Optimising Fairness in Insolvency and Restructuring: a Spotlight on Vulnerable Stakeholders

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I. Introduction

Between 2019 and 2022 there have been significant and rapid changes to the global economy. The whole market was revealed to be vulnerable to the pandemic only a massive state response contained the damage. The COVID 19 pandemic has revealed many weaknesses in the approach to healthcare, social protection, and many other areas of society that can be affected by the economic shock. particularly acute have been the issues around the financial difficulties that have beset small and medium sized companies, not to mention the individual financial impact. Not only have individuals and institutions been forced to face their own vulnerabilities, but the universal nature of vulnerability was shown by the impact of the pandemic through its effect on the fundamental pillars of societies and polities all over the world.

The ability to respond to vulnerability is the relative resilience of an individual or an institution. Resilience is the key to understanding both the impacts of the pandemic and whether the insolvency and rescue system works adequately to deal fairly with the relative vulnerabilities of its various stakeholders. Modern insolvency law frameworks respond well to the vulnerability of the secured creditor, for example, as it serves to give these stakeholders power in the process while also strongly supporting the recovery of their losses; however, this responsiveness is less impressive relative to other categories of less powerful stakeholders, such as employees, tort victims, and environmental claimants. As noted in a conversation between the author and Graham Ferris, expert in the field of vulnerability theory, 'to treat major financial institution and individual creditors or employees or victims of corporate misfeasance "equally" is obviously absurd.' Financial institutions can secure their risks in lending contracts and although the state does respond to some of the vulnerabilities of employees by assigning them preferential status, this can be inadequate protection in practice, particularly in a liquidation scenario which will also leave customers, trade suppliers and tort victims to the wolves. Every insolvency stakeholder is vulnerable, but only some have their risk of harm adequately mitigated through the legal structures of insolvency law. Thus, although vulnerability is shared, the assets that support resilience, which include powers, rights and control over processes, are most unequally distributed by the current system in that it gives first priority to the already powerful financial institutions which are already more able to use their power to conclude favourable contracts and whose efforts in both litigation and lobby have been effective in maintaining a system that makes their resilience a first priority in the system itself.[1]

The pandemic experience may be a challenge to the status quo in the way that financial distress resolution is viewed. There have always been conflicting areas of interest in the intersection of corporate rescue and restructuring and overall fairness in the way rights are managed and distributed. Whereas wealth maximisation tends to continue to underpin the overarching goals of collective procedures, whether they are rescue-oriented or not, fairness brings to mind broader interests among stakeholders who may not be contractually connected to the company, such as tort creditors and debts owed as a result of environmental claims, and their relative resilience to the impact of insolvency and restructuring. In addition, there will also be some contractual creditors who suffer due to the power imbalance that is often present in a restructuring or rescue process, despite continued adjustments in many systems to account for and ringfence distributive rights to redress some of that imbalance and weaker resilience to financial impact. Finally, employees remain perhaps the most significantly impacted group due to the far-reaching effects that loss of employment causes to individuals, families, and wider communities, as well as the draw it has on taxpayers due to social security costs.

[1] My thanks to Graham Ferris for his expertise and advice in reviewing this editorial prior to publication.

During this time of shifting economies and rapid - sometimes permanent and sometimes temporary - regulatory changes, it could be that we are at a turning point in considering how to approach fairness in insolvency and restructuring, which may call for a new theoretical paradigm. The intersecting areas of insolvency (wealth-maximisation) and fairness (distribution) have ever been a value-laden and complex balancing act. It is necessary to tread a line that attempts to balance two often conflicting areas of law and society: the need for a regulatory framework that allows businesses to thrive by attracting investment and another (often-competing) regulatory framework that provides a buffer for more vulnerable corporate stakeholders against the impact of unbridled self-interested capitalism.

II. A New Theory

A theoretical framework that considers the choices of all stakeholders affected by the decisions of a corporate entity is worth exploring in these uncertain and changing times, before things begin to solidify into a new normal. Law and economics considerations, and by extension the Jacksonian adherence to creditor wealth maximisation as the underpinning rational for insolvency procedures, is exclusionary.[2] It depends on legal ties connected to the law of contract. It does not allow for a balancing of the vulnerabilities caused by involuntary parties and information asymmetries inherent in processes instigated at the behest of a large or powerful creditors. A socio-legal perspective, however, allows for an analysis of current legal structures in such a way that is directly linked with the social situation to which the law applies,[3] thereby allowing for a focus on the impact on stakeholders who wield less power or who may be involuntary parties to an insolvency and unable to adjust their level of risk accordingly. Such stakeholders may also be less resilient to the financial impact of an insolvency or restructuring due to socioeconomic dependencies resting on the debtor.

Martha Fineman's vulnerability theory provides a potential theoretical framework within which these conflicting areas can be viewed and balanced. Although Fineman's theory was constructed with the very human dependencies associated with social and cultural discrimination, with some adjustment it can also provide a new lens through which to view legitimately vulnerable stakeholders to a corporate insolvency or restructuring. Equality may even be an unjust measure when it is applied to 'situations of inescapable or inevitable inequality where differing levels of authority and power are appropriate', such as in an employer/employee relationship or even the power imbalance between secured and unsecured creditors.[4] Extending this to insolvency situations, it can serve to recalibrate fairness between the clearly differential power structure among the various stakeholders due to the rights attached to security and regulatory priorities where applicable.

One of the key underlying precepts of collective insolvency procedures globally is that of equal treatment,[5] although there are so many priority carveouts that it is arguable whether this remains the case.[6] Martha Fineman notes, in respect to equality of treatment between individuals, that, where equality is 'reduced to sameness of treatment or a prohibition on discrimination, this has proved an inadequate tool to resist or upset persistent forms of subordination or domination.'[7] Furthermore:

> This version of equality is similarly weak in its ability to address and correct the disparities in economic and social wellbeing among various groups in our society. Formal equality leaves undisturbed- and may even serve to validate – existing institutional arrangements that privilege some and disadvantage others.[8]

Although the treatment of creditors already carries with it the obligations that were in place under a contract for the repayment of debts due, the nature of debts for goods and services or for loans is different in nature from the obligations owed to employees under an employment contract or indeed the

[2] See Thomas Jackson, The Logic and Limits of Bankruptcy Law (Beard Books 1986).
[3] David Schiff, 'Socio-Legal Theory: Social Structure and Law' (1976) 39(3) Modern Law Review 287, 287.
[4] Martha Fineman, 'Vulnerability and Inevitable Inequality' (2017) 4(3) Oslo Law Review 133, 135.
[5] See Andrew Keay and Peter Walton, 'The Preferential Debts Regime in Liquidation Law: In the Public Interest' (1999) CfiLR 84, 85, as cited in Riz Mokal, 'Priority as Pathology: the Pari Passu Principle' (2001) 60(3) CLJ 581.
[6] For a full discussion on the realities of pari passu in the context of regulatory priorities, see Mokal (above n 4).
[7] Martha Fineman, 'The Vulnerable Subject: Anchoring Equality in the Human Condition' (2008) 20(1) Yale Journal of Law and Feminism 1, 3.
[8] Idem.

obligations owed to non-contractual, involuntary creditors, such as those who have suffered losses as a result of the company's activities. While there are certainly debts in terms of wages for work undertaken, the relationship is far more complex and far-reaching in terms of social implications, particularly when we consider the value of an employee's firm specific human capital contribution to the debtor company and the natural dependencies that employees have on their employment and job security. Equally, the damages owed to tort and environmental creditors tend to be treated as unsecured, so fall very low on the list of priorities.

With regards to environmental debts, the consequences of not paying out can be highly significant when the funds would be used to rectify certain environmental damage. The damage will still need to be rectified – in such circumstances who will ultimately pay? The obligation would likely fall upon society due to the neccessity for governments to rectify the matter, which would inevitably have to be funded by the taxpayer.

Equal treatment in such circumstances is not necessarily fair treatment, given the varying degrees of power and resilience that different categories of stakeholders will have in an insolvency process, as well as the extensive impact that lack of funding can have on the wider society. This is also why so many carveouts already exist to this so-called fundamental principle, such as the categorisation of preferential debts that is often applied to employee claims.[9] These carveouts aim to some extent to redress the imbalance in power due to the greater vulnerability of less powerful stakeholders.

Fineman observes that the term 'vulnerable' can be used to describe:

> …a universal, inevitable, enduring aspect of the human condition that must be at the heart of our concept of social and state responsibility. Vulnerability thus freed from its limited and negative associations is a powerful conceptual tool with the potential to define an obligation for the state to ensure a richer and more robust guarantee of equality than is currently afforded under the equal protection model.[10]

Fineman goes on to explain that 'the concept of vulnerability can act as a heuristic device, pulling us back to examine hidden assumptions and biases that shaped its original social and cultural meanings.'[11] Vulnerability can then provide a valuable context within which critical perspectives on political, societal, and legal institutions can be constructed.[12] A focus on vulnerability goes beyond the normative claims for equality generally, whether formal or substantive, and suggests the interrogation of what may be 'just and appropriate mechanisms to structure the terms and practices of inequality.'[13]

Currently, insolvency procedures continue to be guided by economic paradigms, principally due to its association with corporate law, which are shielded to some extent in the United Kingdom, and to a larger extent in the United States, by the continued reliance on the free-market of Western capitalism.[14] However, given the social implications of corporate insolvency, an adjusted perspective that takes in these non-economic features is overdue.

By placing vulnerability and resilience at the centre of the social policies that have come to influence the preferences and entitlements for employees in insolvency law, it is possible to re-evaluate current approaches and also to consider the vulnerability and resilience of the institutions themselves. As has been evident in the age of COVID-19, some institutions will fail in the face of market fluctuations caused by sudden economic shocks such as lockdowns. By focusing on stakeholder vulnerability, it may be possible to uncover the weaknesses of the institutions in place that were intended to respond to that vulnerability.[15]

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[9] See Mokal (above n 4), 584.
[10] Fineman (above n 6), 8–9.
[11] Ibid., 9.
[12] Idem.
[13] Fineman (above n 3), 134.
[14] M Fineman, "The Vulnerable Subject: Anchoring Equality in the Human Condition" (2008) 20(1) Yale Journal of Law and Feminism 1, 5.
[15] M Fineman, "The Vulnerable Subject: Anchoring Equality in the Human Condition" (2008) 20(1) Yale Journal of Law and Feminism 1, 12–13.

III. Conclusion

Vulnerability theory provides a different perspective from which the treatment of employees (and other vulnerable and involuntary creditors) can be viewed that considers the broader social implications of their role in society and the impact upon this that an insolvency of their employer may have, along with how resilient they may to the exercise of rights held by more powerful stakeholders. Although commentators and scholars of corporate and insolvency law often prefer to avoid the determination of social value in a corporate or commercial context, there can be no denying that the social impact remains and should therefore at least be considered in the context of achieving fairness in the balance of relative reslience between social and business interests when faced by a company's financial distress. As noted by Fineman: '[as] law should recognise, respond to, and, perhaps, redirect unjustified inequality, the critical issue must be whether the balance of power struck by the law was warranted.[16]

Although Fineman generally refers to equality between individuals in her work, given the differences between powerful creditors, vulnerable stakeholders such as employees, and those who are involuntary creditors to an insolvency, a rethinking of the equalities ascribed to insolvency and restructuring procedures is worth undertaking.

[16] M Fineman, "Vulnerability and Inevitable Inequality" (2017) 4(3) Oslo Law Review 133, 142.