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OESTERREICHISCHE NATIONALBANK

Stability and Security.

WORKING PAPER 109
BANKRUPTCY LAW, CREDITORS'
RIGHTS AND CONTRACTUAL EXCHANGE
IN EUROPE, 1808–1914

JÉRÔME SGARD
WITH COMMENTS BY YISHAY YAFEH



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Editorial

On the 30th of September and the 1st of October 2005 the first Economic History Panel: Past, Present, and Policy, co-sponsored and hosted by Oesterreichische Nationalbank was held in Vienna. The Economic History Panel is a project that is jointly sponsored by the Institut d'Etudes Politiques de Paris and the Center for Economic Policy Research in London. Its motivation is the considerable advances that Economic History has achieved in the past, and the growing recognition of its contribution to shape policy responses and to inspire new theoretical research.

The first meeting on the topic “International Financial Integration: The Role of Intermediaries” was jointly organized by Marc Flandreau (Sciences Po, Paris and CEPR) and Eduard Hochreiter (Oesterreichische Nationalbank). Academic economists and central bank researchers presented and discussed current research and tried to review and assess the historical role of financial intermediaries in shaping the patterns of financial globalization. A number of papers and the contributions by the discussants presented at this panel are being made available to a broader audience in the Working Paper series of the Oesterreichische Nationalbank. A selection of these papers will also be published in the *European Review of Economic History*. This volume contains the third of these papers. The first ones were issued as OeNB Working Papers No. 107 and 108. In addition to the paper by Jérôme Sgard the Working Paper also contains the contribution of the designated discussant Yishay Yafeh.

January 5, 2006

Bankruptcy Law, Creditors' Rights and Contractual Exchange in Europe, 1808-1914

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on 'International Financial Integration'
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Abstract

Recent historical research on bankruptcy has been centred almost exclusively on Common law countries, especially the United States. The consequence is that the research agenda includes issues which may, or may not, have broader relevance. This paper is an attempt at including within a larger historical and comparative perspective the evolution observed in continental Europe, during the 19th century. A data set has thus been assembled which includes the main features of a total of 51 codes or statutes, in 15 countries of all legal traditions. An early conclusion is that all these laws defended strongly creditors' rights during bankruptcy, during the whole period under review. This goes against the thesis defended i.a. by La Porta et alii (1998) which state that "legal origins" have a strong, differentiated effect on property and creditors' rights, which would be permanent over history. Two dimensions are then analysed. First, the status of the failed debtor, and whether he was subjected to repression; second, the degree to which the law supported or not the attempts of the parties to negotiate a composition, or continuation arrangement. An early period witnessed repressive, highly regulated frameworks: the paradigm is the Napoleonic, 1808 *Code de commerce*, though its main features were still highly visible half a century latter, in almost all countries. Then emerged a liberal model, between 1865 and 1885 with again a fair degree of convergence: the personal and civic fate of the debtor became much more immune to commercial failure; and the parties get more autonomy to bargain, though a bifurcation emerged between a "menu approach" to re-negotiation in England and in the French law countries, and a "single-option" procedure in German law countries. Beyond, it is proposed that these broad trends reflect the growing capacity of the institutional environment to reduce risks of moral hazards, and more generally transaction costs. By the end of the century, bargaining on bankruptcy had become easier and safer, so that judicial guarantees could be eased.

1. Introduction

The history and the economics of bankruptcy laws have attracted increasing attention since the 1980's. This surely reflects the renewed importance of this institution in the real world, at a time when many economies were becoming more market-oriented, with agents being put under tougher solvency constraints. But how these laws were designed, and how they evolved over time, has also attracted a lot academic interest for their own sake. From a marginal, almost bizarre research topic, bankruptcy laws have achieved a degree of centrality in many different research programmes.

At one end of the spectrum are various trends in cultural history, who often centre on the “moral economy” of debt and default. They would especially insist on the social representations of bankruptcy, within a long term process of secularisation of economic life¹ - an approach which counts Max Weber among its forerunners. Closer to the institution per se, others have focussed on its actual working, how social actors have invested it, and what impact it had during specific economic episodes: for instance, the short life of the second American federal law (1841-42),² the role of the third federal law (1867-1878) on the economic reconstruction of the South³, or the political economic history of the last-to-date, 1978 law⁴.

Beyond are more general studies, which have tried to provide a broader view of bankruptcy laws. Long-term social histories of failure and bankrupt debtors (rather than bankruptcy laws) have been especially abundant in the case of the English economy.⁵ In the case of the United States, some early works have been mostly descriptive, though they contributed to opening the field and identifying the issues at stake.⁶ A classic example is how the debate on bankruptcy reforms in the United States was shaped, after the Civil War, by the opposition between the rural West and the financial centres of the North-East, polarised by the issue of land exemption. This research trend has seen a recent series of publications by Howard Rosenthal and his colleagues, who have provided new insights into the determinants of bankruptcy reforms in the United States, and to some extent in Europe as well. Typically, they argue, reform attempts emerged after economic crisis or severe downturns, under conservative majority at Congress, and generally in an ideologically charged climate⁷. This approach has been extended by David Skeel to 20th century trends, with a rather close analytical language⁸. The storyline here is that of a century-long cycle : first was an era of stabilisation, helped by a build-up of special interest groups around the 1898 statute, followed i.a. by decline under ill-intentioned New Deal reforms, and eventual resurrection after 1978.

Finally, the last years have witnessed a new interaction between historical and present-day research, under the impact of the “Law and Finance” paradigm. The series of articles published since 1997 by Rafael La Porta, Florencio Lopes-de-Silanes, Andrei Shleifer and Robert Vishny (hereafter LLSV)

¹ See for instance Finn (2003), Anderson (2004), Kessler (2004) also Mann (2003) on the late 18th century American experience.

² Balleisen (2001).

³ Thomson (2004).

⁴ Posner (1978), Carruthers and Halliday (1998).

⁵ See Duffy (1985), Hoppit (1987), Lester (1995), see also Marriner (1980).

⁶ Warren (1935), Coleman (1974)

⁷ Berglöf and Rosenthal (2000 and 2004), Nunez and Rosenthal (2002). Domowitz and Tamer (1997), defend, on the other hand, that bankruptcy reforms are anti-cyclical, over the 1790-1994 period. See Berglöf, Rosenthal and von Thadden (2001) for a paper including Europe.

⁸ Skeel (2001)

indeed illustrate an original use of history⁹. On the one hand they clearly write under the influence of the Northian paradigm, which insists on the role of institutions in supporting property and contractual rights;¹⁰ but on the other hand, they propose a profoundly a-historical view of how institutions interact with economic development. Critically, they argue, the “legal origin” of each country – whether it belongs to the Common Law or to various continental traditions – would have a major, long term impact on the other institutions, and *then* on growth. Other authors then further developed the thesis of a specific, higher flexibility of Common law, which would make it more adequate to the development of market economies.¹¹ In the case of the Common law vs. French law, it has then be argued, a discrete bifurcation at the end of the Middle-Age would have injected the respective countries on two almost idiosyncratic historical trajectories, which they would have then bequeathed to their respective colonies¹². This argument is of special relevance here, as LLSV present bankruptcy as a representative example of how the law bears on financial and economic development.

When these various research directions are considered jointly, some striking common features come to the fore. First, almost as a rule, bankruptcy laws are considered as “a bit more than just an institution”, in spite of their relatively self-contained dimension; in other words they are expected to tell something on how capitalism developed, how the competition between interest groups bear on it, or how this institution should now support growth, eg in developing countries. Second, the notion of an optimal bankruptcy law is hardly on the horizon : most authors would rather underline the large variety of law and, often, their instability over time; the most adventurous, theoretically-inclined, would only defend that an optimum would be at best contingent on the state of the overall institutional environment – which is to say that bankruptcy laws are endogenous to other institutions, a statement which may have substantial policy consequences¹³. Finally, as should be already evident, historical research on bankruptcy is massively centred on Common law countries, especially the United States. Indeed, interest in Civil law countries is minimal.

This article is an attempt to enlarge the geographical horizon of this literature to continental Europe, while keeping a rather long-term view – the whole 19th century. In so doing, a first aim is to revisit a series of issues on which recent (mostly anglo-saxon) research has insisted, thus including French, German and Scandinavian traditions. With this view, a data set of 51 laws or statutes has been collected, on a total of 15 European countries. They extend from the 1808 *Code de commerce*, enacted by Napoleon, to a large array of laws at work in 1914. Of course, broader historical and economic concerns are present, but this is not a social, or a political economic history of bankruptcy : it is first and foremost a formalistic, comparative history of the legal texts. Second, though a wealth of variants and local experiments are observed, the main thrust of the paper is on cross-country, long-term trends during a period where bankruptcy laws have probably seen more changes than during either the 18th or the 20th centuries. This article thus rather contradicts the common emphasis on diversity and volatility, and actually ends up proposing two polar models, which dominated respectively the first half of the period, and the three latter decades under review. Differentiation among countries and legal traditions come out as second rank feature.

The second section of this article presents the data set on European bankruptcy laws and the following discusses the LLSV thesis in its light. Section four analyses how the status of the failed debtor evolved over the century, and insists on the disappearance of the repressive element in bankruptcy. Section five addresses the problem of composition, or continuation agreements, and how they were supported or not by the institution. Before concluding, section seven proposes an analytical hypothesis in order to account for the various evidences collected here.

⁹ La Porta R. et alii (1997 and 1998)

¹⁰ North and Weingast (1989), Milgrom, North and Weingast B. (1990).

¹¹ Beck and Levine (2003), Beck, Demirgüç-Kunt and Levine (2002, 2004).

¹² Glaeser and Shleifer (2001).

¹³ Berkovitch and Israël (1999), Ayotte and Hayong (2004).

2. A Data-base on European Bankruptcy laws, 1808-1914.

In order to analyse the evolution of national bankruptcy laws over the 19th century, 51 legal acts, statutes and codes have been collected for 15 European countries, between the enactment of the 1808 *Code de commerce* and World War I¹⁴. Some countries of course did not exist at the beginning of the period, such as Belgium, the German Reich and Italy, though Prussia and the Kingdom of Piedmont are included in the data set. Furthermore, some countries did not have a unified bankruptcy law before mid-century, as Norway, Finland, and a large part of the Northern German Confederation (outside Prussia). The distribution over time of reforms first shows a minor cycle during the 1840s', then a much larger one, centred on the 1870's and 1880s' (graph 1).

Sources are first the primary legal texts, when accessible (often as a translation); and, as a second-best, a substantial number of 19th century legal treatises, collections of commentaries and textbooks.¹⁵ A serious difficulty is that bankruptcy laws *per se* do not, as a rule, include all elements of economic interest - even when they have been codified. Typically, for instance, the impact of the opening judgements on the commercial and civic rights of the debtor *do not* appear in those texts, but are scattered for instance in the electoral code or in the regulations of the stock exchange; another example is that of mortgages and liens which are ruled by specific, well-developed bodies of law.

From an analytical point of view, 23 main line-items have been documented, with some texts providing more precise information on sub-issues. The emphasis has been put, first, on the core institutional elements, such as the voluntary or non-voluntary character of the law, its extension to non-traders, decision rules, etc. Then are the outcomes of the process such as imprisonment for debt, judicial discretion, the residual rights of execution of creditors, etc. Finally a lot of attention has been given to the various forms of possible accords between the parties, whether they take place within the bankruptcy procedure or in alternate, non-bankruptcy, judicial framework.¹⁶

On the other hand, less attention was given to the respective rights of the institutional players *within* the process (commissioners, trustees, *syndics*, representatives of creditors, bankruptcy judges, etc), or on the balance between officially-driven and privately-driven models. As regard the pro-creditor vs pro-debtor bias in the *outcome* of the various laws, more elements are of course available. However, no attempt has been made to propose an index, or even an overall judgement in this respect : a formalistic approach like this is not sufficient to reach such aggregate, comparative conclusions - if ever feasible. The same view is defended as regard the economic efficiency of the laws, a concept which is not within the horizon of this paper, though, on a case by case basis, more or less influential reforms can be identified.

3. On property rights, LLSV, and European legal history

¹⁴ Austria, Belgium, Denmark, England, France, Finland, Prussia/ Germany, Hungary, Italy, The Netherlands, Norway, Portugal, Russia, Spain and Sweden. Greece, Malta and Switzerland are mentioned occasionally but are not included in the data set.

¹⁵ A further feature of this literature is the extent of serial quotations between authors over time (generally non-referenced). The most telling example is probably the etymology of the word "bankruptcy": generations of authors, over centuries, have traced it to the Italian "banco rotto" which would echo the usage, in the Middle-Ages, to brake the banker's wooden bank after he had defaulted or fled away. But not a single author has founded his affirmation on a single primary reference. See Denisart (1771), Laurens (1806), Blackstone (1811), Renouard (1857), Noel (1919), Hilaire (1986). On the other hand, the French "banque" and "route", while possibly more suggesting in literary terms, are definitely less popular.

¹⁶ 'Arrangement' is used here as a generic term which designs all sorts of agreements with the creditors, which allows the debtor to regain control over the assets and restart commercial operations, after his debt had been either rescheduled or reduced. It thus corresponds to the various compositions, *compromisos*, *concordats* and *contrats d'atermoiement*, mentioned in the various legal texts.

In their attempt to measure and compare how national laws protect creditor's rights during bankruptcy, LLSV (1998) single out four overriding criteria, namely:

- the impossibility for the incumbent management to reorganize the firm during the procedure
- the obligation for any reorganisation plan to be agreed by the creditors
- the capacity to repossess collateral's
- the first priority of senior creditors in the distribution of dividends

On that basis, authors propose a simple, additive index which measures the protection of creditors' rights, from 0 (minimum) to 4 (maximum). They then identify a statistical link between differences observed among countries and their respective legal origin: creditors' rights are better protected, other things equal, in Common law countries, than under the German or Scandinavian traditions, and finally under French law. Gleaser and Shleifer (2001) then further reinforce the historical argument and suggest that the original divergence between legal traditions would be as old as the latter Middle-Age, at least as regard the canonical French vs. Common law opposition. Since then, the respective traditions would have given different priority to the defence of property and creditors' rights.

The data presented here do not confirm this latter argument. The provisions of the collected statutes reflect an overwhelmingly strong defence of creditors' rights, during the whole 19th century, whatever the legal family of each country, its degree of development, religion, etc. Some uncertainty vis-à-vis LLSV's conclusions surely stem from the differences in the economic and institutional contexts. Most strikingly, 19th century bankruptcy laws addressed primarily the case of personal firms – traders, small manufacturers, shopkeepers, etc. – while these authors consider the case of corporations which clearly raise much more complex problem in terms of balance sheets structure, governance and issues of going concern.¹⁷ But even when a degree of adjustment in the criteria is added, it is hard to see how any of these 19th century statutes could qualify for less than a 3 mark, on the 4-mark LLSV scale¹⁸. Here are more detailed elements, linked to the respective criteria (see as well Table 1).

LLSV criteria for a paradigmatic bankruptcy law.

A universal rule in Europe, during the whole 19th century, is that the failed trader would lose the control over, and often the legal property of his assets (personal and commercial) on the day his bankruptcy was declared. Indeed, creditors turned to this institution because they wanted his goods and books seized, his house sealed and correspondence opened. Moreover, on the day bankruptcy was declared, he would also lose the legal capacity to trade – i.e. to sell and buy, pay and borrow, etc.. Even a fresh start would not be possible, unless he would be rehabilitated (often a hard act), or he would obtain a composition agreement, from a qualified majority of creditors, subject to confirmation by the judge. The further some (mainly Civil law) statutes would go in limiting this estrangement was to allow the receivers to call for the debtor's advice while managing his estate – which often meant asking him to help out in the liquidation¹⁹; in some case this would earn him some revenue.

In other words, the opposition between “manager-driven” and “manager-displacing” bankruptcy law does not work during the 19th century.²⁰ A significant element is indeed the very limited attention given to the management of assets during the procedure. Under the early statutes, the receivers were in fact safe-keepers, which would only sell perishable goods. The concern for continuing business activity, as for protecting the going concern value of the estate emerged rather late, mostly in countries under the influence of either the 1808 Code or the German tradition. After mid-century, some texts also included provisions on possible new debts incurred during bankruptcy, as a consequence of trading - again in French and German-influenced areas.

¹⁷ A corollary is that the development on limited liability companies has apparently had only a minimum impact on bankruptcy law : the very concept of such capital structure was of course much older, but the large scale expansion of publicly listed companies came latter.

¹⁸ This confirm the conclusion of ia Bergöf, Rosenthal and von Thadden (2001)

¹⁹ This clause is observed in mostly French law countries such as Belgium, France, the Netherlands and Spain.

²⁰ Skeel (1998), Armour, Cheffins and Skeel (2002).

Legal texts were as well very clear and homogeneous as regard arrangements and compositions. As a rule, the initiative came from the debtor though, as mentioned, qualified majority voting and judicial confirmation were required. Typically, the vote would be counted both in terms of number of creditors and sums of claims, with majority thresholds of three quarters and two thirds respectively. Of course, the bankrupt and its senior creditors would have no voice, and in most countries debt titles had to be certified beforehand by a court official. Beyond, no statute provided the judge with the right to impose an agreement on creditors, if they failed to converge (as with the ‘cram down’ provision of the present US Chapter 11). That is, the default option was always liquidation. On the other hand, in many countries, the judge could oppose a voted agreement, if he considered it non-viable or against the interest of the creditors.

Orthodox conclusions are reached finally on the matter of secured creditors: 19th century laws fully and explicitly protected those rights during bankruptcy, with the collateral provision that senior creditors would not vote on any composition (unless seniority was renounced). The sole limit was that foreclosures were generally stayed when bankruptcy was declared, generally until liquidation was decided. But senior interest payments were generally not stayed. In three countries, however, England, Würtemberg and Malta, the debtor would receive a percentage on the proceed of liquidation, depending upon its overall return; this incentive varied within a (5-10%), (5-8,3%) and (5-10%) bracket respectively²¹. This represented an explicit though limited violation of the principle of absolute priority between investors, though it took the form of cash payment to the debtor, rather than a right to new equity.

A more contentious and un-clear issue is that of the privileged (i.e. statutory, non-contractual) claims of third-parties on the bankrupt’s estate: i.e. claims owned by the Treasury and churches, workers and servants, doctors and pharmacists, inkeepers and undertakers. In some cases, these rights may have infringed upon the interests of secured debtors, especially non-mortgage ones, as they were often classified in the same class or in a class superior to them. The problem is the difficulty of collecting and interpreting the underlying data, which make any overall assessment or comparison quite difficult. The strong impression however is that privileges during the 19th century were not used, on a large scale, as in the 20th century, as instruments to funnel extra-contractual interests into the distributive machine that is bankruptcy. Typically, these were not major policy issues, and the provisions they defined, for instance for wage, rents and tax arrears, would be limited to a year or eighteen months relief, plus a ceiling on the amount being reimbursed.²² Finally, no indication has been found of widespread exemptions from bankruptcy, as is traditionally the case in the United States²³.

From the finality of bankruptcy to its operation

Taken together, this indicates that all European laws during the 19th century were in fact much closer to LLSV’s ideal model than the late 20th century statutes they studied. Yet, as they focus on creditors’ rights, these authors (and others) only explore the finality of this institution: its being a non-market mechanism that reallocates property rights and rewrites debt contracts, so that market transactions can start again after a default. At least as important however is how this aim was reached, at a time when the overall institutional environment of market economies was very weak, and when problem of information were magnified by the geographical extension of markets. The historical sources indeed tell that, when confronted to private defaults, with much wealth at stake, the demand of traders and entrepreneurs were quite clear: they wanted maximum guarantees in terms of equity and transparency, which in practical terms implied debtor control, access to information, verification of claim titles, decision making rules, binding agreements, etc. These pressing and complex demands explain why

²¹ The reference in the case of Malta is an 1815 ordinance on civil procedure; not enough elements were available in order to include it in the data set.

²² An hypothesis would be that the main problems in this respect, including on the cost of procedures (reaching people, verifying their claims, settling contestations, etc), may have rather derived from residual feudal or Ancien Regime rights, rather than modern redistributive issues.

²³ Warren (1935), Posner E. (1978).

bankruptcies have taken a judicial dimension since at least the Middle-Ages. Since then courts are typically the place where private defaults end up.²⁴ The problem, however, is that this apparently banal character – bankruptcy being a judicial procedure – has generally had large, unexpected, and highly disruptive microeconomic consequences. The formal complexity of the process, its mix of incentives and threats, the suspension of many contractual rights, the informational challenges to be addressed, the management of the estate: all these in-built features have been, more often than not, the source of large disappointments, even for benevolent lawmakers. Exiting markets was and remains a most complex and dangerous transition, for all parties.

The corollary is that each bankruptcy statute defines a trade-off between two competing demands: first the primary call for redistributive equity, then the attempt to limit the microeconomic disruptions for the agents as for the markets. The more judicialised the process, it seems, the higher the risks of microeconomic distortions. Historically, variations in this trade-off are indeed quite visible. Well into the 18th century, for instance, bankruptcy laws were shaped as last-resort instruments: creditors would “opt-in” when unable to agree unanimously on a solution, or if they fully mistrust the debtor; but the norm between honest and well-meaning traders was to settle defaults out of court, with as little publicity as possible. Later started the slow evolution towards entrusting judicial institutions with a *de facto* legal monopoly over private defaults, with all possible options being decided from within the court. The Napoleonic 1808 *Code de commerce* comes out at this point as the main paradigm, which dominated the continent until the 1860s’. It was then substituted by a more liberal model, which was much less constraining and threatening for the parties, though without becoming less protective as regards creditor’s rights. How the operation of bankruptcy laws evolved over time, rather than their finality, is indeed the core of this history.

4. The debtor’s status : prison and “la mort civile”.

The repression of debtors has long been a defining pattern of bankruptcy statutes, which in their earliest expressions defined them as outright criminals – « publicos ladrones y verdaderos robadores »²⁵. But even after the procedure had become as well a mechanism for settling private defaults, suspicion and threats remained overly present. Hence the endless attempts by lawmakers, judges and traders to identify and protect the “honest but unlucky” trader: for centuries, disentangling outright fraud from moral hazard, and bad luck would remain a defining dilemma and the source of recurring dissatisfaction with successive reforms. But repression generally remained the priority : still in 1808, the *Code* put all failed debtors into jail, at least for a short exemplary period. This, it is known, was explicitly requested by the Emperor, on his return from Austerlitz. But France, or Civil law countries, were no exceptions in this respect : in all European countries, as in America, lots of debtors ended up in jail. And remarkably prison for debt was not at that time a penal issue, but only an instrument for the creditors or the court to pressurise or control the debtor. It was thought out as a mean to protect private rights rather than public order, and had no necessary link to any possible, post-bankruptcy penal conviction.²⁶

This *de facto*, early convergence between countries was then followed, within a relatively short period of time, by a shift to alternate, more liberal model, which main elements are as well observed in most countries. Whereas in 1865 no country had yet suppressed prison for debt, ten years latter 13 of them, including the most developed ones, had taken this step. Prison had apparently become less needed in

²⁴ An early XIX^o French lawyer noticed that bankruptcies were mainly a problem to be settled by the parties, and that the intervention of the judiciary was most often the consequence of conflicts between creditors, i.e. conflicts on who had which rights in the sharing of assets (Laurens, 1806).

²⁵ Spanish act of 1502, in *Novissima recopilacion de la leyes de Espana* (1831).

²⁶ One of the enigma of the history of bankruptcy law during the 19th century is indeed the utter instability of bankruptcy statutes in England and, even more so, in the US (see Coleman 1999). This trend was already commented at the time with irony by continental jurists (see Lyon Caen, 1881), and was *de facto* much less visible outside the Common Law tradition.

order to ensure cooperative behaviour and control moral hazard. Moreover, comparable evolutions are observed as regard other forms of repression, centred on the commercial and civic rights of the bankrupt.

In order to further assess these long-term trends, a simple, additive four variable index has been calculated, which focuses on prison for debt and the conditions for rehabilitation (see Box 1). Its average evolution indeed reflects the liberalisation of the debtor's status, from the mid-century onwards (Graph 2). This evolution was however not unanimous across countries : when differentiated by legal families or religion, evolutions are quite diverse, though in 1914 a fair degree of convergence is observed beyond for-runners and laggards (Graph 3a & b) :

- Common law countries – both England and the US – already had a tradition and reputation for allowing bankruptcies to have limited social costs (at least for entrepreneurs), so that fresh-start would be easier; as a rule however commercial rights were easier to recover than civic or political ones, which were still affected at the end of the 19th century, in England²⁷.
- The landmark German 1877 law then provided a continental model for a bankruptcy law without any repressive feature, modelled as an almost pure procedural, problem-solving instrument. Its belonging to a continental legal tradition, as well as its large influence in neighbouring countries, made it, in the eyes of many commentators, the actual successor of the 1808 French code.
- France had more difficulty distancing itself from its Napoleonic repressive legislation's: it adopted only in 1888 a new status for lawful debtors, which limited professional costs, though political stigma was still present until the early 20th century²⁸. More generally, French and Scandinavian statutes remained comparatively more repressive till the end of the century.

5. Arrangements and the autonomy of private actors.

In a world of perfect information, the failure to raise new debt, followed by default, would reflect insolvency without delay and uncertainty - bankruptcy would only signal the real economic event. Assets would as well cover exactly debts and liquidation costs, and if ever the going concern had more value than the sum of its parts, an investor would surely buy out individual creditors - capital markets allowing. These propositions have two corollaries as regard the real-life economics of arrangements and bankruptcy, in a world where information problems abound: some firms will always fail which should have survived; and liquidation can be very costly, especially if the markets for capital goods or land are illiquid. In other terms, when the debt and money markets function poorly, there will always be a strong interest for debtors and creditors to be able to agree smoothly on continuation plans. A reliable institution should substitute failing, or under-developed capital markets.

Historically, the older, pre-Code model of arrangement is well-represented by the *contrat d'atermoiement* in Ancien Régime France, which was partly imported from Italy via the Lyons fairs. It was rather supported than restricted by the 1673 Ordinance prepared by Colbert, which open-ended framework as regard the bankruptcy process was not very different from that designed in Amsterdam (1659), Bilbao (1737) or Hamburg (1753)²⁹. On that basis, a process of State-judicialisation unfold which, in a remarkable Tocquevillian way, ended up in the 1808 text. Critically, arrangements between the debtor and the creditors, which until then had been mainly private affairs, subjected to light supervision, were then wholly transferred within a minute judicial process, which stated most exactly when, where and under which conditions the parties could speak up. At the time, however, this was not perceived as an attempt to repress private enterprise and contractual autonomy, but as the best

²⁷ This however applies only to traders, merchants, entrepreneurs, etc.. Small debtors, which today would rather belong to consumer bankruptcy, have traditionally suffered a much harder fate in England ; thousands of them were still imprisoned on the eve of the First World War (Lester 1995).

²⁸ Percerou (1935).

²⁹ Ricard (1722), Savary (1770), *Ordenanzas de la ilustre Universidad* (1794), Saint-Joseph (1844).

possible guarantee offered to creditors against fraud, dissimulation and corruption – which were perceived as the hallmarks of financial work-out techniques under the Ancien Régime.

The striking point, over the following decades, is the extent to which most countries did *not* attempt to inject more flexibility into their respective bankruptcy laws, so as to free the parties from the strictures of judges and officials. The sole object of reforms, in a limited number of countries such as Belgium and Portugal, was the introduction of a *judicial stay* : it would help addressing short-term liquidity problems, provided the solvency of the debtor had been checked and a qualified majority of creditors had acquiesced. New concepts emerged only during the last quarter of the century, which allowed for more complex and comprehensive restructuring agreements, which would i.a. allow bargaining to extend to the asset side of the balance sheet, rather than only liabilities.

This trend is reflected in an index of creditors' autonomy, which adds six variables (Box 2) : it reflects the degree to which the parties were offered one or more options; and then the extent to which the judge had some discretion when confirming the arrangement. A pattern of liberalisation comes out indeed after 1870, which seems even 'steeper' than with the debtor's rights (Graph 3). Brake-down along the religious line then shows Catholic countries being more liberal than Protestant, though this counter-intuitive proposition is then put into perspective by the "legal family" variable (Graph 4a & b): whereas the two leading innovators – England and Germany – had neatly converged in relaxing the costs of bankruptcy for the debtor, they have apparently taken opposite roads as regard contractual bargaining.

England being here an innovator is indeed surprising, considering it had not succeeded, or attempted, before the mid-19th century to offer judicial guarantees to arrangements³⁰. Until that time, apparently, creditors could only choose between unanimity accords under private seal and bankruptcy, which would exclusively lead to liquidation with the only option of granting the debtor a discharge on her residual debt³¹. Still in 1825 and 1849, two partial reforms had proved failures: the majority threshold was too high (9/10 in sums in the former case), and the debtor had to relinquish most of his goods, whereas the aim of an arrangement is to avoid undue liquidation.

The breakthrough came in 1861, when these restrictions were abandoned and bankruptcy became *also* an instrument for restructuring balance sheets. The question, at that point, was whether such accord should be negotiated within or outside bankruptcy per se. In other terms, lawmakers apparently tested the trade-off between judicial guarantees and microeconomic disruptions. After some trial and errors, creditors were then left *de facto* in 1883 with three options:

- a full bankruptcy procedure leading to liquidation, with the possibility for the judge to grant a discharge – a kind of augmented Roman *cessio*;
- a continuation or self-liquidation plan, decided outside formal bankruptcy, with limited personal costs to the debtor, but still under tight judicial oversight (the debtor lost the control over assets, he was publicly interrogated, the judge had substantial power to reject the voted plan, etc);
- finally, a high-majority, low oversight formula was close to the past, unanimity *deeds of arrangements*, and appeared to be the favourite option of private agents, as became clear once registration and some publicity rules were introduced in 1887.

Basically, the German (1877) and also the Belgian (1883) reformers then proposed alternate, continental answers to the very same dilemma, formulated on the basis of their respective legal

³⁰ This point will be checked with Forsyth (1854); this anti-arrangement feature is however also apparent in the United States, where they were only introduced in the third federal law on bankruptcy, in 1867.

³¹ For this reason, the debt discharge introduced in 1705, however important in English legal history, does not come out as a major historical innovation, as is often suggested (McCoid, 1986). At that time, the rule was well established on the continent, but it took place within arrangements which were then subjected to more or less stringent clauses for confirmation; this pattern remained until the early 20th century within more or less rigid *concordats*. The true, revolutionary English innovation was in fact to transfer the responsibility of debt discharge from a qualified majority of creditors to the discretion of the judge, in 1843.

traditions, institutions and special interests. As mentioned, the 1877 German reform established an integrated framework, with no intended personal costs to the debtor. Lawmakers then concluded that all forms of arrangements could actually take place within this modern and economical procedure, together with outright liquidation. Belgian reformers however took the opposite direction and opted, with England, for a two-track approach : they invented the *Concordat préventif*, which was to have a large following, especially in French and Scandinavian law countries. The distressed debtor could thus ask to negotiate an arrangement under some judicial oversight, though without entering bankruptcy. For instance, he would not lose control over his assets and his obligations in terms of provision of information were more limited. But if he failed to obtain qualified support to his proposal, he would then be shifted to bankruptcy *per se*.

The logic of the Belgian and English innovations was in fact to bring bankruptcy back to its (Roman) origin, as a pure liquidation device, with compositions being transferred to an alternate framework; Italy indeed took this logic to its ultimate conclusion, in 1903, when it adopted the Belgian model and completely dropped the old-style *concordat* from its law. Here bankruptcy was still perceived as a disruptive, costly event in spite of being less socially repressive: contrary to what the Germans had concluded, liquidation and continuation did not warrant the same cost/ benefit trade-off.

Two possible reasons for this evolution can be proposed : the growth of industrial corporate firms, with large going concern values, which had to operate during financial restructuring, unless large costs would be suffered by the creditors, then the expansion of large, though often volatile, security markets which in many countries were to play an increasing role in the valuation of assets and the restructuring of liabilities. Both phenomena would indeed call for minimising the legal and contractual consequences of entering a restructuring procedure, even after all repressive features had been shed. These innovations should be compared to the extension of equity receiverhip in the United States, especially in the case of railways companies³². Only case by case monographs would tell whether these variables were indeed perceived by the late 19th century reformers; they may also tell whether the German option reflected specific patterns of economic development in this country, or other factors. By 1914 however, the outcome of the competition between legal innovators was rather clear: 10 countries had adopted a twin-track, Anglo-Belgian approach, and only five remained with an integral, German model³³.

6. Conclusion.

A data-set of 51 European laws and statutes has documented the evolution of bankruptcy procedures between 1808 and 1914. Some topical issues in the existing, mostly American literature surfaced as well from European experiences, such as the long debate on imprisonment for debt or the fate of the “honest but unlucky trader”. On the other hand, the struggle around voluntary bankruptcy had no equivalent on the Continent. Another issue is the English debt discharge which looks, with hindsight, much less original than is often assumed, though it underlines an indeed remarkable pattern : the long resistance to, or the lack of demand in England for an *ex post* confirmation of private arrangements by the judicial power. This apparently reflects a very specific relation between contractual exchange and judicial institutions.

Beyond, a key conclusion is that the protection of creditors’ rights was at the very core of these statutes, during the whole century, in all countries. The differentiated, permanent relationship defended by LLSV between legal traditions and the rights of owners and creditors did not come out. There are surely strong elements of continuity in the law *per se*, in its founding concepts, in how the judicial institutions work, or in the professions which inhabit them. But there is no such thing as an “essence” of legal traditions, which would travel untouched through centuries, like a silent meteor, and

³² see Martin, 1974 and Skeel, 2002.

³³ See table 4, the different variants of *Concordat Préventif* adopted in European countries.

always shape property and creditor's rights in the same, a-historical way.³⁴ The relation with actual rights and market interactions is also contingent upon the historical context and economic conditions – including microeconomic ones. Traditions, as historians have known for long, survive and evolve over time, as they are reinvented by agents, confronted to new problems and opportunities.

A good example is provided here by the Common law experience : its originality comes out strongly over the period under review, though its opposition to Civil law statutes was not the same in 1808 as in 1914. Within this larger grouping some countries also innovated (such as Belgium), while others were followers (The Netherlands during the whole century, France over its second half). Some were as well more flexible as regard relaxing the bankrupt's status, while others had a keener eye for contractual autonomy. Moreover, the case of arrangement and compositions presented the case of a bifurcation between countries, which emerged within a few years and had then lasting effects, some of them still visible today : by the end of the century, English law and to lesser extent French legal tradition offered a differentiated menu of options, whereas German lawmakers opted for a one-entry framework, that is less contractual flexibility³⁵. Law, in other words, is definitely a serious question for economists and economic historians : this article tried to illustrate how legal history could find its way in their research. But this conclusion is much less clear for legal traditions: correlations are visible between countries, but we do not really know why these traditions may matter, and we may even not know how to interpret them in economic terms.

Rather than a questionable “origin”, the evolution of bankruptcy laws reflects that of a defining trade off, between two competing demands: one for guarantees of information and inter-creditor equity, which calls for judicialisation; the other for less microeconomic disruptions, which rather demand less interventions into the legal and contractual rights of the parties, as into their rules of interaction. A working hypothesis would propose that this trade-off is determined by the broader economic and institutional environment : property rights generally speaking, capital markets, the banking and payment systems, information channels or instruments of social controls.³⁶ In other words, negotiating on private defaults should be considered as just a specific case of contractual exchange, subjected to standard transaction costs : problems of information, moral hazards, commitments and incentives, etc.

The two successive paradigms which have been identified here would then reflect the changing conditions under which this trade-off was made. The first, highly constraining Napoleonic model, which dominated until the 1860s', would reflect an environment where controlling moral hazards and enforcing contractual commitments was still difficult and often unpredictable. Heavy-handed intrusion into personal and contractual rights would have been the ultimate instruments to satisfy that elementary rule of capitalist economies – the protection of creditors' rights. Then, between 1865 and 1885, the emerging liberal model would correspond to an economic and institutional environment where market discipline had become much stronger and where, possibly, the demand for less microeconomic disruptions had also increased.

Critically, it can be hypothesised, reduced informational problems and less volatile liquidity, at the individual and aggregate levels, had two consequences for the operation of bankruptcy : the risk of undue failure became more limited (the institution was better at screening exits); and the potential for tactical defaults, evasion, and more generally moral hazards became correspondingly smaller. Non-market civic threats on the debtor could thus be shed and more discretion to negotiate could be given to the parties, though without apparently economising on their judicial guarantees. In other words, the cost/ benefit trade-off of judicialisation had become more advantageous : contracting on property rights had become safer and less costly – including outside markets.

³⁴ Musacchio (2005) reach a similar conclusion in the case investors' and creditor's right in Brazil, which appear to have fluctuated widely over time.

³⁵ See also on this Lamoreaux and Rosenthal (2005).

³⁶ This broadly converge with Ayotte and Hayong (2004), who argue that the lower contract enforcement and the quality of information, the more bankruptcy are to be pro-creditor.

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Box 1 – The bankrupt's status, an index

- Is prison for debt a standard feature, or is it limited to open misconduct, bad faith behaviour, etc?
- Can the debtor be freed, once he has transferred all his wealth to his creditors?
- Is rehabilitation a normal outcome of bankruptcy closure?
- Do traders and non-traders follow the same basic procedure?

Box 2 – Contractual autonomy, an index

Are there pre-conditions to the confirmation of an arrangement, in terms of i.a. minimal return?

Does the law include an out-of-bankruptcy, judicial moratorium (or stay) for solvent but illiquid debtors?

Does the law allow broader, out-of-bankruptcy arrangements, with judicial oversight and confirmation ?

Does such arrangement require pre-conditions, in terms i.a. of minimal return?

Are there legal guarantees to extra-judicial arrangements?

Does the law allow the receivers to engage into active trading on behalf of the creditors?

Annex 1

Major bankruptcy laws adopted between 1814 and 1914 in Europe

Austria

1859, law on bankruptcy
1865, end of prison for debt
1869, reform of the law on bankruptcy
1885, new bankruptcy law

Belgium

1830, inherits the French 1808 Code
1851, reform of the bankruptcy law
1871, end of prison for debt
1883, introduction of the non-bankruptcy composition

Denmark

1842, law on bankruptcy
1872, law on bankruptcy,
end of prison for debt
1887, reform of the law
1905, non-bankruptcy composition

England,

1814, reform of the bankruptcy law
1826, reform of the bankruptcy law
1831, reform of the bankruptcy law
1843, reform of the bankruptcy law
1849, reform of the bankruptcy law
1861, reform of the bankruptcy law
1869, reform of the bankruptcy law,
end of prison for debt
1883, reform of the bankruptcy law

France

1808, Code de commerce
1838, new bankruptcy law
1866, end of prison for debt
1889, non-bankruptcy composition
1905, reform of the bankruptcy law

Finland

1868, law on bankruptcy

Germany/ Prussia

1855, Prussian bankruptcy law
1877, law on bankruptcy, end of prison for
debt
1898, partial reform of the bankruptcy law

Hungary

1842, law on bankruptcy
1881, law on bankruptcy

Italy

1842, commercial code (Kingdom of
Piedmont & Sardinia)
1882, new commercial code,
end of prison for debt
1903, non-bankruptcy composition

The Netherlands

1814, inherits the 1808 Code de commerce
1838, reform of the commercial code
1893, reform of the commercial code,
end of prison for debt

Norway

1863, law on bankruptcy
1874, end of prison for debt
1899, non-bankruptcy composition

Portugal

1833, new commercial code
1888, new code oommerce,
1899, non-bankruptcy composition

Russia

1826, *Digest* of commercial law
1903, non-bankruptcy composition

Spain

1829, new commercial code
1885, new commercial code
1897, reform of the non-bankruptcy
composition

Sweden

1830, ordnance on bankruptcy
1862, new bankruptcy law

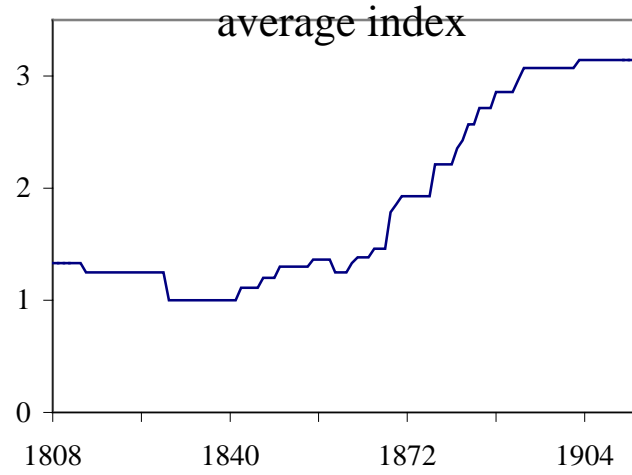
Switzerland

1874, end of prison for debt
1889, first federal law on bankruptcy

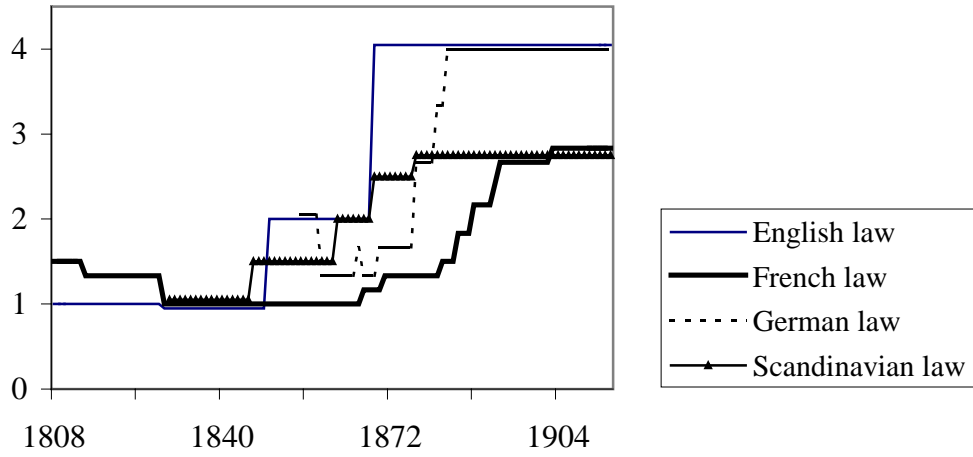
Table 1 - 1865-1885 : towards a new bankruptcy model

The decline of the Napoleonic model		Continuation and Reorganisation		
Traders and non traders joint procedure	Official end of prison for debt	'Old-way' judicial stay	Extra-bankruptcy framework	Within-bankruptcy framework
Denmark, 1846 Austria, 1866 Finland, 1868 England, 1869 Germany 1877 Hungary 1881 Netherlands 1893	Austria, 1866 France, 1866 England, 1869 Belgium, 1871 Germany, 1871 Ireland, 1872 Denmark, 1872 Norway, 1874 Switzerland, 1874 Sweden, 1877 Scotland, 1877 Italy, 1882 Netherlands, 1893 Greece, 1900	The Netherlands, 1814- Belgium, 1830- Portugal, 1833- France, 1848 and 1871 Prussia, 1855-1877 England, 1849-1861 Russia, 1826-1903	England, 1889-1883 Belgium, 1883 Spain, 1885-1897 France, 1889 Switzerland, 1889 Portugal 1899 Norway, 1899 Italy 1903 Russia 1903 Denmark, 1905	Austria Germany Hungary The Netherlands Sweden

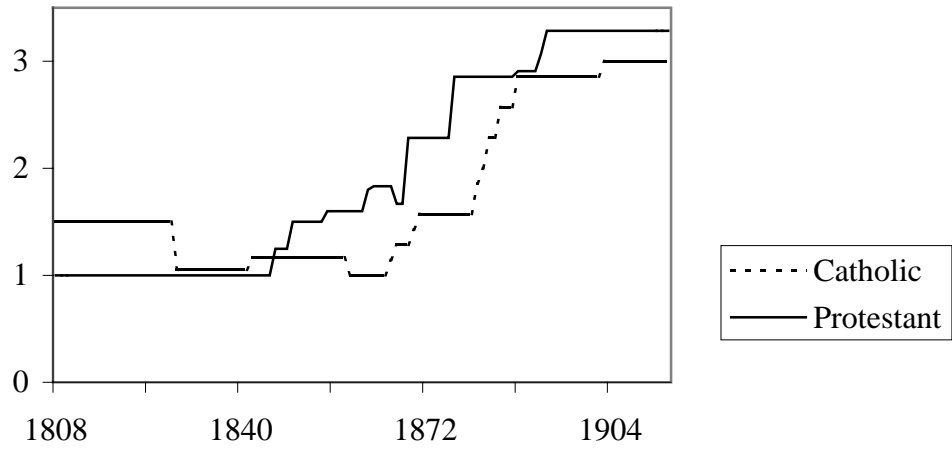
Graf 1 - The liberalisation of the debtor's status,
status,



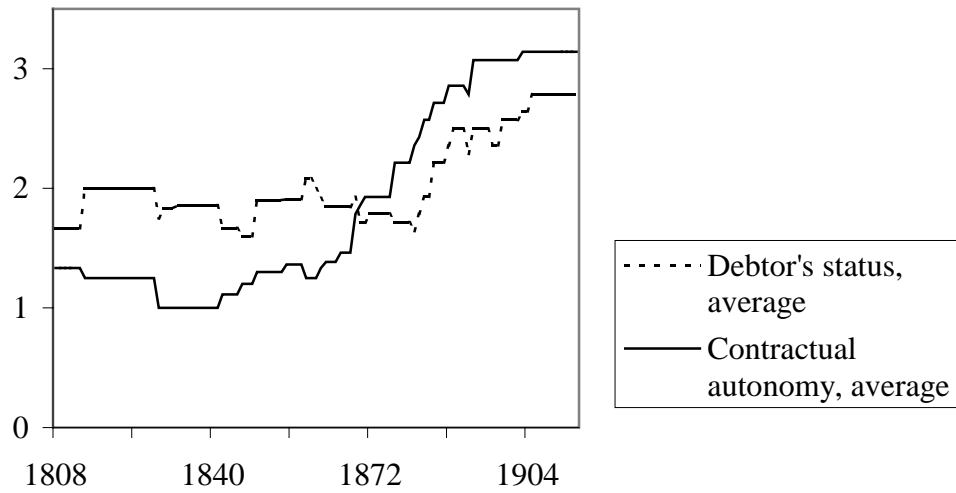
Graph 2a - The debtor's status: legal tradition



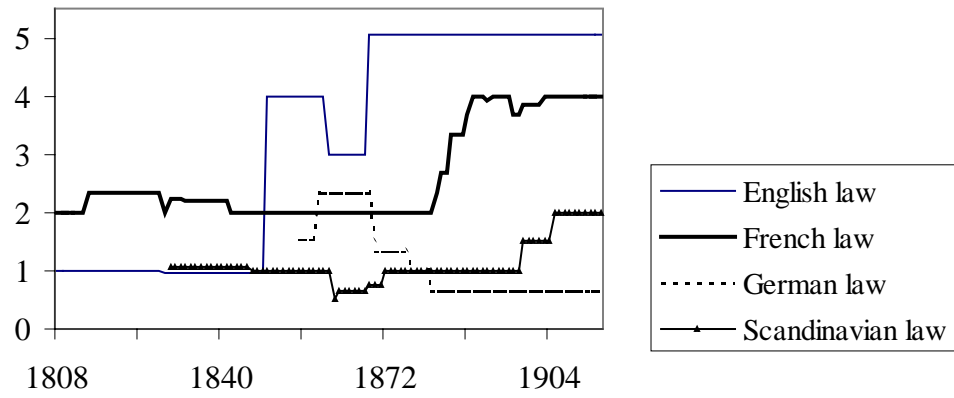
Graph 2b - The debtor's status: religion



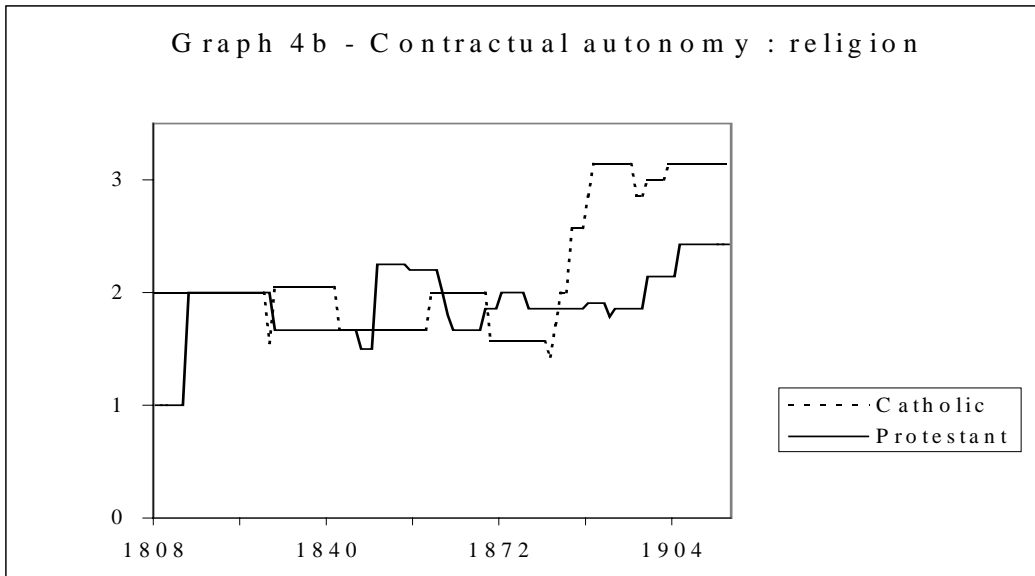
Graph 3 - The debtor's status and contractual autonomy: average indices



Graph 4a - Contractual autonomy: legal tradition



Graph 4b - Contractual autonomy : religion



Discussion

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The paper compares the evolution of bankruptcy law across a large number of European countries. It offers a wider scope than most comparisons, and this is one of the great merits of this paper. The main finding is a striking similarity in the evolution bankruptcy laws in the 19th century across Europe, which appears to contradict the standard La Porta et al. (1997, 1998) view of the world (henceforth abbreviated to LLSV).

The main shortcoming of the paper is that, in its present form, it is not guided by clear, refutable hypotheses and does not “look” like most papers in economics. The focus of my discussion will therefore be on setting up a series of hypotheses that the (very nice) data in this paper can support or refute.

- (1) Does the author think that bankruptcy laws TODAY differ substantially across countries? If the answer is YES, when and how did the differences emerge? Rajan and Zingales (2003) document “Great Reversals” in the extent of financial development across countries starting in the early 20th century. France or Japan, for example, used to have active stock markets, but political and other changes negatively affected them later on. The present paper can document changes in legislation and examine if those are correlated with the decline in financial markets in some countries, as the LLSV view of the world might suggest. If the author's answer is NO, that is, he disagrees with the common perception that investor protection in some (typically civil law) countries is weaker than in others, why did LLSV get the wrong impression? Is it

because of the measures they use in their empirical analysis of investor protection around the world?

- (2) If bankruptcy laws were indeed similar in the past, were there important differences across countries in informal institutions upholding the rights of investors? The role of informal methods of investor protection has often been raised as a counter-argument to the legalistic focus of the LLSV view of the world: for example, work by Franks, Mayer and Rossi on informal corporate governance in the UK suggests that there may have been substitutes to formal legislation. See also work on the Corporation of Foreign Bondholder in new Mauro-Sussman-Yafeh OUP book.
- (3) A related question: Is there systematic evidence on differences in the application of the law in different countries? Again, the LLSV-based literature emphasizes the extent of legal enforcement, not just the letter of the law as it appears in legal texts. Some parts of the present paper seem to imply that England, for example, was different from other countries in the sample in the way certain laws were interpreted and implemented.
- (4) And an unrelated question: do we know anything on shareholder protection, if there was any? Did it develop in tandem with the development of creditor protection documented in this study? Shareholder protection could be very important for the development of financial markets – again, see LLSV (1997 and 1998).
- (5) If creditors were equally protected across Europe, what might explain variations in the development of debt instruments and markets, if there were any? The LLSV view of the world regards investor protection as a primary determinant of the development of financial markets. Was this really the case? If not, can differences in the extent of (perhaps informal) investor protection across countries be related to different degrees of financial development?

(6) And a political economy question: what triggered the new legislation in France in the early 19th century (and elsewhere)? Perhaps the existing informal institutions were no longer adequate? A growing recent literature has emphasized the political economy of financial markets and investor protection (e.g. Pagano and Volpin, 2005). Are the observed changes in the historical data consistent with modern arguments on the extent of investor protection as an outcome of some political processes?

In sum, this is a potentially very interesting paper, which is not yet set up to make the most of the fantastic data collected. It would be great if the author could propose tests and answers to some “big” questions in the law and finance literature using the material gathered.

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