'Vulnerability theory in insolvency law

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1. Introduction

The purpose of insolvency law is underpinned by an approach to fairness among 'stakeholders'[1] which generally takes into account pre-insolvency (or restructuring) legal or contractual entitlements. There are a number of internal mechanisms that seek to introduce this fairness into collective procedures, particularly for stakeholders who have less power in the process, such as employees. Typically, such less powerful stakeholders that are given advantages in a company's insolvency or restructuring process can still establish a contractual connection to the company in financial distress as some direct species of creditor. However, there are a number of other entities and individuals that may have a vested interest in a company's continuation or liquidation that may not be connected by choice or may have less of a capability to adjust themselves to the circumstances of a company's financial distress. They may not have 'pre-insolvency entitlements' *per se*. Such stakeholders may include tort creditors, environmental claims, certain parties to executory contracts, non-employee workers, and the wider communities within which the company operates.

The idea of considering the interests of all stakeholders in corporate law and insolvency law is certainly not new. Stakeholder Theory as a business ethics proposition has been around in some form or fashion for half a century. These ideas have crept their way into the realm of insolvency theory in the communitarian and contractarian visions and even into some of the more nuanced approaches to the creditors' bargain. However, there, the identification and assessment of stakeholders and their relative positions in an insolvency as well as the social and moral obligations that these may entail have usually been a separate philosophical question based on a 'values network' (shared purposes and values in the company) that has tended to conflict with the strategic 'value chain', which is more squarely focused on financial value.[2]

The following chapter will introduce a new way of considering stakeholders in a collective procedure (insolvency or restructuring) that seeks to internalise the 'values network' by considering the vulnerability and resilience of the various stakeholders insofar is it affects their power within such procedures. It will reach beyond entities possessing pre-contractual entitlements to provide a perspective on the fair treatment of a broader array of stakeholders, embracing both a contractarian and communitarian style of vision while advancing a combination of the two towards a more measurable test of fairness that can be applied to create bespoke priorities for the dramatis personae of stakeholders in a particular collective procedure. The end result builds upon the early conceptualisation of stakeholder theory and recognises how it has been used within theoretical discussions about insolvency and restructuring (intentionally or otherwise) in the works of Jackson, Baird, Dworkin, Korobkin, Warren, Westbrook and others. It then advances and builds on these approaches by applying Martha

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[1] See section 2 for an extensive discussion on the definitions of stakeholder and stakeholder theory, providing a basis upon which a new approach to fairness in collective procedures based in measures of vulnerability and resilience can be situated.

[2] R E Freeman, Robert Phillips and Rajendra Sisodia, 'Tensions in Stakeholder Theory' (2018) 59 Business & Society 213, 217.

Fineman's Vulnerability Theory to create a new framework within which fairness toward a variety of stakeholders can be tested and achieved in treatment, priorities, and distribution from within collective processes.

2. Stakeholder theory

There is a close relationship between corporate theory, business ethics, and insolvency theory. The conclusions of this chapter build upon some of the historical discussions in both these theoretical realms to establish a new theoretical paradigm that extends and deepens the application of established and legitimate theories that have been accepted and applied in corporate and insolvency law scholarship as well as in policy approaches to drafting and reforming related legislation. Stakeholder theory is one of the earliest approaches to considering company strategy that began to divert from the pure stockholder focus that had underpinned the concept of the limited company since the financial revolutions of the seventeenth and eighteenth centuries.

2.1 Stakeholder approach to strategic management

In 1984, R. Edward Freeman published a book[3] that would become the bible for stakeholder theory for decades, with both the concomitant dogmatic criticisms from scholars who otherwise perceived the corporate entity and at times evangelical defences from purists. Freeman himself was merely writing a textbook for business policy strategy courses,[4] so there was no intention to create an entire movement that would guide, confuse, and consternate scholars for decades to come. In fact, he was 'amused and somewhat horrified' at being called the 'father of stakeholder theory'.[5] Rather, he credited serendipity and other writers for the broad appeal of the theory.[6]

Stakeholder theory has mostly been connected to business strategy and was initially developed as a way of organising information which, in modern business vehicles, has become increasingly important to strategic planning.[7] The concept of stakeholders is implied in works published in Sweden as early as 1965 by Eric Rhenman and Bengt Styme[8] and enjoyed early applications by Russell L. Ackoff[9] to assist a Mexican brewer in 'understanding the importance of government in their business model.'[10] However, it was Freeman who first presented what was perceived by scholars, if not himself, as a legitimate theoretical framework for the corporation with stakeholders at the centre.[11] Simply put, he argued that 'exiting management theories were not equipped to address the "quantity and kinds of change which are occurring in the business environment"'[12] This he placed at the feet of shifts in the corporate environment

[3] R E Freeman, *Strategic Management: A Stakeholder Approach* (Pitman 1984).
[4] Freeman, Phillips and Sisodia (n 2) 215.
[5] R E Freeman, 'The Development of Stakeholder Theory: An Idiosyncratic Approach' in KG Smith and MA Hitt (eds), *Great Minds in Management: The Process of Theory and Development* (Oxford University Press 2005) 417, 433.
[6] A O Laplume et al, 'Stakeholder Theory: Reviewing a Theory that Moves Us' (2008) 34 Journal of Management 1152, 1152-1153,
[7] Freeman, Phillips and Sisodia (n 2) 214.
[8] E Rhenman and B Styme, *Företagsledning I en foäränderlig värld* (Aldus/Bonniers 1965).
[9] R L Ackhoff, *Redesigning the Future* (John Wile, 1974) and *Creating the Corporate Future* (John Wiley 1981).
[10] Freeman, Phillips and Sisodia (n 2) 214-215.
[11] Laplume et al (n 6) 1157.
[12] Freeman (n 3), p. 5.

among both internal and external stakeholders and cautioned that managers should 'take into account all of those groups and individuals that can affect, or are affected by, the accomplishment of the business enterprise.'[13] This simple view would become the foundation for scholarly arguments and repartee for decades to come.

2.2 Defining stakeholders

The invention of the term 'stakeholder' has been viewed as deriving from 'stockholder' 'to signify that there are other parties having a "stake" in the decision-making' of the company in addition to shareholders.[14] Stakeholders, as defined by Freeman, include 'any group or individual who can affect or is affected by the achievement of the organization's objectives.'[15] One might think that this could extend to any individual or entity touched by the company's activities; however, in reality the early view of the individuals who is 'affected by' the organisation is actually taken from the perspective of how those particular individuals might come to affect the company in the future, should their interests not be considered in decision-making. This approach is further explained by Freeman:

> Groups which 20 years ago had no effect on the actions of the firm, can affect it today, largely because of the actions of the firm which ignored the effects on these groups. Thus, by calling those affected groups 'stakeholders', the ensuing strategic management model will be sensitive to future change.[16]

The view of Kenneth Goodpaster on this approach asserts that such a strategic stakeholder approach does not actually introduce an ethical parameter into managerial decision making nor is it immoral; rather, he describes it as 'nonmoral'. The strategic reasoning based on this model is concerned with the consequences of one's actions insofar as those consequences could affect the best outcomes of the company on a future date rather than adopting a genuine moral concern for avoiding injury or unfairness of those affected by the actions of the company, regardless of the retaliatory potential of any aggrieved parties.[17] While it would seem that such an approach might capture most stakeholders, Goodpaster asserts that absent a pre-established linkage between a company's success and ethical success, some stakeholders will sometimes be affected quite a lot, but will not be able to affect the company in any major way to bring them within the 'affected by' definition enough for a company to justify a legitimate consideration of their interests that will also be in the future interests of the company in this paradigm.[18] The stakeholder approach, from this limited perspective in which importance is placed on effective business strategy rather than genuine ethical concerns for those affected by the activities of a business, is not, at its core, therefore, an enlightened approach that shifts focus from profit to the inherent social obligations of business as a social construct in the service of humankind.

2.3 Combining business strategy and business ethics

Freeman responds to Goodpaster's interpretation of his stakeholder theory suggesting that separating the ethical from the business does not help the progress of a more enlightened

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[13] ibid 25.
[14] K E Goodpaster, 'Business Ethics and Stakeholder Analysis' (1991) 1 Business Ethics Quarterly 53, 54.
[15] Freeman (n 3) 46.
[16] ibid.
[17] Goodpaster (n 14) 60.
[18] ibid 61.

approach to fairness in a corporate setting that also serves the interests of the company. Freeman acknowledges that this separation is ingrained in business school pedagogy, describing it as a Separation Thesis that makes it possible to hold certain business concepts up to ethical ideals and glorifying or condemning business as a practice. Freeman sarcastically notes that as long as the two discourses remain separate, business ethicists will need to continue to make it up as they go along by holding pieces of business activity or ideals up to the light of reason. Keeping ethics to the side, business theorists remain free to make up 'supposedly morally neutral theories such as agency theory, which can be used to justify a great deal of harm.'[19] Freeman asserts that instead, the whole point of adopting a stakeholder approach is to get rid of the whole Separation Thesis idea and reject what he calls the 'Principle of Who and What Really Counts' and to set aside the 'Principal of Making it up as You Go along'.[20] Rather, ethics should form a part of business theory, and by extension those theories underpinning collective procedures.

Freeman goes a step further in defining a collective of normative cores upon which a legitimate stakeholder theory might be based. He adopts contractarian, communitarian and, interestingly, ecological cores around which a stakeholder theory could be designed. Whereas the contractarian approach largely echoes traditional approaches to corporate stakeholder interests, the communitarian version adopts a feminist standpoint that rethinks how 'value creating activity' could be structured according to principles of caring and connection.[21] The ecological approach would mean a corporation would be run 'in accordance with the principle of caring for the earth.'[22] It has been argued that environmental issues are completely left out of a stakeholder theory that considers operations with the firm at its core.[23] However, the approach suggested at the end of this chapter shifts the focus from a firm-centered approach to that of fairness measured against vulnerability and resilience of stakeholders, redefined to include any impact of a company that could be compensated in an insolvency or rescue process, whether that is to entities, individuals or in relation to *chose* in action, such as environmental claims.

If one considers these issues from a social contract perspective, in which it is not only economic connections that defines relationships and obligations, there are other values that can also be considered in the stakeholder approach. Stakeholder Theory should include the human actors in the corporate processes beyond situations in which they add economic value to include the 'alignment of values, norms and ethics as mechanisms for efficient and effective flourishing within and among organizations.'[24] This embraces the concept of the social contract within the stakeholder context. As recognised by Friedman and Miles, social realists

> […] recognize that society depends on human activities and that both society and people are changeable and affected by each other. Social realists also accept that, in the context of social interaction, actions are taken and ideas formed in relation to a perceived (socially constructed) reality, thereby changing the social reality.[25]

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[19] R E Freeman, 'The Politics of Stakeholder Theory: Some Future Directions' (1994) 4 Business Ethics Quarterly 409, 412.
[20] ibid.
[21] See for example A Wicks, D Gilbert and R E Freeman, 'A Feminist Reinterpretation of the Stakeholder Concept' (1994) 4 Business Ethics Quarterly 475; R E Freeman and J Liedtka, 'Corporate Social Responsibility: A Critical Approach' (1991) 34 Business Horizons 92.
[22] Freeman (n 19).
[23] A L Friedman and S Miles, 'Developing Stakeholder Theory' (2002) 39 Journal of Management Studies 1, 3.
[24] Freeman, Phillips and Sisodia (n 2), 219.
[25] Friedman and Miles (n 23) 4.

Companies and corporate structures are essentially a construct of our society that has been framed within law and principle. In reality, they would not exist without the permission of the human beings who such institutions should serve. Thus, it is sensible to consider the wider implications of the corporate form, beyond the economic and financial value that can be ascribed to the traditional emphasis on shareholder value. As further noted by Friedman and Miles from a Law and Economics perspective:

> […] social structures and systems of ideas endow different sections of society with different vested interests and opportunity costs associated with different responses to those structures and systems. These do not force actions, rather they put prices and premiums on different interpretations of situations as well as associated activities.[26]

In short, if one considers the corporation with the inherent aim to serve humanity, then it is only logical to consider a wider view of the impact of the corporation and its financial viability. The consideration of such wider impacts satisfies the obligations of those implicit contracts derived from social duty and moral obligation. Further, it 'reflets a coherent worldview of business that reflects a broader awareness about its role, purpose, and full range if immediate and long-term impacts on society.'[27] Taking this perspective limits the idea that the only relevant stakeholders 'affected by' the company should be those who may eventually affect the company without that consideration because it flips the obligation from a tacitly self-interested consideration to a direct obligation based in the broader obligations of the social contract.[28] Rather, '[i]t is rooted in a more humanistic conception of the business as a vehicle for human cooperation to realise outcomes not otherwise attainable.'[29] With all that being said, without a purpose that embraces these social obligations derived from the original social contract, as it were, the natural default of businesses will return to profit maximisation. In addition, without a coordinated purpose based in shared values, even stakeholders will eventually operate at cross-purposes to pursue their own interests.[30] As such, measures need to be incorporated into the fabric of business principles and, by extension, insolvency and restructuring principles, to achieve these higher aims.

3. Insolvency theory and the sociology of law

Fundamentally, the end recommendation of this chapter will be to adopt a specific socio-legal approach based on Martha Fineman's Vulnerability Theory to an assessment of fairness in insolvency and restructuring frameworks. Such an approach eschews the positivist and isolated conception of law as an institution whose concern is technical and prescriptive and integrates the explanatory and descriptive characteristics of sociology. Although such an approach may render the clear lines of the law a bit fuzzier, it also introduces a reality to the consideration of law and legal reform that admits to the social relationships that the law administers. Legal relations are clearly not solely economic nor are they all explicable in purely economic terms,[31] as Law and Economics scholars often claim, and which tends to underpin traditional approaches to insolvency theory. However, the social aspects of insolvency and restructuring are not unheard-of considerations among insolvency law theorists, either.

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[26] ibid.
[27] Freeman, Phillips and Sisodia (n 2) 219.
[28] Friedman and Miles (n 23) 7.
[29] Freeman, Phillips and Sisodia (n 2) 219.
[30] ibid 220.
[31] R Cotterrell, *The Sociololgy of Law: An Introduction* (Butterworths 1992) 5.

Given the multi-layered and highly complex web of relationships in the global economy, there is value to considering the wider impact of a collective corporate process in terms of the fairness of these processes for non-adjusting and involuntary creditors. This is in addition to employees, who have long been recognised as being in a weaker bargaining position and unique as not only being a creditor, but also a key stakeholder, for a company in financial distress.[32]

Vanessa Finch provided an in-depth survey of the most commonly debated theoretical approaches to insolvency law in a prescient article in 1997. In it, she considered the viability of the current (at the time) measures of insolvency law, including the classical creditors' bargain theory;[33] the oft-cited broad-based contractarian approach;[34] a communitarian vision that has often been referred to as a traditionalist approach;[35] a forum vision;[36] an ethical vision; and a multiple values/eclectic vision.[37] For the purpose of this chapter and its focus on updating the stakeholder approach to introduce measures that can be used to test and apply fairness criterion to collective processes, the following section will focus on those that are relevant as building blocks to the new socio-legal paradigm suggested herein. What is clear is that despite the wealth of theoretical debate and discussion, a complete view of the appropriate measure of insolvency law still fails to emerge.[38] Although many of these theories do consider the social impact of insolvency and rescue, they tend to continue to start from an economic standpoint and deviate from that along fairly predictable lines.[39]

3.1 Recalling the creditors' bargain

The best-known approach to fairness in insolvency law focuses on contractual creditors who, behind a Rawlsian veil of ignorance, bargain to create a collective process that ensures fairness among creditors vying for repayment of their debts from a financially distressed debtor based on a pro-rata distribution according to pre-insolvency entitlements.[40] The aim of this creditors'

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[32] Jennifer LL Gant, 'Reconsidering Fairness for Vulnerable and Involuntary Stakeholders in Insolvency and Restructuring' in E Vaccari and E Ghio (eds), *Insolvency Law: Back to the Future* (INSOL Europe 2022) 55.
[33] First introduced in T H Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press 1986).
[34] See D R Korobkin, 'Contractarianism and the Normative Foundations of Bankruptcy Law (1993) 71 Texas Law Review 541 and 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91 Columbia Law Review 717.
[35] See E Warren, 'Bankruptcy Policy' (1987) 54 University of Chicago Law Review 775 and 'Bankruptcy Policymaking in an Imperfect World' (1993) 92 Michigan Law Review 336; K Gross, 'Taking Community Interests into Account in Bankruptcy' (1994) 72 Washington University Law Quarterly 1031; B Adler, 'A World without Debt' (1994) 72 Washington University Law Quarterly 811.
[36] See A Flessner, 'Philosophies of Business Bankruptcy Law: An International Overview' in J S Zeigel (ed), *Current Developments in International and Comparative Corporate Insolvency Law* (Clarendon Press 1994) 13; P Miller, 'Calculating Corporate Failure' in Y Dezalay and D Sugarman (eds), *Professional Competition and Professional Power: Lawyers, Accountants and the Social Construction of Markets* (Routledge 1995) 51; R B Stewart, 'The Reformation of American Administrative Law' (1975) 99 Harvard Law Review 1667.
[37] See P Schuman, 'An Attempt at a "Philosophy of Bankruptcy"' (1973) 21 UCLA Law Review 403.
[38] V Finch, 'The Measures of Insolvency Law' (1997) 17 Oxford Journal of Legal Studies 227, 242.
[39] Gant (n 32).
[40] See Jackson (n 33) chapters 1 and 2. See also D Baird and T Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 University of Chicago Law Review 97; D G Baird, 'The Uneasy Case for Corporate Reorganizations' (1986) 15 Journal of Legal Studies 127; D G Baird, 'A World without Bankruptcy' (1987) 50 Law and Contemporary Problems 173; T H Jackson and R E Scott, 'On the Nature of Bankruptcy: An Essay of Bankruptcy Sharing and the Creditors' Bargain' (1989) 75 Virginia Law Review 155; B E Adler, 'A World without Debt' (1994) 72 Washington University Law Quarterly 811; B E Adler, 'A Theory of Corporate Insolvency' (1997) 72 New York University Law Review 343; D G Baird and R K Rasmussen, 'The End of Bankruptcy' (2002) 55 Stanford Law Review 751; B E Adler, 'The Creditors' Bargain Revisited' (2018) 166

bargain is to maximise the collective return to creditors by avoiding the free-for-all of enforcement during times of corporate crisis that would otherwise dissipate assets to the detriment of the overall collective of creditors and, of course, the ultimate survival of the debtor (if possible). These approaches focus on this 'common pool' problem that is created when creditors assert their rights against the common pool of the debtors' assets.[41] The 'creditors' bargain' based insolvency framework justifies

> the compulsory, collectivist regime of insolvency law on the grounds that were the company creditors free to agree to collectivist forms of enforcement of their claims on insolvency, they would agree to collectivist arrangements rather than procedures of individual action or partial collectivism.[42]

There are many pragmatic arguments that naturally favour an approach that protects creditors' rights in the circumstances of a debtor's financial distress; however, it is arguable as well that such an approach makes more sense in the more straightforward insolvency solutions that lead to the sale of corporate assets and dissolution of a company through liquidation as there are fewer choices of resolution available. Once other victims of corporate decline are thrown into the mix and the aim becomes the rescue of a viable corporate entity or business, the bargain becomes fraught with conflict due to the significantly different interests that stakeholders such as employees will have. Jackson and other creditors' bargain theorists get around this by arguing that the protection of non-creditor interests such as employees, managers, and members of the community, and indeed the aim of keeping firms in operation at all, is not and should not be one of the goals of insolvency law.[43]

It is perhaps not surprising, therefore, that the strict creditors' bargain approach has been subject to significant criticism. Concerns have focused on the principle that an insolvency process should be strictly a debt collection process for the benefit of contractual creditors. However, it has been said that such a view fails to recognise the legitimate interests of many others who do not fall into the category of contractual creditors.[44] Whereas an end-of-life corporate situation may be suited to a strict creditors' bargain approach, modern solutions to financial distress are not necessarily suited to this narrow view, particularly given the focus today on the rescue of viable companies and businesses.

In the last few decades, however, and in particular since the turn of the millennium, there has been a steady shift from an acceptance of liquidation as an inevitable outcome of corporate insolvency for most companies, to a policy and regulatory emphasis on a desire to rescue viable companies where possible. Justifying this shift has been discussed by many eminent academics, usually with a focus on not only the financial benefit of preserving value, but also the social benefits often associated with the preservation of corporate life. Given the overall approach is geared towards the broad economic and social benefits of the preservation of viable corporate entities, it is also surely appropriate to consider these as stakeholder deserving of consideration in any collective process that might be undertaken to rescue that entity or its business.

University of Pennsylvania Law Review 1853; and T H Jackson, 'A Retrospective Look at Bankruptcy's New Frontiers' (2018) 166 University of Pennsylvania Law Review 1867.

[41] Jackson (n 33) 17.

[42] Finch (n 38) 231.

[43] ibid.

[44] See for example the works of E Warren and K Gross, 'Taking Community Interests into Account in Bankruptcy: An Essay' (1994) 72 Washington University Law Quarterly 1031.

3.2 Broad based contractarianism

Broad based contractarianism was introduced by Donald Korobkin within a Rawlsian paradigm, somewhat similar to the creditors' bargain theory.[45] Although the 'contractarian' aspect would seem to closely reflect the Jacksonian approach, Korobkin takes the concept of the contract beyond that of the purely legal connection aimed to maximise the returns to contractual creditors into a broader approach under the more philosophical social contract principles.[46] Although both Jackson and Korobkin produce their insolvency law paradigms from behind a Rawlsian veil of ignorance, Korobkin includes not only the contractual creditors, but representatives of all the stakeholders who might potentially be affected by a company's decline. Such stakeholders include employees, managers, owners, tort claimants, and members of the community.[47] One commonality that most of these stakeholders share is that they do not 'assume the risk' of a debtor's default or financial distress.[48]

In typical Rawlsian fashion, Korobkin justifies insolvency frameworks by introducing a veil of ignorance behind which the included stakeholders would agree to how they should be treated within the process resolving a debtor company's financial distress. Principles are chosen without knowledge of individual legal status, position within the company or other characteristics that might lead them to prefer personal interests over those of the collective. Parties behind the veil, Korobkin argues, would first introduce a 'principle of inclusion' which would make all affected parties eligible to press their demands. The second would be a principle of 'rational planning' that would determine whether 'and to what extent persons would be able to enforce legal rights and exert leverage.'[49] These principles would lead to a 'maximisation of aims' rather than a maximisation of wealth, which would be sought by the application of creditors' bargain principles. The maximisation of aims would inherently include formulating the most rational long-term plan to realise the best interests of the business enterprise and all affected stakeholders, a goal that is specifically excluded in most creditors' bargain approaches. Korobkin's approach also provides a basis for accounting for the vulnerabilities of stakeholders bargaining behind the veil of ignorance. Applying Rawls' 'difference principle', there would also be a mandate that those stakeholders in the worst off or most vulnerable/least resilient position, such as non-adjusting and involuntary creditors, should be protected over those who are in more powerful positions with the resilience to adjust to the debtor's financial distress and the processes that may occur to resolve that distress. Stakeholders in such worse off positions 'would be those relatively powerless to promote their aims, yet with the most to lose on the frustration of those aims.'

There are, or course, many criticisms of the Rawlsian approach taken by both creditors' bargain and contractarian theorists. Principally, it is lacking in reality because it is impossible to 'strip the individual completely yet conclude that he or she would choose the difference principle'.[50] This assumption does not take into account whether some stakeholders might be more or less risk-averse than others and therefore willing to take the risk that they might find themselves in one of the positions of power once the veil has lifted. In such cases, they may bargain with a perceived self-interest that is not level with the lowest common denominator, which would

[45] J Rawls, *A Theory of Justice* (Oxford University Press 1972).
[46] D Korobkin, 'Contractarianism and the Normative Foundations of Bankruptcy Law' (1993) 71 Texas Law Review 541, 575-589.
[47] Finch (n 38) 234.
[48] D Korobkin, 'Employee Interests in Bankruptcy' (1996) 4 American Bankruptcy Institute Law Review 4, 6.
[49] Korobkin (n 46) 575-589.
[50] Finch (n 38) 235.

distort the fairness envisaged by a Rawlsian approach. In addition, it is unclear to what extent diminutions in justice would be willingly traded off against gains in wealth, for example. Such an approach may actually be so protective as to create an uncertain result that would be catastrophic in terms of the effect that such a regime developed under Rawlsian principles would be on the cost of credit.[51]

While the contractarian approach does introduce a fairly robust framework within which a fair insolvency system could be created, it does not provide measurable tests to assess the most vulnerable. Therefore, it remains uncertain in the broad-based contractarian vision who should enjoy priority of protection over those in more powerful positions.[52] This is an issue that repeats itself in the next theoretical approach: the communitarian or traditionalist vision.

3.3 Communitarian or traditionalist approaches

The communitarian vision developed by Elizabeth Warren eschews the contractarian approach while embracing a similar broad range of stakeholder interests that call for some redistribution of value so that high priority insolvency claims must give way to less powerful stakeholders.[53] It also embraces an aim that is in direct contrast to the creditors' bargain with its focus on the collective of contractual creditors. Communitarianism, instead, focuses on a fair distribution of the risk of insolvency by reference to relative power among the stakeholders rather than the fair distribution of wealth as a result of that insolvency.[54]

The communitarian approach also specifically takes into account non-entity stakeholders such as environmental cleaning costs that will affect a community should a corporation not have the ability to rectify such damages. In such circumstances, a communitarian vision would not only prioritise the less powerful involuntary creditors but would also redistribute the costs of environmental damage to be shared by both the debtor and its contractual creditors. These costs would be shared through a redistribution of value towards paying for those costs, which would reduce the pot for the collective of contractual creditors. However, such redistribution within the communitarian visions is not seen as an aberration from the protection of creditors' rights, but rather as a core function of insolvency law insofar as it should be a 'scheme designed to distribute the costs amongst those at risk.'[55] As Warren puts it:

> I see bankruptcy as an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors. Bankruptcy encompasses a number of competing – and sometimes conflicting – values in this distribution. As I see it, no one value dominates, so that bankruptcy policy becomes a composite of factors that bear on a better answer to the question, 'How shall the losses be distributed?'[56]

The communitarian approach will also inevitably encourage the survival of viable but financially distressed companies in order to ensure those most vulnerable stakeholders are able

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[51] ibid.
[52] ibid 236.
[53] E Warren, 'Bankruptcy Policy' (1987) 54 University of Chicago Law Review 775.
[54] Ibid 777. See D Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91 Columbia Law Review 717 for an analysis of Warren's and Baird's argument between the creditors' bargain and a communitarian approach with detailed discussion of the strengths and weaknesses of both.
[55] Warren (n 53) 790.
[56] ibid 777.

to survive and recuperate their costs.[57] The rescue of viable businesses will also serve the distributional interests of many stakeholders who do not fall within the category of creditors but who do have an interest in the continuation of the business. These could include older employees who cannot realistically retrain, customers who would have to resort to alternative suppliers with less attractive goods and services, suppliers who will be losing current customers, nearby property owners who may suffer declining property values, and governments that may have shrinking tax bases that would otherwise benefit from a successful reorganisation. The provision of rescue options within insolvency frameworks acknowledges the potential losses of those who have depended upon the business by redistributing some of the risk of loss from the default.[58]

Although this approach embraces the UK Cork Committee's[59] vision that acknowledge that there are societal interests to be considered in insolvency as well as those of contractual creditors, it is also lacks a degree of focus that is present in both the creditors' bargain and broad-based contractarianism approaches, which at least provide a paradigm within which a framework can be developed.[60] Further, the communitarian approach embraced by Warren does not provide a means of weighing community interests. One of the principles upon which the communitarian visions rests is that it is possible and effective to entrust a bankruptcy judge with the discretion to balance the conflicting and competing interests of the various stakeholders.[61] Baird points out weaknesses among the other principles upon which the communitarian vision rests, but for the purpose of this chapter, an approach with vulnerability and resilience at its heart may well provide the missing measures. Finch asks, for example, 'How might a court balance the community's interests in maintaining employment against potential environmental damage?'[62]

Warren herself admits that she offers a 'dirty, complex, elastic and interconnected' view of insolvency law from which outcomes cannot be predicted nor are all the factors relevant to a decision on policy fully articulated. Certainly, an economic account such as that espoused by Thomas Jackson and Douglas Baird in the creditors' bargain can justify its approach its approach empirically as a wealth maximisation mechanism benefitting the collective of legally connected stakeholders. However, a value-based account building on Warren's more socially conscious but philosophically fuzzy approach takes a step toward creating a measurable test that could be applied to the fairness of stakeholder treatment in insolvency and restructuring. Korobkin suggests a value-based approach founded on a deeper understanding of the concern to which bankruptcy law is addressed, which includes not just the economic, but also the moral, political, personal, and social problems that affect all stakeholders.[63] However, Korobkin slips back into a pseudo-Rawlsian standpoint insofar as he posits the worth of an insolvency law providing a forum for the representation of diverse values, adopting another social-contract style of approach:

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[57] Finch (n 38) 237.
[58] Warren (n 53) 788.
[59] *The Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558) (1982).
[60] B S Schermer, 'Response to Professor Gross: Taking the Interests of the Community into Account in Bankruptcy' (1994) 72 Washington University Law Quarterly 1049, 1051.
[61] D G Baird, 'Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren' (1987) 54 University of Chicago Law Review 815, 816.
[62] Finch (n 38) 237.
[63] D Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91 Columbia Law Review 717, 762.

> Under the value-based system, bankruptcy law has the distinct function of creating conditions for discourse in which values of participants may be rehabilitated into an informed and coherent visions of what the estate as enterprise shall exist to do.[64]

This is in contrast to Warren's policy argument that simply focuses on the values to be protected in an insolvency distribution and the effective implementation of those values to assist decision makers even if, admittedly, there are no specific answers that can be derived from a testable set of criteria.[65] Whereas neither Warren or Korobkin dictates specific answers in relation to how interests should be assessed outside of the pre-insolvency contractual entitlements, an approached based in vulnerability and resilience may offer a framework within which specific answers can be found by the application of a test.

4. Vulnerability theory as a fairness paradigm in insolvency and restructuring

A theoretical framework that considers the choices of all stakeholders affected by the decisions of a corporate entity is worth exploring given the somewhat recent shift from an emphasis on efficient liquidation outcomes to a preference for rescuing viable companies where possible. This shift raises a number of new issues that were not indicated in the collective processes used in traditional insolvency. Traditional approaches have tended to embrace the concept of creditor wealth maximisation, with fairness typically considered from a creditors' bargain perspective, which are generally drawn from a law and economics standpoint. However, Law and Economics considerations, and by extension the Jacksonian adherence to creditor wealth maximisation as the underpinning rational for insolvency procedures, is exclusionary, particularly in the more complex circumstances of business and company rescue.[66] It relies upon legal ties connected mostly to contract and property law. It typically 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 a way that is directly linked with the social situation to which the law applies,[67] 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. Although both Korobkin's broad-based contractarianism and Warren's communitarian vision adopt an essentially socio-legal perspective, they do not succeed in creating a concrete paradigm within which a realistic corporate rescue framework can be designed that will be useful for the modern corporation in financial distress.

Though the theories mentioned in this chapter certainly have their place and provide useful frameworks for analysing and measuring the complex issues raised by the circumstances of financial distress, they do not necessarily cater to the shift in emphasis from efficient

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[64] ibid 781.
[65] Finch (n 38) 241.
[66] Jennifer LL Gant, 'Floating Charges and Moral Hazard: Finding Fairness for Involuntary and Vulnerable Stakeholders' in J Hardman and A McPherson (eds), *Floating Charges in Scotland*: *New Perspectives on Current Issues* (Edinburgh University Press 2022) 228, 241.
[67] D Schiff, 'Socio-Legal Theory: Social Structure and Law' (1976) 39 Modern Law Review 287, 287.

liquidation to the rescue of viable business that drives insolvency law policy today. In addition, current available theoretical frameworks either do not cater for the diverse needs of a rescue-based insolvency policy (creditors' bargain) or are not specific enough in terms of how to measure those diverse interest and introduce fairness between them (broad-based contractarianism and communitarianism). As such, there is a need for a new paradigm with vulnerability and resilience at its heart to meet the needs of the modern firm in financial distress. Such a paradigm will have a broader and more applicable set of measures for assessing the fairness of insolvency and rescue procedures, considering not only an economic and legal approach but also attempting to balance the social and moral issues that are also at play.

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 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,'[68] such as in an employer/employee relationship or even the power imbalance between secured and unsecured creditors. A vulnerability approach applied to situations of financial distress may serve to recalibrate fairness between the clearly differential power structure among the various stakeholders due to rights attached to security and regulatory priorities. The resilience of a stakeholder will inevitably be linked to their ability to exercise power over a process which includes access to information, participation, and the notional ability to exercise control over their fate.[69]

4.1 What is vulnerability theory?

Vulnerability and resilience have been referred to multiple times in this chapter without a full explanation of what is meant by these terms. Before applying these concepts to assess and establish a new test of fairness, a brief description of Fineman's theory is necessary.

Vulnerability has been described as challenging the dominant conception of the universal legal subject as an autonomous, independent, and fully-functioning adult, a static figure that does not cater for the reality of humans who are socially and materially dynamic with varying levels of *resilience*. Fineman asserts that there should be political and legal implications for the fact that humans live within a fragile environment constantly subject to positive and negative change in both physical and social circumstances. Whereas vulnerability, according to Fineman, is a universal human constant, our relative resilience to that vulnerability varies over time. The inequality of human resilience is at the heart of vulnerability theory because it turns attention to society and social institutions. Resilience is produced, protected, or supported within and through institutions and relationships that confer privilege and power, and these relationships tend to be largely defined and reinforced by legal mechanisms.[70]

Legal institutions, as mechanisms of the social contract, have a responsibility in the structuring of societal relationships and institutions, which means that the state should bear some responsibility to ensure that these institutions and relationships are functioning fairly. Those

[68] M Fineman, 'Vulnerability and Inevitable Inequality' (2017) 4 Oslo Law Review 133, 135.
[69] Material for section 4 was drawn from Gant (n 32); (n 66); and Guest Editorial: 'Optimising Fairness in Insolvency and Restructuring: a Spotlight on Vulnerable Stakeholders' (2022) 31 International Insolvency Review 1.
[70] See M Fineman, 'The Social Foundations of Law' (2005) 54 Emory Law Journal 201.

involved in vulnerability theory as a policy project, predominately in the United States and within the orbit of Martha Fineman at Emory University in Atlanta, Georgia, aim to build an ethical framework for confronting neoliberalism with its emphasis on individual autonomy and personal responsibility. Whereas autonomy assumes independence and the possibility of a choice and that non-discriminatory access to opportunities exist, the reality is quite different when one considers the limitations affecting the human condition. Vulnerability theory recognises the many ways in which social relationships are shaped, reinforced, and modified by the law and argues that the state is always actively involved in the allocation, preservation, or maintenance of privilege and disadvantage. Therefore, the state also bears a responsibility through the introduction of fairness legislation to rectify the disadvantages and/or privileges that its institutions perpetuate.[71]

Institutions, as human creations, are also, though differently, vulnerable. They can be corrupted, captured and can decline and perish. They can cause harm and create situations that exacerbate or exploit human (or less powerful institutional) vulnerability. However, institutions, such as a fair corporate rescue and restructuring framework that accounts for the less resilient stakeholder, can also mediate, compensate, and mitigate vulnerability. As has been evident between 2020-2022 (at the time of writing), events such as the COVID-19 pandemic, the war in Ukraine, and the spike in energy prices can cause difficulties or even failure of institutions in the 'wake of market fluctuations, changing international policies, institutional and political compromises, or human prejudices.'[72] Given the human made nature of law and corporations and government, it is only sensible that these institutions should serve the human requirement for resilience. If the things humanity creates are not used to serve the needs of humanity, what is the point of having them at all?

4.2 Equal treatment is not always fair treatment

Fineman's vulnerability theory has been proposed as an alternative to 'traditional equal protection analysis' and has been described as a 'post-identity' enquiry focused not on discrimination against defined groups, but rather 'concerned with privilege and favour conferred on limited segments of the population by the state and broader society through their institutions.'[73] Traditional approaches to equality have been associated with John Locke's liberal subject which is based on the well-known ideal that human beings are by their nature free and endowed with the same inalienable rights.[74] However, these rights are not always accessible to all individuals due to differences in position and circumstance which affects the ability of those individuals to make use of their inalienable rights and freedoms. They begin from a starting line, for lack of a better analogy, that is behind more privileged groups or individuals. They must, therefore, 'work harder' to arrive at the same level of socio-economic success in the same time period. This incidental (or intentional) privilege that is enjoyed by some groups of people (in the traditional equal rights perspective) makes it difficult to rise above the original circumstances in which some find themselves. A similar paradigm could be applied to non-adjusting, involuntary, and non-traditional stakeholders in an insolvency or restructuring if one considers the power differentials inherent in these processes.

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[71] ibid, 225.
[72] M Fineman, 'The Vulnerable Subject: Anchoring Equality in the Human Condition' (2008) 20 Yale Journal of Law and Feminism 1, 12-15.
[73] ibid 1.
[74] ibid 2.

One of the key underlying precepts of collective insolvency procedures is that of equal treatment,[75] although there are so many priority carveouts that it is arguable whether this remains the case.[76] 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".[77] Furthermore:

> [t]his 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.[78]

Although the treatment of creditors already carries with it the obligations that were in place under a contract for the repayment of debts, 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 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 necessity 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.[79] These carveouts aim to some extent to redress the imbalance in power due to the greater vulnerability of less powerful stakeholders.

4.3 The concept of vulnerability in corporate insolvency

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

[75] See A Keay and P Walton, 'The Preferential Debts Regime in Liquidation Law: In the Public Interest' (1999) Company Financial and Insolvency Law *Review* 84, 85 as cited in R Mokal, 'Priority as Pathology: the Pari Passu Principle' (2001) 60 Cambridge Law Journal 581.
[76] For a full discussion on the realities of *pari passu* in the context of regulatory priorities, see Mokal (n 75).
[77] Fineman (n 72) 3.
[78] ibid.
[79] Keay and Walton (n 75) 85.

> 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.[80]

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'.[81] Vulnerability can then provide a valuable context within which critical perspectives on political, societal, and legal institutions can be constructed.[82] 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.'[83]

Currently, insolvency procedures continue to be guided by economic paradigms, principally due to their association with corporate law, which are shielded to some extent in the UK, and to a larger extent in the US, by the continued reliance on the free market of Western capitalism.[84] 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, a similar approach could be taken to assess the resilience of other less traditional stakeholders in order to determine their power status as well as the greater societal impact they may have without intervention in a corporate insolvency or restructuring situation. 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 the ability for stakeholders to respond to a company's financial distress – their resilience - it may be possible to uncover the weaknesses of the institutions in place that were intended to respond to that vulnerability in terms of introducing and maintaining fairness according to the inherent needs of different stakeholders.[85] In so doing, those institutions can be adjusted to better account for the resilience of those affected by corporate distress.

5. Conclusion

One of the first steps to introducing a new paradigm of assessing the fairness of insolvency and rescue frameworks must be to have a clear definition of who or what is a stakeholder for the purpose of that fairness assessment. This chapter has developed the stakeholder idea from the early days of stakeholder theory from the context of business theory and ethics and how that has influenced the identification of stakeholders in early forms of insolvency theory. The creditors' bargain took a narrow view in its exclusive concerns around contractual creditors' interests and its simplistic conception as the corporation as a pool of assets belonging to the collective of creditors when a corporation enters insolvency.

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[80] Fineman (n 72) 8-9.
[81] ibid, 9.
[82] ibid.
[83] Fineman (n 68) 134.
[84] Fineman (n 72) 5.
[85] ibid 12-13.

The broad-based contractarian approach widened this out to include any entity affected by the activities of a financially distressed company, insisting that all stakeholders should be party to the bargain behind the Rawlsian veil of ignorance. Whereas the communitarian vision adopts a similar broad premise, its indeterminate nature failed to create a measure of insolvency fairness that could effectively create a satisfactorily certain test.[86] A focus on vulnerability provides a baseline upon which tests of fairness can be built. It asks policy makers to look closely at the institutions that create fairness in insolvency and restructuring and ensure that they account for the impact that such process have on those stakeholders who may be less resilient in the process than others due to their non-adjusting or involuntary nature. The socio-legal approach based in vulnerability will also allow for an assessment of the dependency that stakeholders have on the institution of the corporation in financial distress, which will impact their relative resilience when it comes to ultimate failure or other dispositions of a company's assets.

Although this chapter has not introduced a concrete test based in vulnerability – that is yet to come in the research trajectory of this author - it has gone some distance to developing upon decades-old themes in insolvency theory that have previously failed to take hold in the context of insolvency policy in large part due to their uncertainty and indeterminacy. However, if one considers the broad base of stakeholders included in both the broad-based contractarian and communitarian approaches who have legitimate interests in the continuation of a financially distressed company, the theoretical paradigm becomes fully inclusive. In addition, if one considers the effect of power differentials among the insolvency or restructuring stakeholders and the concomitant need to mitigate to some extent the controlling economic power that may be detrimental to the less powerful, one may be on the way to creating a fairness paradigm with resilience of stakeholders at its heart.

[86] Finch (n 38) 242.