

# The liberalisation of bankruptcy law in Europe, 1808-1914

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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 19<sup>th</sup> 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 strong elements of *de facto* convergence : the personal and civic fate of the debtor became more immune from his commercial failure, and the parties get more autonomy to bargain. It is proposed that these 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 life<sup>1</sup> - 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),<sup>2</sup> the role of the third federal law (1867-1878) on the economic reconstruction of the South<sup>3</sup>, or the political economic history of the last-to-date, 1978 law<sup>4</sup>.

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.<sup>5</sup> 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.<sup>6</sup> 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, with the issue of land exemption a core one. 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 climate<sup>7</sup>. This approach has been extended by David Skeel to 20<sup>th</sup> century trends, with a rather close analytical language<sup>8</sup>. The storyline here is that of a century-long cycle : first was an era of eventual stabilisation, helped by a build-up of special interest groups around the 1898 statute, followed 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 (here LLSV) indeed

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

<sup>2</sup> Balleisen (2001).

<sup>3</sup> Thomson (2004).

<sup>4</sup> Posner (1978), Carruthers and Halliday (1998).

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

<sup>6</sup> Warren (1935), Coleman (1974)

<sup>7</sup> 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.

<sup>8</sup> Skeel (2001)

illustrate an original use of history<sup>9</sup>. 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;<sup>10</sup> 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. In the case of the Common law vs. French law, 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 colonies<sup>11</sup>. 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 consequences<sup>12</sup>. 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 19<sup>th</sup> 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 18<sup>th</sup> or the 20<sup>th</sup> 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.

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 six 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.

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

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<sup>9</sup> La Porta R. et alii (1997 and 1998)

<sup>10</sup> North and Weingast (1989), Milgrom, North and Weingast B. (1990).

<sup>11</sup> Glaeser and Shleifer (2001).

<sup>12</sup> Ayotte and Hayong (2004).

In order to analyse the evolution of national bankruptcy laws over the 19<sup>th</sup> 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 I<sup>13</sup>. 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 19<sup>th</sup> century legal treatises, collections of commentaries and textbooks.<sup>14</sup> 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, 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.<sup>15</sup>

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

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

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<sup>13</sup> 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.

<sup>14</sup> 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.

<sup>15</sup> '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.

- 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

The authors 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 19<sup>th</sup> 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, 19<sup>th</sup> 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.<sup>16</sup> But even when a degree of adjustment in the criteria is added, it is hard to see how any of these 19<sup>th</sup> century statutes could qualify for less than a 3 mark, on the 4-mark LLSV scale<sup>17</sup>. Here are more detailed elements, linked to the respective criteria (see as well table 2).

*LLSV criteria for a paradigmatic bankruptcy law.*

A universal rule is that the 19<sup>th</sup> century failed European trader lost 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 loose 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 agreements, from a qualified majority of creditors, subject to confirmation by the judge. The farther 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 liquidation<sup>18</sup>; 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 19<sup>th</sup> century.<sup>19</sup> 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 trading activities, for the common good of creditors, emerged rather late, mostly in countries under the influence of either the 1808 Code, or the Prussian, then 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.

The rules 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 in both sum and number, with majority thresholds of three quarters and two thirds respectively, with no voice of course for the

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<sup>16</sup> 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.

<sup>17</sup> This confirm the conclusion of ia Bergöf, Rosenthal and von Thadden (2001)

<sup>18</sup> This clause is observed in mostly French law countries such as Belgium, France, the Netherlands and Spain.

<sup>19</sup> Skeel (1998), Armour, Cheffins and Skeel (2002).

bankrupt; 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); in other terms, 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: 19<sup>th</sup> 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 respectively<sup>20</sup>. 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 19<sup>th</sup> century were not used, on a large scale, as in the 20<sup>th</sup> 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.<sup>21</sup> Finally, no indication has been found of widespread exemptions from bankruptcy, as is traditionally the case in the United States<sup>22</sup>.

#### *From the finality of bankruptcy to its operation*

Taken together, this indicates that all European laws during the 19<sup>th</sup> century were in fact much closer to LLSV’s ideal model than the late 20<sup>th</sup> 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 rewrite 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 growing extension of markets. The historical experience indeed tells that, when confronted to private defaults, with much wealth at stake, traders and entrepreneurs had quite clear demands. They wanted maximum guarantees in terms of equity and transparency, which in practical terms means debtor control, access to information, verification of claim titles, decision making rules, binding agreements, etc. These pressing and complex demands explain why bankruptcies have taken a judicial dimension since at least the Middle-Ages. Courts are typically the place where private defaults end up.<sup>23</sup> The problem, however, is that this apparently banal character – bankruptcy being a judicial procedure – has had large, unexpected, and highly disruptive microeconomic consequences. The formal complexity of the process, its mix of incentives and threats,

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<sup>20</sup> 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.

<sup>21</sup> An hypothesis would be that the main problems in this respect, including on the cost of procedures (reaching people, verifying their claims, settling testations, etc), may have rather derived from residual feudal or Ancien Regime rights, rather than modern redistributive issues.

<sup>22</sup> Warren (1935), Posner E. (1978).

<sup>23</sup> An early XIX<sup>e</sup> 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).

the suspension of many contractual rights, the informational challenges to be addressed: all these in-build features have been, more often than not, the source of large disappointments, even for benevolent lawmakers.

In other terms, each bankruptcy statutes reflects a given 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 18<sup>th</sup> 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 at the main paradigm, which dominated the continent until the 1860s’, but was then substituted by a more liberal model : it proved 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 »<sup>24</sup>. But even after the procedure had also become a mechanism for settling private defaults, suspicion, threats and punishment remained overly present. Of course, for centuries, the law, the jurisprudence, and merchants’ textbooks discussed at length how to differentiate the “honest but unlucky trader” from the rogue one. But still in 1808, the *Code* would put them all 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 real exceptions in this respect : in all European countries, as in America, lots of debtors ended up in jail. And remarkably, at that time, prison for debt was not 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.<sup>25</sup>

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 order to ensure cooperative behaviour and control moral hazard. Moreover, the same 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 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 (Graph 3a & b) :

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<sup>24</sup> Spanish act of 1502, in *Novissima recopilacion de la leyes de Espana* (1831).

<sup>25</sup> One of the enigma of the history of bankruptcy law during the 19<sup>th</sup> 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.



- 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 19<sup>th</sup> century, in England.
- 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 injury, though political stigma was still present until the early 20<sup>th</sup> century. 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'atermoient* 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)<sup>26</sup>. On that basis, a process of State-judicialisation unfolded 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 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*.

What is striking is the extent to which, over the following decades, 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, was the introduction of a *judicial stay*: this which 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

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<sup>26</sup> Ricard (1722), Savary (1770), *Ordenanzas de la ilustre Universidad* (1794), Saint-Joseph (1844).

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-19<sup>th</sup> century to offer judicial guarantees to arrangements<sup>27</sup>. 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 debt<sup>28</sup>. 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 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 loose 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

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<sup>27</sup> 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.

<sup>28</sup> 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 20<sup>th</sup> 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.

disruptive, costly event in spite of being less socially repressive : liquidation and continuation did not call for the same cost/ benefit trade-off, contrary to what the Germans had concluded.

A first possible reason is the growth of industrial corporate firms, with large going concern values : they had to continue to operate during financial restructuring, unless large costs would be suffered by the creditors. Then was 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 : again the legal and contractual consequence of even a non-repressive bankruptcy may cause serious disruptions<sup>29</sup>. Case by case monographies would tell whether these variables were indeed perceived by the late 19<sup>th</sup> century reformers; they may also tell whether the German option reflected specific patterns of economic development, 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 model<sup>30</sup>.

## 6. Conclusion.

A data-set of 51 European laws and statutes has helped documenting the evolution of bankruptcy procedures between 1808 and 1914. *Vis-à-vis* the existing, mostly American literature, some topical issues surfaced as well from European experiences, such as the long debate on imprisonment for debt. On the other hand, the struggle around voluntary bankruptcy had no equivalent there. Another issue is the English debt discharge which looks, with hindsight, much less original than 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.

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 : it cannot be considered as intrinsic. 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 always shape property and creditor's rights in the same, a-historical way.<sup>31</sup> The relation with actual rights and market interactions is also contingent upon historical contexts 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.

This survey provides many examples of how national laws evolved, become sometimes more differentiated but also converged over the 19<sup>th</sup> century, as they interacted with other dimensions of economic development. For instance, the originality of the Common law experience comes out strongly, 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. The case of arrangement and compositions then showed that a bifurcation between countries could emerge within a few years and have lasting effects, some of them still visible today. Law, in other words, is definitely a serious question for economists and economic historians, but this is much less clear for

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<sup>29</sup> In this sense, the emergence and succes of extra-bankruptcy accords such as the *Concordat Préventif* can be compared to extension of equity receiverhip in the United States, especially in the case of railways companies (see Martin, 1974 and Skeel, 2002).

<sup>30</sup> See table 4, the different variants of *Concordat Préventif* adopted in European countries.

<sup>31</sup> Musacchio (2005) reach a similar conclusion in the case investors' and creditor's right in Brazil, which appear to have fluctuated widely over time.

legal traditions: correlations are visible between countries, but we don't really know why they may matter, and we may even not know how to interpret them in economic terms.

Rather than a questionable "origin", it has been argued in this paper that 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, at this point, is that this trade-off would be 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.<sup>32</sup> 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 main paradigms which have been identified 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.

Critically, it can be hypothesised, reduced problems of information and less volatile liquidity, at the individual and aggregate levels, had two consequences for the operation of bankruptcy : the risk of undue failure was more limited (exits were better screened), and the potential for tactical defaults, evasion, and more generally moral hazards were smaller. More discretion to negotiate could thus be given to the parties, and non-market civic threats on the debtor could be shed, though without economising on the judicial guarantees of creditors. Apparently, the cost/ benefit trade-off of judicialisation had become much more advantageous, thanks to changes in the environment. Contracting on property rights had become safer and less costly – including outside markets.

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<sup>32</sup> 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*

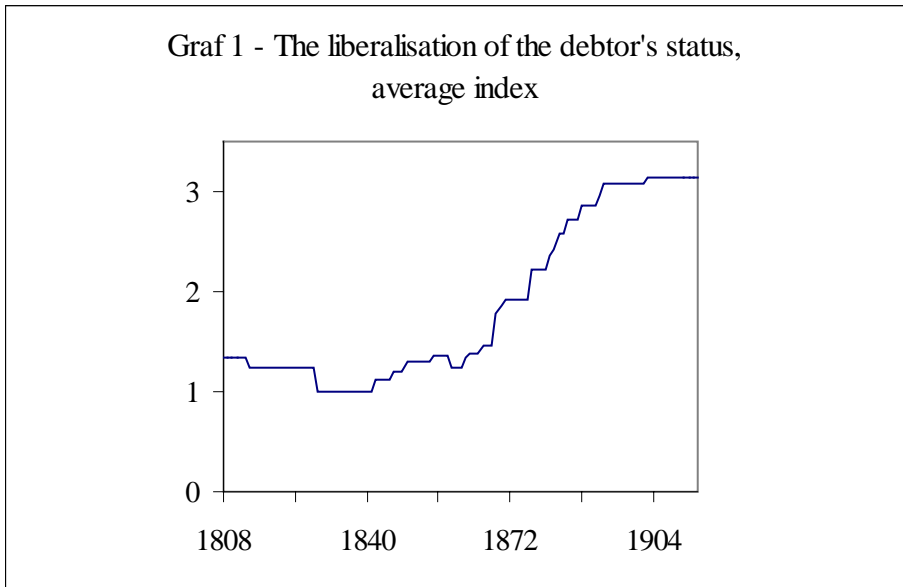
1874, end of prison for debt  
1889, first federal law on bankruptcy

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

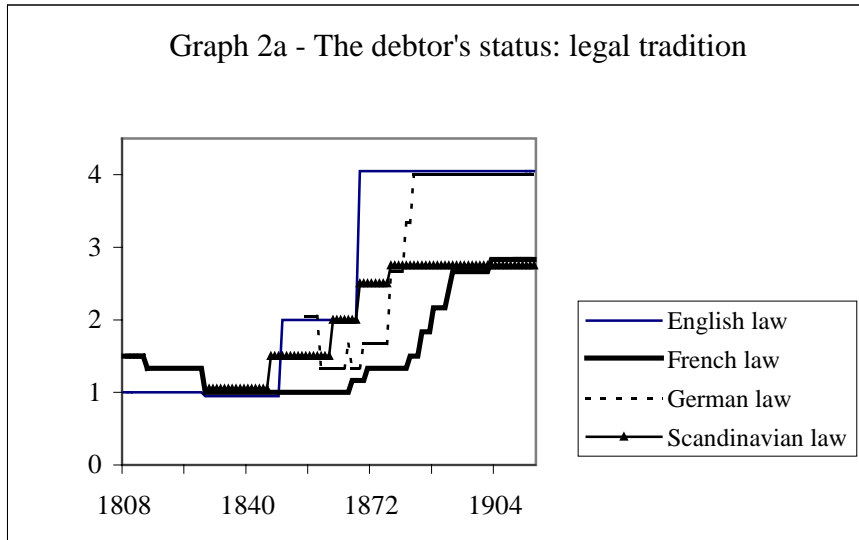
<b>The decline of the Napoleonic model</b>		<b>Continuation and Reorganisation</b>		
<b>Traders and non traders joint procedure</b>	<b>Official end of prison for debt</b>	<b>'Old-way' judicial stay</b>	<b>Extra-bankruptcy framework</b>	<b>Within-bankruptcy framework</b>
Denmark, 1846 Austria, 1866 Finland, 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,  
average index

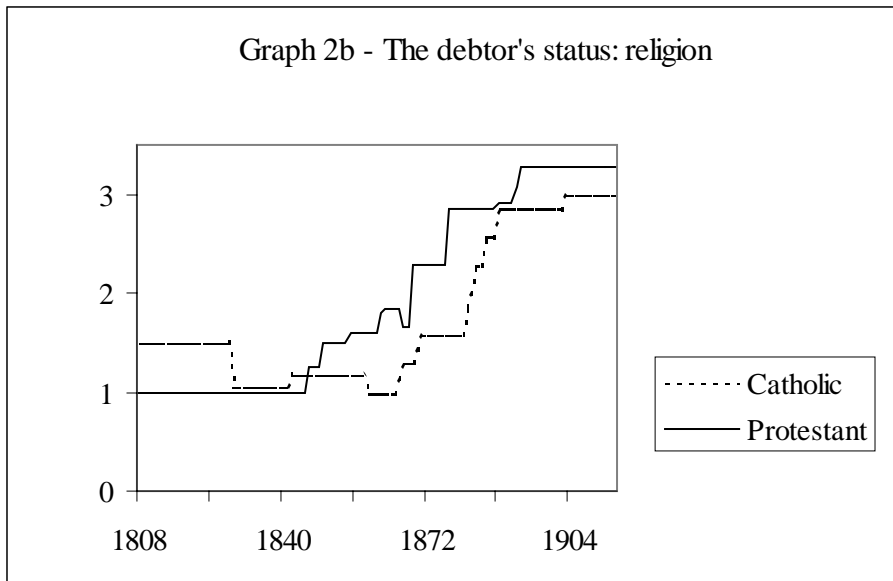


Graph 2a - The debtor's status: legal tradition

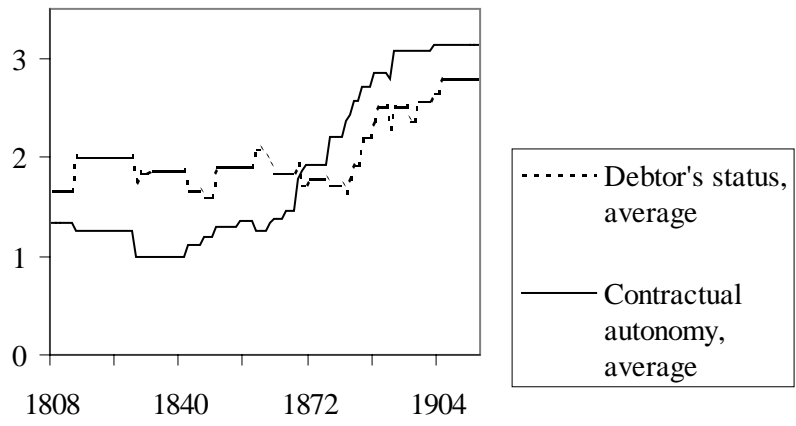




Graph 2b - The debtor's status: religion



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



Graph 4a - Contractual autonomy: legal tradition

