in the Companies Act which

seeks to deal with such matters. Again the question arises as to whether these codes are satisfactory in today's conditions and whether it would be desirable to treat them on a much more comprehensive and thorough basis.

THE INQUISITORIAL ASPECT

42 Although, as has been seen, this aspect was regarded as an important feature of the 1883 Act as regards individuals, and has its place in the Companies Act, nonetheless the question must arise whether in today's conditions, it plays too prominent a role in insolvency proceedings or whether the information to gist is worth the expense of collecting it. Just as the Insolvency Act 1976 has pointed the way to alleviating the position of undischarged bankrupts, so that Act has gone some way to denote the significance of the public examination, which is essentially a feature of individual bankruptcies and is hardly ever resorted to in winding-up. The trend may have been started, not so much out of concern for the debtor, but due to the costliness of operating the system. Nonetheless to what extent ought the trend be encouraged and accelerated ?

43 In the case of substantial failures the considerations which Mr Chamberlain mentioned in 1883 are now dealt with increasingly by means of the department's enquiries or inspectorships. Is not this the approach for the future?

44 In this respect, having just referred to the Insolvency Act 1976, it may also be worth noting that the strict control previously existing over trustees has been partially relaxed, again because of economic pressures. However, is the general trend desirable?

45 Speaking in 1803 about the United States Bankruptcy Act, modelled on the English Act, an American congressman observed:

> ". . . the commercial world cannot exist without such an Act. Its necessity arises from the nature of trade and doesn't belong to other classes of citizens. It is founded on the principle that commerce is built on great credits and great credits produce great debts. Owing to the risks arising from these and other circumstances, the most diligent and honourable merchant may be ruined without committing any fault. Not so as to the other classes of citizens; either the cultivators of the soil, the mechanics or those who follow a liberal profession. They live on the profit of their labour, not on profit derived from credit."

46 There is the dilemma. Is it really possible to devise a comprehensive system covering non-traders, now coming to be known as consumer bankrupts or debtors, on the one hand and large commercial enterprises on the other? English law in a somewhat haphazard manner has for the last century attempted to do this with a consequent accumulation of anomalies and absurdities far too numerous to enumerate. The foregoing is an attempt to adumbrate some of the arguments in favour of and against a new radical departure.

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