History of Insolvency and Bankruptcy
from an International Perspective

EDITED BY KARL GRATZER AND DIETER STIEFEL

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History of Insolvency and Bankruptcy from an International Perspective

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Portrait of Eduard Kosmack by Egon Schiele, 1910

Picture on back cover:
The Capture of the Nuremberg patrician Hieronymus Paumgärtner by A.v.
Rosenberg at Windsheim, 1552, by Mathias Zündt, German artist, 1498 – 1572.

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Contents

Karl Gratzer
Introduction.................................................................................................................. 5

Part I: National macro-oriented studies

Karl Gratzer
Default and Imprisonment for Debt in Sweden: From the Lost Chances
of a Ruined Life to the Lost Capital of a Bankrupt Company .............................. 15

Margrit Schulte Beerbühl
The Risk of Bankruptcy among German Merchants in Eighteenth-century
England...................................................................................................................... 61

Sakis Gekas
Credit, Bankruptcy and Power in the Ionian Islands under British rule,
1815-1864 ............................................................................................................. 83

Part II: Micro-oriented studies

Michel Fior
Financial Instability in Transition Economies during the 1920s: The
European Reconstruction and Credit-Anstalt Insolvency ............................... 119

Philip Ollerenshaw
Innovation and Corporate Failure: Cyril Lord in UK Textiles
1945-1968 .............................................................................................................. 143

Mirko Ernkvist
Down Many Times, but Still Playing the Game: Creative Destruction
and Industry Crashes in the Early Video Game Industry 1971-1986 ........... 161

Richard D. Gritta, Bahram Adrangi, Sergio Davalos & Don Bright
A Review of the History of Air Carrier Bankruptcy Forecasting and the

Jeanette Fors
A Network Perspective on Bankruptcies, Mergers and Acquisitions ........ 215
Part III: A comparative legal perspective

M. Teresa Ribeiro de Oliveira
Economic Policies and Bankruptcy Institutions: Brazil in a Period of Transition from Colony to an Independent Nation ..................................................241

Paolo Di Martino
The Historical Evolution of Bankruptcy Law in England, the US and Italy up to 1939: Determinants of Institutional Change and Structural Differences...........................................................................................................263

Dieter Stiefel
Insolvency and Privatization: The European Transition Economies in the 1990s ........................................................................................................................................281

Annina Persson
Security Interest and Insolvency: A Comparative Analysis between Swedish, Estonian, Latvian and Lithuanian Law.........................................................299
Introduction

Karl Gratzer

This book brings together new international research on bankruptcy and insolvency. The book is divided into three sections and consists of 12 chapters. The first section deals with national and macro-oriented studies. Micro-oriented case studies are collected in section 2. Studies with a comparative legal perspective are presented in section 3. However, two major themes connect the studies in sections one, two and three. In particular, the book is held together as a unit by the institutional theoretical framework, which is very clear in several cases while it serves more as an underlying screen in others. The second theme that ties the chapters in the book together is the explanations for the reasons of bankruptcy. The analysis of underlying reasons for insolvency plays an important role in several articles.

All contributions try to answer questions about these problems from different perspectives, subject-specific traditions and levels of investigation.

The researchers who participate in the book are from various disciplines in the social sciences but are brought together by the same object of study. The represented disciplines are law, business administration, financial economics, economics, statistics, history and economic history. The interdisciplinary approach is illustrated in the mixture of chosen empirical, methodological and theoretical connections. It is hoped that the book can provide more in-depth insights into some of the general problems that research on insolvency is wrestling with today. In particular, this applies to questions that concern explanations, processes and effects: Why did the bankruptcy system emerge? How and why did the system change? Was the change in the bankruptcy system related to other parallel processes? What were the effects of the institutional changes? The contributions in the book put these questions into a larger context of Europeanization, globalization and change.

The emergence and change of the bankruptcy system

A connecting concept that links together the chapters of the book is institutional change. The history of credit is probably as long as the history of humanity. When an individual applies for credit or borrows money, he or she enters some kind of written or oral agreement. If there is no repayment, the
debtor breaks a contract that is considered fundamental in every economy. The treatment of people who have become insolvent can thus give us an indication of how those who failed or could not fulfill their borrowing contracts have been considered from the point of view of the legislator. Already in Classical Antiquity, different systems were created to deal with insolvency. Bondage, corporal punishment and debtors’ prison were used. Europe remained without a (well-) functioning bankruptcy system for a long time. Such a system did not develop until the period of the prosperous Italian medieval commercial towns. An insolvent person was thus dealt with according to common law or according to regulations that had emerged before or outside a bankruptcy system. The debtor was dealt with in harsh terms and insolvency was thus considered as equal to theft from the creditor. A reason for this was that in Europe the Roman notion *fallitus ergo fraudator* (insolvent thus a swindler) worked like a distorting shadow to explain how insolvency had occurred. This continued late into the nineteenth century. Thus, undesired characteristics, such as pride, vanity and an exaggerated tendency to speculate, were often considered as reasons for insolvency. Debtors’ prison was created to force a debtor who *a priori* was considered a swindler to reveal possibly hidden sources. The system of debtors’ prison allowed time-limited custody in jail or “debtors’ prison” for a debtor who did not fulfill his or her financial obligations. For several centuries, the system co-existed with a slowly emerging bankruptcy system. Corporal punishment and prison sentences were disappearing and the debtor was less and less subjected to social stigma during the eighteenth and nineteenth centuries. The emergence and spread of joint stock companies, changes in the credit market and knowledge about the existence of the business cycle movements were factors that served to depersonalize further the notion of the reasons for insolvency. A more varied picture of the reasons for economic failure slowly emerged and many countries established modern bankruptcy laws in the mid-nineteenth century. From the mid-nineteenth century and onwards, bankruptcies are increasingly seen as an economic rather than as a moral failure. It became easier for entrepreneurs who had failed to return with a new business after a bankruptcy.

The original aim of the bankruptcy system was to achieve equality among creditors in questions of loss upon debtor’s insolvency. If there were no rules regulating insolvency, all possibilities of obtaining any kind of payment in connection with a debtor’s insolvency would be entirely dependent on being first with one’s execution claims. There would be a race among creditors for the debtor’s assets. A bankruptcy system creates a completely different situation. There is a decrease in the incentives for racing since each creditor and debtor can file for bankruptcy and thus obtain equal conditions for the creditors. At the same time, it then becomes possible to make other agreements that ensure the continued existence of viable firms in crisis. The regulatory system thus affects the frequency of bankruptcies. In general, creditors and
debtor-biased or creditor-biased. On a sliding scale, it is thus either the debtor or the creditor who is most favored in a bankruptcy. The creditor-biased perspective means that the focus is on the executive procedure and that the creditors are to be paid on as equal conditions as possible. The legislation builds on the old classical view of the principle of fairness and equality. This view has long been predominant in European legislation. In the 1990s, there was an intensive ongoing debate on the design of the future bankruptcy legislation. One of the bases for this discussion originated in the American Bankruptcy Code system, which constituted a model for the attempt to create a uniform legislation on insolvency within the EU and other parts of the world. This debtor-biased perspective shall increase the incentives for debtors to return with a “fresh start” after a bankruptcy. This view has existed in Anglo-American legislation for a long time. In the last few decades, a socio-economic perspective has also become of increasing importance in the legislation. Fiscal interests, employment interests and entrepreneurship, as well as regional policy reasons might be of importance.

A well-functioning market economy requires a well-functioning legal system for dealing with insolvencies. Without such a system, society lacks a basis for evaluating what firms are to be considered as “sound”. Furthermore, well-functioning insolvency legislation is an important component in what is usually called the dynamics of business. A common view is that the bankruptcy system is a purgatory bath that sorts out inefficient firms. Bankruptcy is considered an instrument that deals with unsound firms in a final stage. A firm’s assets do not cease to exist but are redistributed to more efficient areas of use. From this (orthodox) perspective, firm bankruptcy seems to be a less important procedure in an experimental economy. The bankruptcy system redistributes resources among competitors on a free market. Not only innovations but also liquidation of existing business is a prerequisite for societal dynamics and development. From this perspective, the liquidation of firms serves to clean up the economy.

The fact that it is normally inefficient firms that are sorted out through bankruptcy has been discussed and questioned based on the results from empirical studies. It has been shown that the bankruptcy system can also be used for aims that were not intended by the legislator. In the past few years, bankruptcies and insolvencies have received daily attention in the media. One reason for this attention was that there were indications of the bankruptcy system increasingly serving as a financial institution on the market that redistributed assets in a non-desired and sometimes even criminal direction. A general problem is that the dividends in bankruptcies have continuously been decreasing and that bankruptcies have been used as a strategic tool for business executives. In the US, e.g., “Strategic bankruptcy” under Chapter 11 has been used to cancel work agreements with trade unions. In
Europe, there are “convenience bankruptcies”. This refers to instances in which the firm itself chooses to file for bankruptcy. This is the easiest way of clearing the firm of debt with the aim of continuing the business in a new firm. This procedure means that other creditors that have transferred assets to the new company are left without any share. Taxpayers and subcontractors with unprivileged claims pay the costs. Such a procedure is usually not a violation of the current legislation. In these cases, the bankruptcy system is used as a link in a reconstruction procedure that was not intended by the lawmaker. We lack any knowledge of how large assets are redistributed through the bankruptcy system in different countries.

Reasons for bankruptcy

The perception of the reasons for why insolvency and bankruptcy occur have changed over time. Through the development of the market economy, bankruptcy increasingly seemed to be the result of impersonal forces that are less easy to influence. A general use of bookkeeping and an emerging insight into the existence of national and international business cycle movements were, among other things, factors that served to depersonalize the question of cause and responsibility. The nineteenth century was, according to Mann (2002), characterized by “a redefinition of insolvency from sin to risk, from moral failure to economic failure”. His observation was based on the conditions in the US, but can be assumed to constitute a reasonably good description of European development.

Somewhat simplified, in modern studies we can discern two fundamentally different concepts of how and why firms succeed or fail in surviving on their markets.

A microeconomic interpretation uses two different analytical explanations. The first explanation (individual-oriented) presumes a central role for the decision making of management. This currently predominant approach within the management literature considers firm behavior to be the result of awareness and deliberate and purposeful actions. The background, competency, motivation, attitudes and cognitive ability of management are considered crucial variables in explaining economic failures. Lack of knowledge, experience and competency in management is often seen as the most common reasons for bankruptcy. Individual-oriented explanations have a long continuous history.

The second (firm-oriented) explanation, which we most often meet in prognosis models for future credit risks, uses databases on information about the annual accounts, payment history, solvency, returns and other internal company variables. By combining these variables in different ways, models are constructed claiming to be able to separate firms with the potential of surviving from those that run the risk of disappearing within a certain period.
A macroeconomic interpretation takes its starting point in institutional, structural and business cycle explanations. Firm behavior is mainly considered determined by forces outside the firm, i.e. forces over which management largely lacks control. The explanatory variables have often been real economic or financial. Taxes, labor market legislation and economic policy, e.g., have also been important institutional variables that create obstacles or possibilities for firms to survive.

Finally, bankruptcies have been assumed to co-vary systematically with business cycles. In a business cycle upturn, business terminations are claimed to decrease and vice-versa. Economic historians in particular have discussed the extent to which the scope for action for the firm and the entrepreneur has been governed by the cyclical context. Besides changes in business cycles and the real economy, changes in the financial system play a part in business terminations. The fact that financial variables, such as the interest level, the exchange rate trend, terms of trade and lending, are of importance for the firms’ abilities to pay their loans is generally known. Using microeconomic variables and econometric models, attempts have been made to forecast the bankruptcy risk for firms. A problem with these models has been that they work badly when there are changes in the macroeconomic environment and that they cannot forecast speculative bubbles.

The outline of the anthology

Part I: National macro-oriented studies

Karl Gratzer’s article Default and imprisonment for debt in Sweden is a survey on Swedish bankruptcy law in a long-term and comparative international perspective. The study points out that Roman and Swedish legislation are path-dependent and contribute to the discussion on institutional change.

Margrit Schulte Beerbuhl’s article analyzes business terminations among German businessmen in eighteen century Britain. As the analysis is made on both the aggregate and the firm level, it is possible to follow the development in detail. The article points out differences as well as similarities in the bankruptcy patterns of both British and immigrant German businessmen. Because German businessmen were part of the contact network of their home country, they were also affected by its financial problems.

The aim of Sakis Gekas’ article on bankruptcies in British colonies on the Ionian Islands is to analyze the underlying reasons for insolvency. Among other things, the article deals with how the relation between personal confidence and institutional frameworks has affected the granting of credits and insolvency. The analysis also shows the importance of and the relationship between different traditions in bankruptcy situations.
Part II: Micro-oriented studies

Michel Fior’s article on the European economy in the 1920s and the 1930s and the consequences of the insolvency of the Austrian bank Creditanstalt mainly builds on previously published work. The article also introduces a new approach with its starting point in sociological institutionalism.

Philip Ollerenshaw’s article on the textile industry of Cyril Lord is constructed as a traditional firm-historical example. It contains a detailed description, in particular about Lord’s actions and the problems of the firm, which constitutes the basis for a discussion about underlying economic causes.

Marko Ernvist’s article on the market of video games is an example of how financial problems emerge and are dealt with on a “new” market. The analysis does not only provide us with knowledge about a market that remains largely unexplored, but also gives us an interesting insight into how a group of firms within a common sub-line of business is hit by similar problems in a short period.

The article by Gritta, Adrangi, Davalos and Bright tests different quantitative methods in predicting financial crises in American airline companies. The study is interesting, although not easily accessible to someone without a good knowledge of statistics.

Jeanette Fors’ article on networks and bankruptcies is exciting from a methodological perspective. After an extensive survey of how network theoretical aspects can be applied to individual lines of businesses and firms, the presentation of the article is largely concentrated to a case study – the IT company Nocom. This example shows, down to a relatively detailed level, how contacts between different firms have worked under financial stress.

Part III: A comparative legal perspective

In Teresa Ribeiro Oliveiras’ article, there is a discussion on how the insolvency legislation in Brazil was designed in the early nineteenth century as part of the national economic policy. In the analysis, there is also a discussion on how the use of special bankruptcy rules for gold and sugar production changed when there was an increase in the need for capital to develop the productive capacity. The article clearly shows how institutional change can be generated and what the consequences of this are for different agents.

In Paolo Di Martino’s article, the focus is on the design of bankruptcy law in Britain, the US and Italy before 1940. The analysis takes its starting point in the foundations of institutional theory, where institutional change holds a central role. The study points out differences in efficiency between different types of legislation. Because of its structure, this article constitutes an important theoretical contribution.
Dieter Stiefel’s article deals with the emergence of bankruptcy law in three Eastern European transition economies (Czech Republic, Hungary and Poland) in the 1990s. This article opens up for future research in the area, in particular when – in a different context – there is a possibility of extending the study in time.

Annina Persson’s article takes a comparative legal perspective on insolvency and other relevant bankruptcy-related legislation in Sweden and the Baltic countries. The article is problem-oriented and not country-oriented, which facilitates a direct comparison. The article can be used as an “encyclopedia” for relevant legislation in the area of bankruptcy.

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References


Part I: National macro-oriented studies
Default and Imprisonment for Debt in Sweden: From the Lost Chances of a Ruined Life to the Lost Capital of a Bankrupt Company*

Karl Gratzer

Although borrowing and lending have been important themes in Swedish economic history research, the special subject of the insolvent debtor has received no systematic attention. The history of credit is as long as human history and predates the use of money. It has been argued that money was introduced because of the need to measure and pay debts (Kilpi 1998). The word credit itself is derived from the Latin word *credere*, to believe, to put confidence in someone, to trust someone. Credit stands for a person’s ability (the trust one person possesses) to sell a promise to repay in the future so that he or she can make purchases in the present. To give credit means to transfer the property rights to a given object (e.g., an amount of money) in exchange for a claim on specified objects (e.g., certain sums of money) at specified points in time in the future. To take credit, to become a debtor, is the other side of the coin (Conant 1899, Baltensperger 1987).

When a person applies for credit, lends money, etc., he or she enters into some form of contractual arrangement.1 These contracts can be verbal or written. All credit transactions involve the risk that the debtor may fail to honor his or her financial obligation. If the repayment is not made, the debtor is declared to be in default. By not delivering those property rights as promised, the debtor violates one of the most fundamental contracts of the economy (Stiefel 2005).

It should be observed that there is a difference between default and the more modern terms *insolvency* and *bankruptcy*. Default essentially means that a debtor has not paid his debt. Default may occur if the debtor is either unwilling or unable to pay a debt. Insolvency is (today) a legal term meaning that a debtor is unable to pay his debts. The debtor is in financial difficulties when his or her total assets are less than his or her total liabilities, or when

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1 Loan contracts are agreements that are voluntarily established between lenders and borrowers. One party (person) promises or agrees to perform certain acts while the other party (person) agrees to pay in return for the performance of the contract.
he or she is unable to pay debts for other reasons as they become due. Bankruptcy is a legal finding that imposes court supervision over the financial affairs of those who are insolvent or in default. In modern legislation, insolvency is often a necessary but not sufficient condition for bankruptcy. For the latter to exist, one needs a bankruptcy law. Insolvency and bankruptcy laws can be seen as part of an authority’s determination to protect property rights. A basic problem to be solved is “how shall the losses be distributed?”

The development of the legislation can be described using at least two perspectives as the starting point: one targeting creditors and one targeting debtors. The perspective targeting creditors means that the focus is on the constitutional procedure and that creditors are to be paid on as equal terms as possible. The perspective targeting debtors aims at making it easier for the debtor to carry on his business with the creditor’s confidence and be able to come back after insolvency. Legislation dealing with debtors who could not or would not meet their obligations dates back to ancient times (Mathews 1994). During long periods in history, there was no working bankruptcy system. Such a system does not emerge until trade and credit are developed. Debtors who had neglected their payments were dealt with by common law or by such legislation as medieval constitutional law, executive regulations and enforcement orders, i.e. regulations that were outside the bankruptcy legislation. The bankruptcy system developed relatively late and in a rather tentative way. Its main aim was to achieve equality among creditors, i.e. equality as concerns loss when the debtor became insolvent. This can only happen through general agreement. If there were no bankruptcy system but only regulations on distraint, every possibility of obtaining payment upon debtor’s insolvency would be entirely dependent on who first required the distraint. Upon a threat of insolvency, there would be a race between creditors about the debtor’s assets.

Thus, one distinguishes between two kinds of execution claims: body execution and general execution. Body execution takes place through distraint, imports and sequestration. General execution takes place through bankruptcy. In principle, body execution only takes place if it is in the interest of the person requiring the execution. Upon bankruptcy, however, all creditors can register and are paid a share to the extent that this is possible. Bankruptcy covers all assets of the debtor, whereas body execution only covers single, special objects (Olivecrona 1964). The general use of the bankruptcy system is when there are several creditors and the debtor is insolvent. The bankruptcy system played a considerable role for the trading cities in Europe. Debtors who lacked sufficient property to secure their debt could be killed, tortured, sold as slaves or imprisoned. An imprisoned debtor’s hope of release lay in meeting the creditors’ demand. The debt collecting system

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2 For reasons of readability I will from now on use the term “he” as a synonym for the “he or she”-form, “his or hers”-form etc.
of imprisonment in Sweden can be traced back to the thirteenth century. It continued alongside a developing bankruptcy system up to 1879. A bankruptcy system first tentatively emerges in Sweden during the era of mercantilism when trade and credit are developed in the seventeenth and eighteenth centuries and a more modern bankruptcy legislation was implemented after the breakthrough of liberalism in the nineteenth century (Brommé 1888, Inger 1977, Thuula 2001).

Any credit transaction is characterized as an insecure situation, i.e. of high uncertainty under imperfect information. One main problem in the estimation of credit risks is information. The borrower has better information about his economic circumstances than the lender. Therefore, there have always been many opportunities for fraud, deceit and misjudgment (Berghoff 2005). This might be an explanation for why many cultures already at an early stage introduced drastic measures with the aim of protecting credit and private property. This appears from regulations for dealing with insolvency and bankruptcy as well as with fraud connected with these situations (e.g., Hunter 2000). For long periods, debtors unable to pay their debts were subjected to severe treatment. Default, insolvency and bankruptcy were often equaled to theft or robbery from the creditors, who usually had the right to the debtor’s property and body. The death penalty, servitude, stigmatizing penalties involving shame and debtors’ prison were still in existence well after the Middle Ages.

A question in this study is: How do institutions such as the bankruptcy system and debtors’ prison emerge and why do they change? Debtors’ prison can be traced back to Roman law. Individuals who had run into debt and who could not or did not want to repay loans were placed in custody and the creditor paid a minor sum for their subsistence. The period in prison was not limited in time and went on either until the debt had been paid or as long as the creditor was prepared to pay subsistence money for his prisoner. In Sweden, the system of debtors’ prison is mentioned as early as in the thirteenth century. The system of debtors’ prison was not limited to Sweden but was widespread (Harold 1983). In 1834, a British parliamentary commission reported that imprisonment for debt existed in every country in Europe, except Portugal (Ford 1926). There are several important foreign studies on debtors’ prison (Lester 1995, Bressler 2004, Feer 1961, Brown 1996, Randall 1952, Ford 1926).

In Sweden, the medieval system of debtors’ prison coexisted with a slowly emerging bankruptcy system for a long time up until 1879. The question of how institutional change took place could be illustrated by surveying the views of the legislator of a debtor who had not paid his debt and what

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3 The English practice of imprisonment for debt, which started during the time of Henry III, was used by barons as a threat to encourage their debtors to repay debts, so that the barons could themselves honor their obligations to the crown. Williams.
penalty measures were proposed at different points in time. The period of investigation covers many centuries. Looking over a long period is an effective way to see variations in what we today take for granted. It is also a way of seeing processes when the discursive frames are produced, such as when a stigma for debt begins, is added or disappears. Unfortunately, there is insufficient information for creating a complete and satisfactory picture. Besides certain methodological difficulties in following a bankruptcy system over many centuries and several different legal cultures, there is no sufficiently stable basis of sources on which such a project could build (Friedman 1969). During long periods, the basis of the study is limited to dips into legal texts and decrees that have been preserved. Laws can be considered as an agreement between different parties or as a way of institutionalizing the division of power. Laws and decrees constitute normative source material that can provide us with interpretations of what was considered right and wrong in a society. They can be interpreted as relics from a bygone time (Sjöholm 1988, Larsen 1994, Hedenborg 1997). Credit grantors are protected by the legal system in different ways and by studying both legislation and practice, we can get an insight into the relations between different groups of people. As mentioned above, for a long time in history default was punished as being equal to theft. But the meting out of punishment as it is expressed in legal practice can often be something different than what is stated in the legal texts. In certain areas in which the legislation is incomplete, practice might be the major legal source (Söderberg 2000). There is only scarce information in Swedish archives about the legal practice that was used when punishing an insolvent debtor and about the principles and solutions that were stated in the decisions of courts and other authorities. In the following, a few examples of this development will be described. I will also try to make the presentation more colorful by using quotes and descriptions of particular cases in order to create a sense of being close to history. Previously, Swedish historians and economic historians have made no such research on this issue. They have often used these sources for economic judgements and not for examining the juridical system as such. German and Swedish legal historians have studied insolvency legislation, but usually without any contact with other subjects. Unfortunately, there is no theory (a merger of legal science and economic historical anthropology), which is the reason why the presentation is relatively narrative and sometimes divided. The problem of how to deal with those who have failed in their promises has been solved in different ways at different points in time and in individual areas. The Roman center transferred its solutions to the periphery where they were locally adapted.

4 The concept of legal culture has been defined by Lawrence M. Friedman as the values and attitudes of people in relation to legislation and the legal system. What do people think about the legislation? How prone are different parts of the population to obtain their rights through the legal system? Whether the legislation and the authorities are respected are some of the questions on which there is a focus in this theoretical perspective.
Christianity and trade constituted a channel for transmissions towards the north.

After this introduction, I will provide a survey of the early Swedish regulations on default, insolvency and bankruptcy. That section describes the Swedish development from the time of the law-rolls of the Swedish provinces until the introduction of a modern bankruptcy law during the second half of the nineteenth century. The presentation focuses on how an insolvent debtor should be treated according to these regulations and it is mainly based on information from the Royal Statutes, Ordinances, Bills and Decrees, all of which can be found in the Royal Library in Stockholm (Uncatalogued Printed Material Section).

Using various sources, ranging from published statistics and political pamphlets to prison records from Stockholm and Gothenburg and from court depositions to parliamentary diaries, I will try to give a quantitative picture of the use of debtors’ prison. Next, there is a section dealing with how, when and why the institution of debtors’ prison disappeared in Sweden and what happened after that. The reason for the emphasis on this aspect appears to be the fact that this was the last formal institution in Sweden to stigmatize the debtor. The study then concludes with a summary.

The present Swedish legislation on insolvency and bankruptcy has its roots in Roman, German and Italian law (Olivecrona 1862, Tuula 2001). Thus, a retrospect of history might be appropriate here.

Default debtor in Roman law

The term Roman law today often refers to more than the laws of Roman society. The legal institutions developed by the Romans influenced the laws of other people long after the disappearance of the Roman Empire and in countries that were never subject to Roman rule.

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5 This part of the study is partly based on earlier studies in legal history. Studies on how Roman and Medieval European law regulated the treatment of the insolvent debtor have been carried out by, among others, Beyer (1850), Löning (1876), von Hoiningen (1878) and Kaser (1955). The history of Swedish insolvency laws has been written by Bergström (1771), Olivecrona (1862), Lantmanson (1866), Broomé (1888), Agge (1934), Olivecrona (1964) and Tuula (2001). Studies of how the laws on criminal offences against bankruptcies developed have been carried out by Rydin (1888), Neumeyer (1891), Bergendahl (1933) and Löfmarck (1982, 1991).

6 In Sweden, the legislation on insolvency was not collected in one single law. The regulations about how an insolvent debtor was to be dealt with were mainly to be found in old national and general urban law codes, commercial codes, enforcement codes and the bankruptcy law.

7 To take the most striking example, in a large part of Germany Roman law was in force as “subsidiary law” until the adoption of a common code for the whole empire in 1900, i.e. it was applied unless superseded by contradictory local provisions. However, this law, which was in force in parts of Europe long after the fall of the Roman Empire, was not Roman law in its original form.
Long before the time of the Roman emperors, a legal procedure emerged regulating the relationship between creditors and insolvent debtors. A basic feature of this regulatory system was that the life and property of an insolvent debtor accrued to his creditors. The debtor as a person was the main target of the distraint. This execution of the person necessarily came to develop so that the debtor’s property (the execution of the tangible assets) became the main objective of the distraint. This shift in the emphasis from an execution of the person to an execution of the tangible assets went on for several hundred years and at least two phases can be distinguished: (1) the proceedings in the older Roman law according to the Twelve Tables and (2) a weakening of the creditors’ power through *lex Poetelia* and *lex Julia*.

In the early legislative period (the Twelve Tables 451 B.C.), it was customary for a person wanting to get credit to commit himself, his family and his property to the creditor as a pledge. If the debtor could not fulfill his payment obligations, he became the creditor’s slave and the latter even had the right to kill him. If there were several creditors, the Twelve Tables gave them the right to dismember the debtor’s body (Alexander 1892, Lantmanson 1866, Erler, 1978). It is unclear to what extent this law was exercised, but an insolvent debtor always ended up in servitude; he and his family could be sold as slaves.

The next step in the development towards a bankruptcy system was taken when creditors were given instant access to the debtor’s property. Through *lex Poetelia* (326 B.C.), omitting to fulfill a debtor’s contract became a criminal offence. At the same time, the creditor’s unlimited rights to the life, property and family of the debtor were restricted. Among other things, this law abolished the right to ill-treat, kill or sell the debtor and his family as slaves. The debtor was still forced to stay in the creditor’s private prison in a kind of debtor’s servitude, but he regained his freedom if the debt was settled. Only if the debtor was suspected of trying to escape, was the creditor allowed to put him in chains. A debtor who kept in hiding could be subjected to a kind of bankruptcy process (missio in bona). This meant that the creditor received a letter of attorney (missio) from the receiver (praetor) to dispose of the debtor’s property (bona). An insolvent debtor still also lost his civil rights (infamia). No consideration was taken of whether he had become insolvent by accident or whether he was responsible for the situation himself. A temporary inability to pay a due debt thus led to the destruction of the debtor’s entire existence.

A *lex Julia*, attributed to Caesar by some and to Augustus by others, removed the creditor’s power one step further from the debtor as an individual and towards his property. This innovation in the legal system was called cessio bonorum. The debtor now had the possibility of avoiding the disgraceful consequences of missio in bona because he was given the chance of declaring his insolvency and voluntarily surrendering (cedere) his property (bona) to his creditors. Roman law had now separated the debtor as a person from
his property and had introduced the principle of equality between creditors in losses that were due to the debtor being insolvent. The main objective of the execution, i.e. distraint, was no longer the debtor as a person and his body, but his property. This must be considered as a very important innovation.

In principle, all insolvent debtors could ask to be allowed to voluntarily surrender their property (*cessio bonorum*), which exempted them from disgrace. Thus, the door was now open to abusing the new system. When a careless debtor no longer had any assets, he could declare to his creditors that he had become insolvent and wished to surrender his property without losing his citizen’s rights. To prevent further abuse, this exemption was restricted to those cases in which the debtor was found not to have caused his insolvency himself. Only those who could show that they had become bankrupt because of external circumstances (such as fire, shipwreck and attacks from robbers) were exempt from disgraceful treatment. In those cases in which the debtor himself was considered to have caused his insolvency, *cessio bonorum* still meant infamy and severe treatment. At the same time, the punitive measures against a debtor who had been careless or fraudulent towards his creditors by withholding assets before or after the default became more severe. He was sentenced to prison (*carcer*) and debtor’s servitude (Beyer 1850, Hoiningen 1878, Kaser 1955, Olivecrona 1964, Löfmark 1986, Neumeyer 1891). By this legal usage, Roman law had introduced the important difference between honest and dishonest debtors.

**Default debtor in Germanic legislation**

The Roman Empire collapsed during the flood of the Great Migration and many of the systems developed by the Empire eroded or disappeared. This was a degenerative process for legislation. The migrating Germanic peoples brought their own legislation into the previously Roman areas in Gaul, Italy and Spain where they lived according to their own laws along with the Romanized population and its laws. Germanic law characterized European society in the Middle Ages and together with Roman law, it still constitutes one of the bases for European legal culture.

Germanic law is originally a common law, i.e. a product of people’s customs, which, for a long time, were only retained in the oral tradition in the minds of those learned in the law (cf jurisdictional district). Not until the late Middle Ages was a consciously innovative legislation introduced, often produced by the emerging royal power and the church (Amira 1913).

According to old Germanic law, an insolvent debtor was subjected to just as severe a treatment as in old Rome. Default was in itself seen as a crime. A freeman could be exiled or sentenced to become a slave for debt not properly paid. Slavery for debt seems to have been the more common of the two. Slavery began when the creditor could not satisfy his claim in the debtor’s
property and no third person came to the debtor’s rescue. The German view that the inability to pay a debt equaled theft from the creditor thus played an important role. If the debtor had no assets, he would be sentenced to become the creditor’s bondsman (Wergeland 1902). Prison and even torture were used as means of extracting property. Surrendering one’s property was often followed by degrading ceremonies, where the debtor wore a special gown, was forced to walk barefoot, and so on (Amira 1913).\(^8\)

In contrast to Roman law, older Germanic law did not distinguish between honest and dishonest debtors. The distraint was first aimed at the debtor’s fortune, but if this was not sufficient, he was handed over to the creditor as a bondsman and could be sold or killed. In Norwegian legislation (leyfingsbalken kap. 15), it is stated that a creditor can bring a debtor to court. If no one ransoms him, the creditor can cut off upper and lower parts of the debtor (Grimm 1881).

Besides debtor’s servitude, the debtor could also be subject to a feud or become an outlaw. Debtor’s servitude was not limited in time or defined as to its contents. The debtor’s responsibility could also be regulated in a contract of responsibility. Pledges and hostages also appear in these contracts. If a hostage was held as a pledge, the personal responsibility for the debt was taken over by a third party. Like other material pledges, hostages were handed over to the creditor who was to keep the hostages in custody. If the debtor did not satisfy the creditor in time, the hostage became the creditor’s property. The hostage then lost his freedom. The collective responsibility of the family required its members to become hostages for the sake of a family member in need. Debtors could put up even wives and children as hostages.

Not until the era of the Franks (Prinz 1985) were creditors’ initiatives superseded by the state.\(^9\) Judges would hand over an insolvent debtor to his creditor, who could then freely dispose of him. If the creditor’s claims were satisfied, he was to give the debtor his freedom back. The debtor was considered as a compensation or substitute for a pledge.

During the period of the Franks, a debtor could voluntarily enter into servitude, a proceeding reminding us of Roman law. The ongoing development is parallel to the direction earlier taken by Roman law. An insolvent debtor is no longer killed or sold but is put to hard labor for the creditor. At the same time, the servitude was allayed because the debtor was given the right to

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\(^8\) A visible sign of slavery was shaved hair and in certain parts of medieval Europe easily identifiable clothes.

\(^9\) The realm of the Franks (Regnum Francorum, ca 600 - 900) is by many people considered the starting point of the institutions and cultures of the medieval European forms of government (in particular, for France and Germany). Remnants of the antique culture were retained and changed, which constituted a first stabilizing factor during the confusion of the Great Migration. This stabilization was achieved by creating a closer relation between Roman and German people. The center for political processes was moved from the Mediterranean towards the northwest of Europe.
work off his debt. Sources from the Carolingian monarchy (approx. 800 – 1000) confirm the beginning of a transition from life-long to limited servitude (Erler 1978a). In German cities, creditors could still take debtors into custody without the intervention of a court and at their own initiative. Outlawry developed into a procedure for arresting escaped debtors. This procedure of taking people into custody was also used for insolvent debtors at a later stage. It was first used in cities against foreigners who were reluctant to pay (Schuldturm).

A developed bankruptcy system did not exist in German law before the mid-sixteenth century. The main principle of German law was the creditor’s focus on the debtor as a person. This might be one of the reasons why the severity against the debtor was maintained for such a long time. A default debtor should, after the application from a creditor, “according to old customs”, first be clapped in irons and after 3 days be transferred to a debtors’ prison where he was to be kept until he had paid his due (Oetker 1847).

Some time between the end of the fifteenth and the beginning of the sixteenth century, the Roman system cessio bonorum was incorporated into German law in a reform of criminal law (Conrad 1966). The possibility to surrender one’s property voluntarily was immediately seized by debtors to avoid debtors’ prison. At the same time, the door became wide open to fraudulent proceedings towards creditors. Debtors lacking the funds to satisfy their creditors or who did not wish to do so could, however, escape from the severe consequences of insolvency by surrendering their assets. This led to an abuse that made legislators return to a more severe treatment of irre-

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10 The reform of medieval bankruptcy legislation started in Germany with the Lindau parliament 1496/97. The reason for this was complaints from the general public that had been submitted to a higher court. They were accused of having judged and executed a large number of innocent people. The following parliament at Freiburg 1497/98 thus decided to implement a general reform on law in the country. In 1500, the parliament at Augsburg decreed that such a reform was to be implemented. The reform proposal was implemented in 1532 after many revisions. More than 30 years passed before the new legislation had been adopted under the name of Constitutio Criminalis Carolina. In the new legislation, domestic German ideas were adapted and connected to foreign ideas, often borrowed from Italian criminal doctrine. Carolina constituted a turning point in the development of German criminal law. It interconnected the German legal views with the ideas on Italian criminal law without unilaterally copying the original. Carolina replaced the traditional, general descriptions of a crime with a clearly defined deed. The law now distinguishes between deliberately committed crimes and crimes that have been committed under emotional stress. The murderer and the killer are now punished differently. The intention of the legislator was that the perpetrator can only be punished if guilt can be proved, which was an important innovation. The new law also considers the perpetrator’s responsibility for his actions (e.g., young people and those who are mentally deranged). The Carolinian penal system still shows the harshness of medieval law with many corporal and maiming punishments.
sponsible or dishonest debtors. The extensive "Reichs-Polizei-Ordnung" from 1548 is the first law to regulate penalties for dishonest debtors in Germany and the final traces of debtor’s servitude did not disappear until the eighteenth century in that country. The procedure with a voluntary surrender of property and the ensuing abuse of the new system that leads to the creation of special laws against dishonest creditors is similar to Roman law (Conrad 1966). The first relatively complete bankruptcy procedure is to be found around 1610 according to Oetker (1847:14)\(^1\)

**Default debtor in Italian legislation**

A legal system that included bankruptcy proceedings emerged in the Italian city-states from the twelfth century and onwards, but it only applied to merchants.\(^1\) Debtors were subjected to very severe treatment, including a very strange and humiliating ceremony, even for honest debtors. Torture was permitted in order to extract hidden assets (Uhlenbruck 1977). The following statement by Baldus, a Roman learned in law, could be copied as a suitable motto for the older Italian bankruptcy law: *fallitus, ergo fraudator* (insolvent, thus a swindler). It is unclear to what extent there was empirical support for these severe judgments but obviously fraud (*fraus*) was suspected in each case of insolvency and thus an additional statement was made: *falliti sunt infames* (insolvency means disgrace). The thirteenth century was an intense century for legislation in an international perspective. In that century, Roman law had a strong influence all over Europe (Inger 1980). The treatment of people in debtor’s servitude was naturally influenced by these views. Only a debtor who could prove that he had become insolvent by accident could escape prison. The penalty for fraudulent debtors varied among cities and the circumstances of the crime. Withholding property and escape could incur a penalty ranging from the loss of rights to death. In many cities, a voluntary surrender of property (*cessio bonorum*) was completely excluded (Rydin 1888). The administration of justice was still focusing on the consequences of criminal law and public moral stigmatization. A developed bankruptcy system was a prerequisite for the economic boom in the north of Italy in the later Middle Ages. For members of merchant networks at that point in time, bankruptcy of an individual member constituted a disadvantage for everyone. Thus, public stigmatization by pillorying a person is as important as the distribution of the debtor’s assets among the creditors. Because international trade was spreading, the basic characteristics of the Italian bankruptcy system also became a successful export good (Gessmer 1978). The

\(^{11}\) Würtembergisches Landrecht from 1610.

\(^{12}\) Important bankruptcy statutes were created in Venice (years 1244, 1395 and 1415), Milan (year 1341), Florence (1415); see Alexander (1892).
view that behind each debtor there was a swindler who should be severely dealt with was spread to, above all, France, Spain, England and Germany by Italian merchants (Hunt & Murray 2000).\(^{13}\)

**Default debtor in Swedish legislation**

Not until the year 1000 can we talk about a joint Swedish kingdom. The structure of this kingdom was fairly loose, however. This agrarian society did have a common king, but it was still dominated by families that had constituted the basis of society for a long time.

Within the Swedish kingdom, the different provinces constituted independent units in many different senses. The larger ones had their own laws called law-rolls of the Swedish provinces. Knowledge of the law was inherited among district judges through oral tradition. As the laws developed, it became increasingly difficult for each citizen to know all their details. Probably under the influence of church law, one law-roll of the Swedish provinces after another started to be put into writing from the thirteenth century and onwards. Ever since the beginning of the fourteenth century, the old legal differences between the Swedish provinces began to disappear quickly. The provinces that had already previously been unified into a political entity also started to merge as concerns legal aspects. In the mid-fourteenth century, several royal regulations were issued\(^{14}\), which can be seen as premonitions of or even preparatory work for a uniform national law code. This national legislation came to apply for a long time in the Swedish countryside (Abrahamsson 1726)\(^{15}\). As in other Germanic countries in the Middle Ages, the Swedish national legislation had a general urban law code that only applied to cities. The emergence of the general urban law codes was due to the special economic requirements of cities and their independent administration of justice. The oldest remaining general urban law code in Sweden is Bjärköarätten. The name Bjärköarätten comes from the Icelandic word Bjaerk or Bjark (Bjarkeyaretter), which means trade and that was a general

\(^{13}\) A law that was introduced in 1321 in Barcelona can be mentioned as an example of this. This law prescribed that private bankers who had gone bankrupt would be imprisoned for a year on water and bread until they had paid all their debts. If they did not succeed, the consequences were drastic. An example of this legal practice might be the fate of the banker Francesco Castello. He was beheaded in a public place outside his bank in 1360.

\(^{14}\) King Magnus Eriksson was to implement this innovative project around 1350. A common law for the entire kingdom was drawn up in the form of Magnus Eriksson’s national law code and Magnus Eriksson’s general urban law codes.

\(^{15}\) See Schlyter *Sveriges gamla lagar “Sveriges rikes landslag”*, published by S. Abrahamsson 1726.
From debtor’s servitude to debtors’ prison

At the time of the law-rolls of the Swedish provinces, the barter economy was the predominant system and the credit system was poorly developed in the countryside. According to most of the law-rolls of the Swedish provinces, a debtor might be taken into servitude if a procedure of distraint (maet) was without result. Both maet and debtor’s servitude were decreed in the case when a creditor required payment. These laws contained no bankruptcy procedure for living debtors (Lantmanson 1866, Löfmark 1987, Tuula 2001). In the twelfth century, Swedish law began to use imprisonment as a means of coercing borrowers into paying their debts. In the law-rolls of the Swedish provinces, the right to revenge had not yet been abolished but was subjected to certain limits. The oldest court procedure depended on the injured party finding out who was the criminal. Then, he would take him to court or to the judge where he would complete his claim. Instead of public custody, private housing was used for a long period. The oldest Swedish laws do mention “fängsel” (fetters) and their use but not “fängelse” (prison). The medieval view of punishment as a kind of redress for the injured party is, according to Munktell (1943), based on primitive feelings of revenge. As an example, the execution of corporal punishment was originally entrusted to the prosecutor and, at times, he had the right to choose whether he wanted a death penalty to be enforced or whether he would accept a fine from the criminal.

Prison was still compulsory for all debtors and various kinds of disgraceful punishments were added to the punishment of being deprived of one’s freedom (Schulte 1861). The debtor was reduced to the state of a slave: his hair

16 There has also been an attempt at deriving the origins of the word from the word birk 'secluded area', 'trading place', and from the name Biærkø, referring to Björkö in lake Mälaren, where the city of Birka was located.

17 The Norwegian bjärköarätterna from the twelfth and thirteenth centuries are considered the oldest ones; they were intended for the cities of Nidaros and Bergen. A Swedish bjärköarätt remains, which is dated no earlier than 1345. It has been used in Lödöse in the province of Västergötland but was probably originally intended for Stockholm. Besides this copy, only a few fragments remain from no earlier than the mid fourteenth century. Bjärköarätten was published in writing by J. Hadorph 1687, C.J. Schlyter 1844 and Å. Holmbäck and E. Wessén 1946.

18 In Östgotalagen (The Östgöta law), to legally take someone into custody was stated to mean to fetter or shackle the feet and tie the arms of the criminal, lock him into a house and guard the house (Thaet aer lagha haefta fjaetra ok aerma binda ok hus ivir hanum lykkja ok ivir husi varp halda.).
was cut and a strap or collar was passed around his neck. The debtor was also stigmatized by having to walk at the very end at weddings or in funeral processions or by having to sit with the women in church. Debtors’ children who were born after a bankruptcy were not allowed to wear jewelry, a rapier or a dagger (Conrad 1966). Debtors’ prison is mentioned as early as in the oldest general Swedish urban law code, the Bjärköarätten:

A man now arrives in the city who is involved in debt, notwithstanding if he is indebted to a man in the city or to someone else; the bailiff, the district court judge or two men of the city or the swains of the bailiff and the city are informed. The man or his property shall be taken into custody and he pays the debt he acknowledges. If he does not have enough money, he sets a bail to the person who requires the payment of the debt that satisfies the latter. If he wishes to deny the debt, [he does so] with the oath of three men, if it amounts to less than six marks [if it amounts to six marks] or more, he defends himself with six men. Now he leaves custody and does not pay his way; then he pays a fine of three marks and the debt, notwithstanding if he is a courtier, priest, farm-bailiff or a peasant. A peasant can be taken to debtors’ prison and his property be seized but not his wife. If a widow with property in the city arrives and is in debt, she can be put in debtors’ prison according to the laws of the city.19

As appears from the quote, the creditor could, with the aid of the bailiff, have the debtor put in debtors’ prison. The debtor could deny the debt with the aid of three or six sworn witnesses. We can also see that in Bjärköarätten the debtor’s property and person can be sequestrated. He himself is deprived of his freedom due to his debt. In both cases, the Swedish verb “bysätta” is used. This double meaning of “bysätta” continued to exist in legal language for a long time.20 The Swedish town Visby was a flourishing commercial Nordic center with relations with countries and cities where Roman law was known or applied. Visby Stadslag (the general urban law code of Visby), which was written in the fifteenth century, contained regulations for taking debtors into custody instead of making them subject to debtor’s servitude. In the law code of Visby (II: 30), the term “besetten” was used in the sense of sequestrating goods because of debt.

The transit from debtor’s servitude at the creditor’s to custody in the city jail started in the twelfth century in England and Germany, but did not become more common practice in small cities until the 16th century (Löning 1876, Erler 1978a, Bressler 2004). The transition from servitude to debtors’ prison would start by the creditor applying to the magistrate for disposing a room in one of the city buildings for keeping a debtor in custody. Gradually, this service came to be considered as a matter of course by the public. Cus-

19 Chapter 40 from the translation into modern Swedish by Holmbäck and Wessén (1946).
20 In the law of 1734, the Enforcement Code chapter 8 is “About distraint and debtors’ prison”. The former means that a debtor’s property is secured so that it can be used to pay the debt; the latter means that he is deprived of his freedom because of his debt.
tody for debt became a substitute for serfdom for debt (Hoiningen 1878, Bressler 2004).

An emerging bankruptcy system

Traces of a bankruptcy procedure are probably first found in *Upplandslagen* (a law-roll from a Swedish province from the end of the thirteenth century), and only in those cases where the debtor had passed away. An adequate pledge was required from living debtors and the rest of the claim was extracted by enforced work or by exercising pressure through debtors’ prison. A somewhat more elaborate view on bankruptcy can be found in the general urban law codes. In the cities where credits were of importance for the growing business life, the circumstances were somewhat different. An example of such a tentative development of a bankruptcy system in Sweden can be seen in Visby stadslag from the end of the fifteenth century. Visby stadslag was the first in Sweden to consider a kind of bankruptcy proceeding for living people. Furthermore, there were regulations stating that debtors having escaped with property face a lifetime sentence. Visby stadslag does not make any explicit statement about the possibility of surrendering one’s property as a key to freedom for an insolvent debtor voluntarily surrendering his assets. But there are signs of a familiarity with the doctrine of Roman law of a *beneficium cessionis bonorum*. It was considered that a debtor could, in some cases, free himself from his obligations by surrendering his fortune (Olivercrona 1866).

Regulations on the voluntary surrender of assets (*cessio bonorum*) existed as early as in Magnus Eriksson's National Law Code and in Carl IX’s Privilegier för Göteborg av 1607 (The Privileges of Carl IX for Gothenburg of 1607). Surrendering one’s property probably gave the debtor all the advan-

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21 This also explains the then common statute that the *gäldstugan* (debtors’ prison) that had been established at that time must not be “unpleasant” (thus not be situated below ground) and the creditor was to cover a minimum of the debtor’s subsistancy. With the aim of making hidden assets emerge, the stay in debtors’ prison was made as difficult as possible. The only meal often consisted of bread and water. It was not uncommon to put the debtor in the stocks or in heavy shackles.

22 It is here decreed that, upon a lack of funds in the estate of a deceased debtor, deductions should be made from the creditors’ claims in proportion to the size of their claims, i.e. a kind bankruptcy of the estate.

23 The history of the Swedish commercial town of Visby goes back at least as far as the twelfth century. Visby was part of the powerful German Hanseatic League and quickly developed into one of the largest cities in Northern Europe and one of the main cities of the Hanseatic League.

24 Here, a new reason for opening a bankruptcy procedure is first mentioned, i.e. if a debtor, with several creditors, had escaped. The creditors created an interest group for taking care of the debtor’s property and a scheme of arrangements is mentioned. Only a handwritten document in German from about 1340 still exists. The contents of Visby stadslag are in many parts similar to Bjärkōarätten.
tages of this system (Lantmanson 1866, Löfmark 1987). The principle was that in case of an accident in which the debtor was not at fault (war, damage at sea, piracy, fire and the failure of others), the debtor was offered to make a compound, whereas a fraudulent debtor was severely treated. If the debtor lacked the appropriate means, he was sentenced to pay off his debt by work. Fraudulent debtors were put in custody until they had satisfied their creditors (Olivecrona 1862).

A legal commission submitted a legal proposal in 1643 containing the first Swedish attempt at creating bankruptcy legislation. The proposal clearly distinguishes between debtors whose insolvency is due to an accident and those responsible for their insolvency themselves. The former became free men as soon as they had voluntarily surrendered their assets to their creditors. An extensive legislation on insolvent debtors began to take shape at the end of the seventeenth century.\(^\text{25}\)

The development of Swedish legislation in the sixteenth and seventeenth centuries is characterized by a considerable influence from foreign law (Inger 1997). Rules and views from Roman, Germanic and Italian law were often echoed in Swedish regulations. The conventional wisdom in Italian law at the time was that man failed because he deserved to fail – because of personal deficiencies. Failure to pay one’s debt was often ascribed to a couple of personal sins: speculation and wastefulness. It seems to me that these views had a strong influence even on the Swedish conception of economic failure until the nineteenth century.

A Royal Decree in 1673 extended the possibility to surrender goods to apply to the entire country. A person who had voluntarily entered into bankruptcy and proved the bankruptcy to be due to an accident that he had not caused himself not only became a free person but was also – which was an important innovation – liberated from any future claims from his creditors. In that way, the stipulations in Roman law about *cessio bonorum* lessened the effects of a severe Swedish executionary procedure. This relief particularly applied to honest debtors. In 1694, there was a proposal on how insolvency was to be dealt with in litigation proceedings and the concept of *Concurs* is introduced as terminology for the first time in 1695. The proposal is considered as the first attempt at real bankruptcy legislation (Agge 1934, Tuula 2001, Welamson 1961).

Speculation and extravagance were also considered the most important reasons for bankruptcy in the written Swedish debate in the eighteenth cen-

\(^{25}\) For example, the Royal Statute of July 10, 1669; the Royal Resolution and Declaration of the delegates’ appeal for all Estates, given on October 3, 1675; the Royal Resolution from November 9, 1685; the Royal Resolution and Declaration of May 28, 1687; The Royal Reply to Svea Hovrätt on October 7, 1687; The Royal Resolution on executions, etc., on November 29, 1688; The Royal Resolution on N.N. Suppliquer on May 16, 1689; Royal Letter on October 14, 1689; The Royal Bill and Decree of March 14, 1699, to mention a few.
Consequently, the suggested penalties were harsh. A person who could not pay his debts was always to be punished in proportion to the lacking sum. If two thirds of the debt were lacking, the debtor could be imprisoned for a maximum of 7 years, with certain periods on only bread and water. If the sum exceeded 2000 silver coins, the debtor was first to be subjected to flogging and then to serve life-long imprisonment.

In the seventeenth century, it was up to the Swedish authorities to decide whether the debtor should be allowed to surrender his property. This required that the insolvency was due to an accident (piracy, fire, etc.). If this was the case, the debtor was exempt from enforced work and prison as well as from disgrace and future responsibility for the debt. If it could be proved that the debtor had intentionally taken measures to reduce the creditors’ rights, or if he had been guilty of leniency and carelessness as concerns their interests, there were no valid reasons for using these special provisions. In 1734, new regulations on bankruptcy (within the commercial code) replaced a number of medieval decrees and bankruptcy regulations in general urban law codes and provincial laws. In the following century, three more laws were introduced (1798, 1818 and 1830), which, in turn, were replaced by a more modern bankruptcy law in 1862. The French system, which was regulated in Napoleon’s Code de Commerce from the year 1808, and the Prussian Bankruptcy Code from 1855 constituted a model for the bankruptcy law of 1862 (Bromé 1888, Inger 1997).

The possibility of voluntarily surrendering one’s property in exchange for freedom from future responsibility for the debt disappeared completely in the bankruptcy law of 1818. Even a debtor who had become insolvent by accident remained responsible to pay the debt with any possible assets acquired in the future. In return, the penalty regulations became more detailed in this law. Carelessness was punished and fixed time spans were stipulated for the different crimes. In contrast to older bankruptcy statutes, the bankruptcy


27 Flogging with a stick was a common form of punishment in older times. The flogging was carried out using two sticks at a time. Men were punished with a maximum of 40 pairs of flogging and women with 30 pairs on their bare skin (thus, the expression flogging). The punishment was carried out by the executioner at the pillory or at the entrance of the town hall. Flogging as a general means of punishment was abolished in Sweden in 1855. However, flogging still existed as a disciplinary punishment in prison or institutions of forced labor until 1938.


29 See the regulations on carelessness and fraud in bankruptcy, 3 chap. 4 and §§§, Bankruptcy law in: *Brottsbalken den 21 december 1962 samt översikt över ändringar i strafflagen under*
law of 1818 was characterized by clearly limited regulations on, among other things, the responsibility of careless and fraudulent debtors (Löfmark 1986). French law received a great deal of attention in Sweden. The severe judgment of bankrupt debtors stated in Code de Commerce, which was a moral condemnation of insolvency, once more became predominant. A new bankruptcy law was implemented in 1830. As concerns the issue dealt with here, it was an identical repetition of the law of 1818. The final difference between honest and dishonest debtors disappeared in the bankruptcy law of 1862.

Regulations against dishonest debtors

The possibility for a debtor of escaping disgraceful treatment by voluntarily surrendering his possessions had been abused in the Roman Empire and in German territories. This abuse had brought on special criminal laws for dishonest and careless debtors. The Swedish trend seems to have been similar. In the privilege given to Gothenburg by Gustavus Adolphus II in 1621, the fundamental principle that “Falsantes et Bankarupti” (falsifiers and bankrupts) should be sentenced to serious penalties was sanctioned. However, there are indications that these decrees were not always applied in the courts to the desired extent. In 1664, the Royal Councils complained about the fact that executions of debtors were dealt with


30 Carelessness from the debtor in a bankruptcy case was a known concept for the legislators of 1734 and was mentioned in contrast to fraud, on the one hand, and bankruptcy that was not due to the debtor himself, on the other. The bankruptcy legislations contained certain regulations on the consequences of such carelessness (imprisonment, prohibition against entering the stock exchange or against having any general occupation). Penalty for careless debtor was first introduced in the bankruptcy law of 1818. In the bankruptcy law of 1862, a new class of bankruptcy crimes (referred to as dishonesty) was created.

31 An example of this view: “One has seen businessmen without books, books without any order and context and fairly often books, where the illusory correctness during the last year has been nothing but fraud, a collection of writings created in order to hide the treachery from the creditors, and the crime from justice”. “Bankruptcies, far from being the tools of shame, have become the means of obtaining a fortune, the source of which one hardly tries to conceal; and even if all these bankruptcies were not always the result of crime, they were at least the result of insufficient knowledge, while the whole world wanted to do business without knowing, what was required.” “Also, disregarding the harshness of the law against criminal bankrupts, nothing has been more rare than its application; and nothing has so encouraged these crimes as this absence of punishment.” Corps de Droit Commercial Francais. Paris 1841, pp. 208-09, in Underdånigt Betänkande till Kongl. Maj:t, angående Kreditförhållande- nes och Låneanstalternes ordnande avgivet den 8 april 1853 af särskilt i Nåder utsedde Comiterade. Nordstedt & Söner, Stockholm, 1853.
The legal regulations on insolvency were of importance, for they constituted the key to maintaining the faith in the credit system. A Royal Decree on executions dated July 10, 1669\(^{33}\) (which only applied to knights and noblemen) is, to my knowledge, the first time a more detailed distinction is made between various reasons for insolvency, although from a moral perspective. Paragraph 15 decrees that the court shall determine how debt and poverty have come about. If the court found that the debtor had become insolvent because of an accident where he was without any guilt, he should become a free man but should repay the debt if his financial circumstances improved. If the debtor has contributed to the insolvency himself by “an extravagant and non-virtuous life”, he will receive no compassion leading to a more lenient treatment. He shall then be severely punished with debtors’ prison or custody. § 23 decrees that an insolvent, common person must “pay with his body”, i.e. “work for his freedom or be imprisoned, and can receive no bail”.\(^{34}\)

These were harsh times for the indebted person, who usually was imprisoned. If the person lacked the means of paying for his subsistence in prison, the creditor was obliged to contribute three öre a day in advance.

That a person who had become insolvent “through extravagance and carelessness” was was the same as a swindler and should be “punished and chastised bodily and by work” was clarified anew in a Royal Resolution of 1675.\(^{35}\) Debtors who delayed the investigation or escaped were considered swindlers. It was considered more “difficult to protect oneself against [them] than against thieves and obvious robbers”. Thus, they were not only condemned to serve their entire debt in prison but were also exposed to shaming penalties: to be “put on a pillar in a square or a public venue to be publicly disgraced for two hours and also be sentenced to prison on bread and water or to work in any of the king’s fortresses”.\(^{36}\) The prescribed penalties for debtors with self-inflicted insolvency were further reinforced towards the end of the century. The background to this was that the authorities had, “with the largest dissatisfaction”, observed for a long period an increase in the number of fraudulent bankruptcies that were equaled to serious theft. These swindlers and bankrupt individuals should be “pointed out and be labeled

\(^{32}\) Statutes, Decrees, Letters and Resolutions. Stockholm 1696. The Royal Library, Uncatalogued Printed Material Section.


\(^{34}\) For more information, see 15 chap Rådstugu Balken St. L.

\(^{35}\) Royal Resolution and Declaration of the delegates’ appeal for all Estates, October 3 1675, § 20. The Royal Library, Uncatalogued Printed Material Section.

\(^{36}\) XVI. Cap. 4 § Commercial Code, Royal Decree 1687. Art II. §1.
with general infamy” before they were punished with forced labor. The explicit aim of these harsh punishments was to maintain and reinforce the confidence in given promises and in the credit between trading people.37

It is unclear whether the increase in the number of fraudulent bankruptcies was real or supposed. However, this change in attitudes resulted in the development of a special regulation on bankruptcy crimes. Penalties for bankruptcy crimes were mentioned or assumed in certain older legal works. The first real penal legislation in this area, which concerned fraudulent bankruptcy and escape from bankruptcy, is presumably the Royal Decree of 1699. Here, it is established that a debtor who did not come to the trial, or who had run away, was to be known as wanted immediately and drumming was to take place in all public places. On Sundays and holidays, it should be announced from the church pulpits that the person was wanted. An escaped debtor was declared an outlaw and pursued by the law accordingly.38

If a debtor escapes from debt […] he will never find peace within the borders of the country and will in his absence be condemned as a swindler and his name will be posted on a pillar, and he will be condemned as a swindler in all commercial cities.39

An escaped debtor was sentenced as a swindler in his absence and his name was to be posted on a special notice board for bankrupt people and swindlers in each trading city. The creditors were given the right of disposal of the property of the escaped person, which they could later sell at an auction.40 These penal regulations for deliberate crimes were transmitted to the law of 1734.41

37 Royal Bill and Decree on intentional bankruptcies and their ensuing punishment. Stockholm March 14 1699.
38 Outlawry meant being excluded from the peace that the legal system guarantees its members. The outlaw lost his legal rights but was also obliged to escape from peace and quiet and become an exile. He was given a short period of respite to put himself in safety. Then, anyone could kill or molest him without penalty. As far as we know, there is no known example of such a treatment. Being an outlaw also had certain repercussions on the relationship with those covered by the legal system. Everyone was thus forbidden to house, feed or even socialize with the outlaw. In time, the consequences of being an outlaw were reduced so that the criminal could no longer be killed but only imprisoned.
40 See Royal Resolution and Declaration May 28, 1687 and the Statute of March 14, 1699 in Modee R G, Extracts from Publique Handlingar, Placater, Förordningar, resolutioner och Publicationer, Som Riksens Styrelse samt invärtes Hushållning och Färfattningar i gemen, jämvälv Stockholms Stad i synnerhet angå. Second part Year 1740. Stockholm 1746.
41 See 16 ch 4 and 5 §§ Commercial Code.
Legal regulations of debtors’ prison 1734 – 1879

The next major law, the law of 1734, contained nine codes with concrete regulations applied to both the countryside and the city. They replaced the medieval laws, Kristofers landslag (Kristofer’s provincial law) och the general urban law code. The law built on older practice in courts and was very conservative. The regulations for bankruptcy that were introduced were very brief. Chapter 8 of the Debt Enforcement Law deals with “On sequestration and debtors’ prison”. The former means that a debtor’s property is put up as security so that it can be used to pay a debt, whereas the latter means that the debtor is deprived of his freedom because of his debt. According to the Trade Code Chapter XVI of the same law, the default debtor shall be imprisoned and pay his debt by enforced labor, if it is found that his “poverty is due to wastefulness, gambling, idleness or carelessness”. Debtors’ prison, which had previously been a safety measure against the debtor being able to escape his liability to pay by escaping, was in the new law to an increasing extent used for people with an unsettled bill debt and overdue promissory notes. Debtors’ prison could be used as soon as the debtor had failed in his obligation to pay. The creditor could apply to the city magistrate for permission to put a late, insolvent or reluctant debtor in debtors’ prison.

An example from Gothenburg can serve as an illustration: The shopkeeper Carl Odén had drawn a bill (on Mr N.C. Friedlander to pay 73 Riksdaler on June 15, 1830 at the very latest) that had become due. Jonsson and Andersson, who were servants of the city, certified that a creditors’ meeting had been properly announced. The shopkeeper Odén did not come to the creditors’ meeting and was not available at the distraint. The magistrate thus decided that Odén be put in debtors’ prison. He was further sentenced to pay the debt of 73 Riksdaler at the prescribed rate of 6% from the due date and two Riksdaler to cover the costs of the distraint. The decision could be appealed against by anyone disapproving within 30 days.

For other debts than bill debts, the debtor could be put in debtors’ prison when the debtor had been found to lack the means of paying the debt during attempts at making a distraint. The fact that debtors’ prison continued to work as a remnant of medieval penalties for insolvency is clear. This penalty was in some respects harsher than those to which other criminals with penalties that were limited in time were subjected. The latter, e.g., could ask the

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42 For a more detailed discussion, see Agge (1934) and Tuula (2001).
45 Göteborgs landsarkiv, Överskultens i Göteborgs arkiv, E II:11, extract from the protocol with the creditors of Carl Odenius in the town hall of Gothenburg on February 19 in the year 1830.
king for mercy, a possibility that did not exist for the prisoner in debtors’ prison. An individual could be kept in debtors’ prison until he consented to confess. Neither a criminal act nor a suspicion about such an act was required. If the debtor could not find the money, he or she was completely at the mercy of a possibly vindictive creditor’s discretion. There was still no stipulated limit to the period a debtor could be kept in debtors’ prison, which was thus dependent on the creditors’ willingness to pay.

The Roman view of *fallitus ergo fraudator* (insolvent thus a swindler) also characterizes legislation well into the nineteenth century. The rule that the default debtor should be put on a pillar still existed in the laws of 1734, 1818 and 1830. In those cases when the debtor has behaved fraudulently or tried to escape or hide property, or used treachery and tricks towards his creditors, then “such a swindler shall be put on a pillar equipped with an iron collar, in a square or a public venue, to be put to shame for two hours, and also be sentenced to prison on bread and water" [46] or to work in one of the king’s fortresses [47] between two and five years”.[48]

These were difficult times for an insolvent debtor and many were forced to escape when they could not satisfy their creditors. We will never be able to determine how many they were. In the second part of the seventeenth century, the number of debtors that escaped probably grew in such a way that the legislation started to be implemented. The first decree that equals flight with theft existed as early as in Visby’s stadslag. Thus, one had provided a basis for future revenge using criminal law. Running away from your debtors was still punished in the nineteenth century according to the harsh statues of 1675 and 1699, which further stigmatized the offending party.

The bankruptcy of Carl Wilhelm Hammarsköld can serve as an example of even upper-class people being stigmatized by insolvency (Andersson and

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46 In a Stockholm paper from 1820, there is a description of the harsh consequences that a penalty increase to bread and water might have: Almost as unfortunate, but less terrible (than the flogging) is the penalty with prison on bread and water. The prisoner then receives 420 grams of bread and as much water as he or she can or wants to drink. The penalty was considered connected with the largest health dangers: “Only prisoners who have previously been toughened by previous, long-term prison terms have been able to receive such punishment without interruption. For many prisoners, this punishment had to be interrupted and they were transferred to the cottage hospital. Other prisoners have, after experiencing the punishment, succumbed to its consequences or have suffered from the after-effects for the rest of their lives. Many of those who did not show any sufferings or symptoms during the term of punishment have later caught dropsy and died.” “En blick på Stockholms fängelser”, *Allmänna Journalen* No. 289, 1820-12-12.

47 The prisoners were sent to Carlsten’s fortress in the city of Marstrand in the archipelago of Bohuslän, north of Gothenburg. There, they were usually obliged to carry out work on the fortress from 0600 in the morning to 1900 in the evening. If they became jaded, they were sent to the fortress of Elfsborg, which at that time was the place where jaded prisoners from Carlsten were dumped (Svenson 1904).

48 The Statute Book of Sweden. Approved and Accepted in Parliament in 1734. Her. Foug, Stockholm, 1870. Commercial Code XVI. Cap. 4§. The Royal Library. Also the bankruptcy law of 1818 3 chap. 5§ and the bankruptcy law of 1830 3 chap. 43§.
Hammarsköld was captain of the hussars and director of the largest brass factory in Sweden at that time (Skultuna bruk). He was the descendant of a noble family, dating back to the early seventeenth century. As a friend of King Oscar I of Sweden, he speculated a bit in royal lands in the northern parts of the country with great findings of iron ore. But Carl Wilhelm Hammarsköld had other kinds of business with worldwide connections that removed his attention from his regular business. According to the family chronicles, his business became increasingly reckless and daring towards the end of the 1840s. Despite the fact that the name of Hammarsköld was given unlimited credit, the business was not going too well and he had to consider the possibility of signing for bankruptcy in December 1849. Hammarsköld left for America before the bankruptcy was proclaimed by mid-January 1850 (Hammarsköld 1915). Hammarsköld’s actions indicate that the stigma of bankruptcy was still severe. The crime for which he was sentenced – running away – was not committed until after the bankruptcy in 1850.

Debtors from lower social classes also took flight when faced with the threat of debtors’ prison but they did not have as good possibilities of leaving the country. Once more, an example can serve as an illustration: The restaurateur Bardelius had become bankrupt in Stockholm in 1827. The trustees in the bankruptcy suspected him of treacherousness and fraudulent behavior and Bardelius escaped. He was wanted in the entire country and was caught and returned to Stockholm where he was first arrested and then later moved to debtors’ prison. It is noteworthy that the court took this decision against the will of all creditors. The creditors had – with the aim that the bankrupt’s estate should not be saddled with the subsistence costs in debtors’ prison – requested that Bardelius be liberated.

The issue of debtors’ prison continued to be of importance. A list of decrees follows upon the law of 1734. In particular, regulations on sentencing insolvent debtors to debtors’ prisons were very common. In summary, ac-

49 Exactly what triggered Hammarsköld’s bankruptcy is not known. The verdict from Svea Hovrätt consists of about 500 pages. 611 creditors are named and listed, and the claims of each are examined and treated with care. Many are simple people holding minor assignations while several have larger sums. The king himself, as a private person, claimed the largest sum. Hammarsköld owed him 535 000 Riksdaler (a very large sum) for lands in northern Sweden. Minutes of Svea Hovrätt, criminal cases, 15/12 1853. National Archives, Stockholm.

50 Nyberg (2006) gives another example of a prominent person from a higher social class that escaped from the country. In 1821, the mercantile world of Stockholm was shaken by a scandal. Colonel Ernst Fredrik von Willebrand escaped from the country after considerable fraudulent financial transactions.


cording to the law of 1734 and the decrees issued later on, a debtor could be put in debtors’ prison for bills of exchange and promissory notes as soon as he had failed in his obligation to pay and for other debts when he had been found to lack the means of payment after a distraint. In a Royal Decree on bankruptcy dated 1770, an idea was presented that is once more on the agenda in the modern debate: 53 An honorable debtor who has become insolvent shall be given a new chance:

An unfortunate debtor, who thus honorably renounces his property, and thus gets rid of his debt, can thus get a better credit again, if he is economical, works hard and is happy. 54

A suggestion for a general criminal law made by the legislative committee contained new regulations on bankruptcy crimes. 55 Fraud was divided into two types, a more serious and a lesser one. The proposal tried to define this criminal area in a comprehensive way that would satisfy the new legal principle of “no punishment without law” (nulla poena sine lege). After some changes, the proposal was included in a new proposed bill in 1844. This proposal was not implemented either, but the regulation on bankruptcy crimes was included in the bankruptcy law of 1862. 56 In this law, dishonesty was entered as a particular crime. Thus, there was a division into three kinds of crimes: fraud, dishonesty and carelessness. In the penal law of 1864, these penalty regulations were included in chapter 23 under the heading “on a fraudulent, dishonest or careless debtor in bankruptcy”. 57


53 There is an intensive debate on the extent to which the bankruptcy legislation is to be changed so that entrepreneurs that become insolvent are to have a chance of recovering after a bankruptcy. See, e.g., Gratzer (2001) and Ayotte (2007).

54 “Förklaring om Fallissemang” den 23 Martii 1770. §.3.

55 25 chap. under the heading “Om bedrägligt eller vårdslös gäldenär i konkurs” (“On Fraudulent or Careless Debtor in Bankruptcy”).

56 Competition Law, 8 chap.: Om ansvar i konkurs för bedrägligt förhållande, annan oredlighet och vårdslöshet” (“On Responsibility in Bankruptcy for Fraudulent Circumstances, Other Dishonesty and Negligence”).

57 According to the original regulations in the criminal code, the injured party could only charge dishonesty against creditors, escape because of debt and carelessness. In a law of October 14, 1892, dishonesty and escape were turned into crimes of denunciation and in 1921, both these crimes were put under public prosecution without the requirement of denunciation from the injured party (Ministry of Justice 1975). With some changes, this division of the crimes into three categories was kept until the legal reform in 1942. In the latest reform, all debtors’ crimes were placed under public prosecution, without any requirement for a statement from the prosecutor (Löfmark 1986).
Debtors’ prison

In this section, a quantitative description will be given of the extent of the use of debtors’ prison, the prisoners, the length of the period of confinement and the reasons for release.

Finally, I will try to answer the question of whether the institution of debtors’ prison was efficient, given the aim of squeezing out hidden assets from the debtor, his family or friends.

How widespread, then, was custody for debt? Unfortunately, there exists very little statistical information on this issue before 1835. One reason for this is that there are no collected statistics before 1835. Debtors’ prisons were spread geographically and often only existed as subunits of other institutions. There existed only few special debtors’ prisons and jails as in Stockholm (Elers 1801 and Tjerneld 1949). But prisoners were often kept in special areas in town halls or in special units in other prisons. Thus, e.g., in the 1790s, the prison in Gothenburg was first located in the cellar and then on the upper floor of the city hall. The debtors’ jail or debtors’ prison was also part of this prison, the ”tjuvakistan” (thieves’ coffin) and a unit for people who had been sentenced to prison on bread and water. In the city of Kristianstad in southern Sweden, prisoners in debtors’ prison and prisoners on water and bread were often kept in a room on the upper floor of the town hall while other prisoners were kept four floors below ground.

Based on the existing statistics, figure 1 depicts an approximate picture of how many men and women were sentenced to debtors’ prison in the period 1835-1878. We can interpret the quantitative picture as consisting of three levels: a relatively high level before 1841, a middle level in the period 1841-1867 and a relatively low level during the final phase of this legal system.

The number of people in debtors’ prison, which might have amounted to between five and six hundred a year between 1835 and 1840, decreased considerably in the two following decades. On average, there were about 380 imprisoned debtors per year in 1841 – 1867. Between 1868 and 1878, only about 30 people were put in debtors’ prison every year. The share of women was fairly constant and amounted to an average of about 3.5% in the period 1835 – 1878.

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58 In Stockholm, there was a debtors’ prison in Gamla Stan (the Old Town) in the eighteenth century. It was moved to Hornsgatan in 1781. Moreover, there was also a jail for noble people at Stockholm Castle. Finally, the court for industry and trade (“hallrätten”) in Stockholm had had an institution for workers in debt.

59 Landsarkivet i Göteborg, Göteborgs stadsfängelses arkiv, GLA/11576
60 Landsarkivet i Lund, Kristianstads stadshäktes arkiv, 11046
61 Unfortunately, there are no data for the years 1854-56. Missing data for 1854-56 were computed (median of nearby points, span of nearby points = 2).
Figure 1. The number of persons in debtors’ prison (Sweden 1835 – 1878)

Source: Contribution to the official Swedish statistics B, Juridical system (Rättsväsendet, Överståthållarens underdåniga berättelse), 1837-77.

The difference between the levels covaries with the legislative changes, which all decreased the creditors’ power over the debtor. In 1841, there was a decree abolishing the creditor’s right to use debtors’ prison after distress.\(^{62}\) Through a decree from 1868 debtors’ prison could only be used if it had been discovered during the distress that the debtor’s assets were insufficient to cover the debt and if the debtor refused to take an oath on there being other means than those that had been stated.\(^{63}\) Debtors who refused to take such an oath could be put in debtors’ prison. After having been put in debtors’ prison, the debtor could take an oath in jail in order to be liberated. Moreover, the time in jail was limited to a maximum period of 6 weeks. The consequences of these legislative changes were that the number of prisoners in debtors’ prison, which, on average, amounted to 361 in the period 1860-1868, fell markedly in the period 1869-77 to an average of 29 per year. In the new debt enforcement law of 1877, enforcement of debtors’ prison is not mentioned and as of January 1, 1879 when the above-mentioned law came into force, the last person in debtors’ prison disappeared from Swedish prisons.

\(^{62}\) The Swedish Code of Statutes 1842 No 39.
\(^{63}\) The Swedish Code of Statutes 1868 No 24.
A cross-sectional study can give an indication of the background of the people in debtors’ prison. The number of individuals in debtors’ prison in 1860 was 371, 97% of whom were men. Amongst these, only one prisoner had his origins in the nobility, 67% came from the commoner estates (mainly craftsmen and merchants), 17% were peasants and 4% were servants. Twelve percent derived from the working class. 32% of the prisoners were below 30 years of age and 57% were between 30 and 50 years old. Only 11% had reached an age above 50 years.

The size of the debts was quite small. One percent was arrested for a sum not exceeding five Riksdaler, 53% were arrested for sums between 5 and 100 Riksdaler and 43% for sums between 100 and 1000 Riksdaler. Only 2% of the prisoners were arrested for sums exceeding 1000 Riksdaler. An interesting question is how long these prisoners were kept in jail. Thirty-five percent were kept in prison between 1 and 7 days, 36% between 7 and 30 days, 14% between 1 and 3 months and 5% between 3 and 12 months. Only one person spent longer than 1 year in debtors’ prison.

Given the aim of securing hidden assets, was the use of debtors’ prison efficient? We might get some clues by interpreting the information on why those in debtors’ prison were released. The number of debtors released for paying their debt might be an indicator of the efficiency of the system. Six reasons were mainly stated as the grounds for being released from debtors’ prison: (1) payment (payment fulfilled), (2) an exemption warrant or an agreement with the creditor (a compound), (3) creditors’ neglect to pay for the debtors’ living costs in debtors’ prison (4) swearing “the poor mans oath”, (5) cession and (6) other reasons (those who were released due to illness, madness, death and transfers to other kinds of custody are included in this group).

As shown in Table 1, in the years 1857-59 and 1866-67, only an average of 16 of the total number of convicted were released because they could satisfy their creditors with the whole sum of the debt. The group who transferred their property to the creditors’ collective (cession) constituted the largest share, 38%. Thus, the use of debtors’ prison appears to have been a reason of some importance in cases of bankruptcy. The second largest group was released because they made agreements or compound with their creditors. Their share in the corresponding period amounted to 37%.

In about 90% of all observations, the release usually took place because the person in debtors’ prison paid his debt, declared himself to be bankrupt or made some kind of informal agreement. For that reason, the system of debtors’ prison was quite efficient. The rest of the prisoners were released

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64 SOS, B Rättssväsendet, Arbetsredogörelser samt särskilda uppgifter angående inтеckning och lagfart, utсökningмål 1861. (Statistics Sweden. Series B. Juridical system 1861)
65 The debtor declared himself bankrupt by renouncing all his property to the collective of creditors.
because the creditor grew tired of paying for the upkeep of his prisoner. The main use of the system of debtors’ prisons in this period was thus to force the individual to surrender his property to the creditors. After 1868, swearing the oath was the most common reason for releasing debtors from custody.

Table 1. Reasons for releasing people in debtors’ prison

<table>
<thead>
<tr>
<th>Year</th>
<th>Payment</th>
<th>Exemption warrant from creditors</th>
<th>Creditors’ neglect to pay for debtor</th>
<th>Swearing66</th>
<th>Cession67</th>
<th>Other reasons</th>
</tr>
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<tr>
<td>1857</td>
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<td>86</td>
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<td>81</td>
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<td>22</td>
<td>0</td>
<td>121</td>
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<td>*</td>
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<tr>
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</tr>
<tr>
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<td>3</td>
<td>3</td>
<td>25</td>
<td>3</td>
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</tr>
</tbody>
</table>

*Data not available between 1860 and 1865.
Source: Contribution to the official Swedish statistics B, Juridical system (Rättsväsendet, Överståthållaren’s underdåniga berättelse), 1837-77.

Why did debtors’ prison disappear?

Trends in political culture, legal development and practice and changes in economic life are of importance for understanding why debtors’ prison ceased to exist.

One reason is that the treatment of criminals changed because of the emergence of a more human view of one’s fellow-beings, which is related to the Enlightenment. It took a long time before the view that a crime does not only concern the victim but also the general public to at least the same extent gained any ground. Slowly, the view that the punishment partly constitutes a private settlement disappeared into the background. As shown by Andersson (1998), Söderberg (1993), Jarrick and Söderberg (1994) and Söderberg (2000), the methods for punishing crime became more civilized in Sweden in the sixteenth century. Courts started making sentences more humane at their

66 From 1868, a creditor was released from prison if taking an oath.
67 By renouncing all his property to the collective of creditors, the debtor declared himself bankrupt.
A death penalty for theft was considered reasonable in the late Middle Ages and many people were executed for theft. Two hundred years later, legal practice was much more lenient. Brutal corporal punishments were gradually abolished. The practice of burying people alive disappeared in the sixteenth century. No one had his right hand cut-off for a crime after 1620 and somewhat later the custom to cut the ears off criminals disappeared. In the latter half of the seventeenth century, people were no longer branded with red iron and tongues were no longer cut out for blasphemy. These reforms were implemented in Sweden already in the century before the Enlightenment. Particularly the early nineteenth century was a period of intense debate on the causes of and remedies for criminal offenses in Sweden. The problem of how to reform institutions and the criminals themselves came into focus (Söderberg 2000).

A second reason is that the conventional idea at that time that people failed because they deserve to fail because of personal deficiencies began to erode in the middle of the nineteenth century. The views on default and insolvency seem to have become more ambiguous. Through the development of the market economy, bankruptcy probably increasingly seemed to be the result of impersonal and less easily influenced forces. The culpa perspective (it is mainly the debtor’s actions that create insolvency) was beginning to be crowded out by the casus perspective (insolvency occurs when the debtor has made an erroneous prediction about the future, but has not taken any incorrect action in the legal or moral sense) when joint-stock companies and insights into international business cycle fluctuations were introduced.68

A third reason is the international trend in this legislative area. The Swedish legal system was now even more clearly being phased into a European context. The first steps towards abolishing debtors’ prisons were taken in France where the possibility to use debtors’ prisons was abolished in 1867. The French reform had then more or less been implemented by the North German Confederation (1868), Austria (1868), Belgium (1871), Denmark (1872) and Switzerland and Norway (1874). Also in England – perhaps the country where the use of debtors’ prison was most common – “The Debtors Act” in 1869 considerably reduced this use. Sweden followed in 1879 and in Finland, debtors’ prisons were abolished in 1895.

A fourth reason can also be mentioned, namely the then widespread view that the system of debtors’ prisons had outlived its time. The first criticism, to my knowledge, appeared already in 1767 (Wennberg 1776).69 The subject

68 For a discussion of the terms, see Martinsson (1999).
69 “According to the latest Royal Declaration, as of the year 1768, a Creditor, even if he only has the smallest and most insignificant claim, alone has the complete liberty and right to dispose of the Debtor’s freedom. This is not only harmful for the Debtor but also for other creditors because a greedy and mean person thus has the right to, at the disadvantage and increased sufferings for the others, exhort his entire sum […] when a debtor is weak enough to unlaw-
was frequently discussed in the Swedish Parliament. The discussion was particularly intensive in the years 1847-48, 1859-60, 1862/ and 1868-69. The system of debtors’ prisons was, above all, criticized for sentencing people on basis of confessions, at times without any trace of a crime, and that the period in debtors’ prison might be subject to the discretion of a creditor out for revenge.70 The system was criticized for being a dated remnant of the methods of torture in the Middle Ages.71

From the lost chances of a ruined life to the lost capital of a bankrupt company

A businessman who failed in the early nineteenth century faced inadequate bankruptcy laws, vengeful creditors and idleness in debtors’ prison. Relief actions and legal reforms had made debtors’ prison less important after 1840 but the stigmatizing effect remained. Institutional and economic changes were to lead to a decreased stigmatization of an insolvent debtor. Among the economic reasons can be mentioned the emergence and spreading of joint stock companies, changes in the credit market and knowledge about the existence of international business cycle fluctuations. Altogether, these changes had made debtors’ prison an obsolete institution and had made the pictures of why people fail economically more varied. Changes in views eventually resulted in new legislation.

At the end of the eighteenth century, the Western world needed institutions in which large business groups could become organized to devote themselves to economic activities and still be relatively free from economic government control. Despite the fact that such a prominent author as Adam Smith wanted to deny any usefulness of joint stock companies, it would be the main response of the Western world to this need (Rosenberg and Birdzell 1991). Upon the creation of the law of 1734, private businessmen owned and ran the major part of the commercial businesses in Sweden. The major part of the businessmen consisted of craftsmen and merchants in the city. Legal corporate forms did not exist in the way they do today. The line of demarcation between the finances of the entrepreneur and the finances of the firm had not been drawn up. As a consequence, to fulfill the creditors’ requirements no distinction was made between the assets of the household and those of the firms. All assets were to be part of the bankrupt’s estate and be at the disposal for payment of due debts (Albinsson-Bruhner, 2004). Bankruptcy

fully give a tyrant full compensation at the expense of the other creditors” [own translation from Wennberg]

70 See, for example, the Report of the Standing Committee of Civil Law Legislation 1859/60, No. 41.
71 The protocol of the parliament from the ordinary session of the Riksdag in 1868. First chamber, first volume, Friday March 6, p. 538.
did not mean that the debtor became free from debt. The debt did not disappear until the death of the debtor and if the estate relinquished the inheritance.

By the nineteenth century a clearer distinction between natural persons (sole traders), limited partnerships and other limited companies began to emerge. In particular, trading companies and partnerships were considered personal corporations. Capital corporations usually existed under the name of joint stock companies. The latter corporate form was also most successful in Sweden. This new kind of corporation constituted an organizational innovation, the importance of which can most likely not be overestimated. The growth of joint stock companies was a condition for the development of the financial markets that took place in the eighteenth and nineteenth centuries (Broberg 2006).72 The new form of associations made it possible to finance more long-term, larger projects as well as a greater number of projects by spreading the risk among a larger number of people and limiting it to the invested capital.

For an insolvent debtor, the corporate form meant many important changes. The private fortune was no longer part of the estate and the risk was limited to the capital invested in the firm. Moreover, a joint stock company was liquidated in a bankruptcy so that the debts disappeared with the firm. A bankruptcy in a joint stock company was very likely less stigmatizing for the businessman. For long periods, there had been a widespread view that insolvencies were caused by less desirable characteristics such as arrogance, vanity, a tendency to speculate or insufficient knowledge.73 The joint stock company now distinguished between an increasingly substitutable individual and the firm, i.e. the organization that, in principle, had been given eternal life. Nineteenth century Sweden witnessed a redefinition from sin to risk, from moral failure to economic failure (Mann 2002).

During the periods that were covered by older Swedish legislation, credit was probably given against pledge.74 Economic historians and other people

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72 Like in the rest of Europe, the origins of joint stock companies in Sweden can also be said to go back to the trading companies of the seventeenth and eighteenth centuries. But it was not until the Companies Act in 1848 that this new type of company was regulated by law. A new Companies Act from 1895 marked the transition towards a more modern legislation in which the state formally waived the rights to control individual company formations. The breakthrough of joint stock companies in Sweden was a slow process, taking at least 80 years, where the real period of breakthrough has been dated to the period between 1895 and 1920.


74 The informal credit market in seventeenth century Stockholm has been described by Söderberg. There were a considerable number of claim cases in the courts. As an example of the approximate minimum lower value limit for what was dealt with in court, Söderberg mentions a dispute about an apron. Maria Olofsdotter against the butcher’s maid Kerstin Jönsdoter. Maria has pledged an apron with Kerstin and for this she has obtained bread amounting to the value of six öre. The maid does not deny this. The problem is that Kerstin does not want to
have shown that the cash poor economy of Sweden was predicated upon a web of debt and credit from the Middle Ages to the nineteenth century. Goods, promissory notes and services were continuously exchanged within that web (Adamson 1963, Franzén 2006, Jarrick and Söderberg 1998, Myrdal and Söderberg 1991, Müller 1998, Nyberg 2006, Perlinge 2005, Sundin 1992, Ögren 2003, Ågren 1988). These credit networks constituted a central and essential part of early modern trade and an essential part of the basic conditions for the development of pre-industrial business (Hoppit 1987, Safley 2000, Lester 1995). The networks built on personal knowledge and trust, which decreased the risk of credit transactions and made the future more predictable. Being creditworthy meant that other people had confidence in you as a person. Then, there was the economic side with good solvency and business credit (Nyberg 2005, Nyberg 2006). The development of industrialism and the market economy led to relations that are more anonymous, increasingly complicated business transactions and larger geographical distances. The possibility of personal trust developing between individuals decreased with the increasing number of agents and the geographical expansion of the market. This can be assumed to have devaluated the importance and possibilities of the personal networks, but at the same time increased the needs for dealing with risk and uncertainty.75

Death or rebirth of the businessman?

The fundamental dilemma of insolvency laws has always been whether they are about death or rebirth. Was it a system for picking a debtor’s bones in a more orderly fashion or was it a system that allowed the debtor’s return to the world? In an in-depth study of business failures in Stockholm 1815-1818 (Adamson 1996), the answer to the long-term question if bankruptcies have been a smart expedience for merchants to escape from debts and then start anew is “No”. According to Adamson’s study, it was still impossible to use the bankruptcy system as a clever device for avoiding debt at the beginning of the nineteenth century and it was still very difficult for entrepreneurs to get back into business after a bankruptcy. A study of the burghers and merchants of Gothenburg (Simonsson 2001) supports Adamson’s findings. Those merchants were forced to resign their membership in the Masonic lodge when return the apron. She is sentenced to do this; otherwise, she will have to pay three Riksdaler to Maria. Maria has been obliged to pledge her apron in order to be able to buy bread on credit. Jarrick Arne & Söderberg Johan, 1998, Odygd och vanära. Folk och brott i gamla Stockholm. Raben Prisma, Stockholm.

75 Lacking formal means of payment and credits (the Swedish banking system began to develop in a tentative way only in the nineteenth century), personal promissory notes and bills were used to a large extent. Bill-broking, which was the most common form of financing of trade at the beginning of the nineteenth century, decreased in importance after the middle of the century with the development of a formal credit market (see Andersson 1996).
filing for bankruptcy. Simonsson’s findings are contradicted by the results of a study of merchants in Gothenburg 1619-1820 (Andersson 1977, 1996). According to Andersson, bankruptcy was often the final way out of a severe financial crisis. The result was often the termination of the firm and personal bankruptcy followed by debtors’ prison. As a rule, bankruptcy was the end of the row for businessmen. But Andersson found important exceptions to this rule already between 1815 and 1819. In this period, 139 single traders signed for bankruptcy in Gothenburg; 71 or half as much of these started anew with a firm after bankruptcy.\footnote{76 The tradesmen A. Barclay, R. and J. Dickson, M. E. Delbanco and others are given as examples of good representatives of people who have developed an extensive trading business that survived crises and bankruptcies. They could return after the bankruptcy and further develop their firms. Andersson also gives an example of the fact that the business itself could be rescued from difficulties and crises, even if the individuals in the business did not survive financially. Thus, the tradesman A. Lorent who had moved from Hamburg in 1808 established a factory for refining sugar and producing porter. The works eventually developed into one of the largest industrial works in Gothenburg. When the firm entered into a financial crisis, his brother P. E. Lorent and then his brother-in-law J. Nonnen took over the business and introduced new capital. When A. Lorent died in 1833, the firm filed for bankruptcy. The investigation of the bankruptcy showed a very large deficit (assets amounting to about 3600 Riksdaler against debts amounting to about 1.2 million Riksdaler). In 1836, the works were sold at an auction to D. Carnegy. The firm carried on its business in his name well into the twentieth century (Andersson 1996, 1977).}

There are several indications of there being a paradigm shift in the view of the default debtor in the mid-nineteenth century. The public discussion of the increased existence of “false bankruptcies” might be an indication of this.\footnote{77 “Concerning false bankruptcies, which are one of the most terrible crimes in the area of stealing, it is well-known how the law can be avoided” (Öhman 1847).} A Swedish investigation on credit market conditions from 1853 called attention to a common nation-wide complaint about a lack of trust and an unreliability regarding credit contracts.\footnote{78 Underdånigt Betänkande till Kongl. Maj:t, angående Kreditförhållandes och Låne-anstalternes ordnande avgivet den 8 april 1853 af särskildt i Nåder utsedde Comiterade. Nordstedt & Söner, Stockholm, 1853.} This has caused credit crunches and common insecurities for those who are running a business. Furthermore, it threatens all fundamental property rights for business activities (p 48).\footnote{79 Ibid, pp 48, 54. “It is a great problem that property rights are often violated with regard to both the time period and the amount of the credit. One could say that the state of the art as it has developed under many years can be seen as a monopoly of disorder.” [own translation]} The investigation maintains that the situation in Sweden is similar to that in France.\footnote{80 Corps de Droit Commercial Francais. Paris 1841, pp. 208-09. i Underdånigt Betänkande till Kongl. Maj:t, angående Kreditförhållandes och Låne-anstalternes ordnande avgivet den 8 april 1853 af särskildt i Nåder utsedde Comiterade. Nordstedt & Söner, Stockholm, 1853.} Far from being an object of shame, bankruptcies have become a tool for capturing property whose origins one barely cares to hide. Even though the bankruptcy law is harsh against the fraudulent debtor, nothing has
been rarer than its application. This absence of penalty is pointed out by the investigation as the main cause for these crimes.81

The possibility of abusing the bankruptcy system is described in literary depictions from the beginning of the nineteenth century. These describe how the bankruptcy system is used as a tool for transferring assets from creditors to debtors (Sylvan 1942). These literary depictions must be seen against the background of a large economic crisis at the beginning of the nineteenth century. According to several newspaper articles, a boom with possibilities for speculations and opportunities of obtaining easily earned money had created a range of purse-proud upstarts, stock-exchange matadors and wholesalers. With their newly created fortunes, they could lead “an opulent life of pleasure, luxury and comfort”. The increasing level of living also entailed an increasing trade in luxury goods.82 In 1811, the attention was given to “infamous bankruptcies”, and thus the law could be circumvented and creditors could be put “into serious suffering and the credit, man to man/…/to the detriment of the honorable person, who is in need of financial support”.83 The boom ended in a general financial crisis in 1815.84 Most severely affected were all wage earners and all lenders, who turned into “beggars” while the debtors “without any other profit on their side than that of the gambler” could suddenly appear as “millionaires” (Brisman 1908). The abuse of the bankruptcy system was also pointed out in a journal article in 1824, where it is stated that the bankruptcy (“to become bankrupt”) must be one of the more profitable ways of “enriching oneself”.85 The famous Swedish playwright August Strindberg described in a novel in 1879 how businessmen used the Swedish bankruptcy system with the aim of enriching themselves (Strindberg 1879, here 1976).

There is empirical evidence that in the second part of the nineteenth century it had become easier to come back as an entrepreneur after a bankruptcy. In his study of industrial entrepreneurs in Gothenburg in the nineteenth century, Åberg (1991) found that the level of tolerance towards those who became bankrupt in the mid-nineteenth century was high. He found no support for the common view that bankruptcy was something ugly and dis-

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81 ibid p 49
82 See letter to the editor ”Yppighet och lyx”, Anmärkaren 1816 10/4 and Anmärkaren 1817 30/11.
84 In order to finance a war in Finland, Sweden had been forced between the years 1808 and 1809 to resort to several considerable bank note issues. The consequences were that the nominal value fell while there was a price increase. Because the price level virtually increased in the period 1807-1812, this price revolution created considerable disturbances in the economy.
85 “Om konsten att bliva rik”, Anmärkaren 1824 6/10. According to the Letter to the Editor, the debtor came out of the bankruptcy with a considerable gain, which, after the bankruptcy, allowed him to appear in “a beautiful horse and carriage” before his hungry and ragged creditors. Such fraudulent behavior seems to have been inaccessible to the law because of “insufficiencies in our books of law”.

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honorable. According to his study, failures were common, especially because of the inability of the credit market to deal with crises. Åberg (1991) found several entrepreneurs who had been involved in more than one bankruptcy. The possibility of forming joint stock companies in an increasingly small business sector made it easier for entrepreneurs who had become bankrupt to continue their activities if they so desired. Gratzer (1996) found that it had become possible for entrepreneurs to shift debts to creditors by signing for bankruptcy. A generous interpretation of the bankruptcy legislation often made such income transfers possible. Thus, at the turn of the twentieth century, entrepreneurs who wanted to stretch the limits of the rules of the game had the possibility of returning after a bankruptcy with the same activity in the same or new firms. Bankruptcy was in no way a stigma for them. It is, however, unclear how common such a course of action was among entrepreneurs outside Stockholm (Gratzer 1988).

What came after debtors’ prison?
The state represents institutionalized capacity to deal with collective problems in society. By abolishing the system of debtors’ prison, the possibilities for the state of intervening were also reduced. Some of the disciplinary and supervisory functions of debtors’ prison were now to be taken over by the market. When the Swedish economy grew and became increasingly dynamic and complex in the mid-nineteenth century, old trading traditions that only built on personal trust became less reliable and useful. Merchants and factory owners to an increasing extent made deals with previously unknown people on remote markets. Reformed insolvency legislation around the mid-nineteenth century had not, according to influential Swedish tradesmen and factory owners, been able to create reasonable conditions in the credit area. The entrepreneurs now decided to take the matter into their own hands. An international crisis was the triggering factor. In the fall of 1857, a boom suddenly turned into one of the most difficult business crises that ever affected the world market. The change started in the US where large railway companies and a renowned banking house had become insolvent. When the firm stopped its payments, it led to several trading houses in Hamburg (where Swedish trade and industry got most of its capital at this point in time) going bankrupt. Sweden was now also dragged into the whirlpool. In Stockholm in November, one large renowned firm after another started to fall. It was on November 17 that panic broke out on the Stockholm Stock Exchange after the announcement that the firm Hoare, Buxton & Co in London had stopped its payments (Gårdlund 1947, Andersson 1908).

Large credit losses and bad business cycles resulted in a large need for credit information, i.e. knowledge about debtors. Information was becoming an increasingly important production factor. The increasing need for information led to the emergence of private credit information agencies. Impor-
tant agents in Swedish business life to an increasing extent required information about the economic situation of their business partners. In an economy that was increasingly based on credits with long duration, importers and businessmen always had to evaluate the wholesalers’ creditworthiness. These, in turn, had to assess what scope/respite their distributors and retailers were to be allowed. At the same time, these retailers constantly had to evaluate the creditworthiness of their customers (consumption credits). It was against the background of this crisis, when the financial situation of many entrepreneurs was weakened and was only temporarily upheld through an extensive system of bills and loans against a guarantee that the decision of establishing the Stockholm Wholesale Merchants’ Association was taken in 185886.

This association started as an association of larger merchants in Stockholm and its surroundings, but soon covered the entire country. The statutes of the Stockholm Wholesale Merchants’ Association aimed at improving the credit conditions: “to try to create a better arranged credit system, and both decline and decrease the losses when goods are on loan”. Furthermore, the association was to safeguard the creditors’ interest in case of bankruptcies and suspension of payment and find information about the solvency of businessmen in the country. A number of representatives that were spread all over the country would, against remuneration, send lists of all businessmen with information about their solvency and evaluations of their willingness to pay. There was a scale of estimations with six degrees of credit, as well as estimations about the size of the business and the reliability of the owner. The wholesale merchants’ associations that had been established in different parts of the country merged into an umbrella organization in 1912 – The Central Office for Composition and Bankruptcy Proceedings – with about 530 independent underlying organizations. The members of The Central Office for Composition and Bankruptcy Proceedings consisted of banks, wholesalers and businessmen. Most important in this respect was the Stockholm Wholesale Merchants’ Association, which had a network of “information cells”, a network that was created by the representatives of the association, and thus the association was able to collect information from all over the country. Informal “black lists” and “spy-books” were created.87 These were kept at several levels. Merchants made credit evaluations of wholesalers: the latter evaluated retailers who, in turn, evaluated their customers. In these books, longitudinal data on the solvency and fortune as well as the willingness to pay were collected for entrepreneurs and consumers. In these compiled calculations, each individual was graded according to two vari-

86 Thus, the Swedish trend fitted well with an international pattern. Credit-rating agencies emerged at approximately the same time around the middle of the nineteenth century in the US, England, France, Germany, Austria and Sweden (Sandage 2005, Stiefel 1997, 2006).
87 Such lists are kept in the uncatalogued material section of the Royal Library in Stockholm.
ables – solvency and willingness to pay (Dolck 1901). For each variable, there was a five-point scale according to which each individual could be classified (e.g., punctual payer – doubly impossible payers. For a long time, the legislator did not regulate this activity; firms with the business idea of compiling, centralizing and adapting the information in order to sell it emerged. A classification as being unwilling to pay was stigmatizing, because the individual was prevented from obtaining credit. Credit evaluation had become an increasingly important task on the financial markets. The instruments had now improved but corresponding attempts had been made already in the eighteenth century. The banks’ need for prognoses of future credit risks has given support to an international line of business specializing in credit evaluation.

Summary

The development of the legislation on insolvency has been a long historical process covering several centuries. For long periods, debtors were subjected to severe treatment. Insolvency was often equaled to theft from the creditors who usually had the right to the debtor’s property and body. The death penalty, servitude, debtors’ prison and stigmatizing penalties were still in existence well after the Middle Ages.

We can see some fairly general stages of development in the treatment of an insolvent debtor. First, there is a period when the debtor is treated very severely. In the eldest Roman and Germanic as well as in the Swedish legislation, execution of the person was used as a possibility for the creditor to get possession of the debtor’s property by crushing him as an individual. At this stage, debtors were considered thieves and swindlers and the penalties were compulsory.

Next, there is a stage where the legislator alleviated the often cruel and inconvenient regulations for the treatment of a debtor. The debtor as a physical person was spared, but he often ceased to exist as a juridical person. Debtor’s servitude and slavery were replaced by custody and prison. Private prisons were eventually replaced by public custody.

Successively, the legislation came to accept that the debtor surrendered his property. This always opened the door to fraudulent proceedings, with special laws for careless or fraudulent debtors. Economically more developed societies thus often reverted to stricter legislations.

The situation for default debtors improved in Sweden when legal systems from Roman law were implemented. However, the use of debtors’ prison still played an important part in the latter half of the nineteenth century. Many people were sentenced to debtors’ prison for a short period for fairly small amounts of debt. The system applied the greatest pressure on those people who were least able to pay. Up until 1868, about 90% were released
because they could pay their creditors. The main function of the system seems to have been to squeeze out money from the debtor, his or her family and friends, to discipline and stigmatize him or to enforce bankruptcy. After 1868, when a debtor was released from prison when taking an oath, the institution had become obsolete. Debtors’ prison, the final remnant of the medieval penal system, disappeared in Sweden in 1879. At that time, the institution had become inefficient, given its goals.

When the system of debtors’ prisons disappeared, only fraudulent debtors were penalized according to regulations in the penal law. In my view, this constitutes a shift in paradigms. Since 1879, a person who has become insolvent is not stigmatized by being imprisoned. Entrepreneurial societies learn from failure by giving people a second chance. In the economy of the nineteenth century, business failure became an integral part of economic life. In the middle of the century, resources that had been invested in “failed firms” could be transferred to new firms.

Debtors’ prison ceased to exist at a point in time coinciding with the breakthrough of liberalism and freedom of trade in Sweden. In a growing and more complex economy that was increasingly based on credits, there was a larger need for access to credit information and to disciplinary and supervisory instruments. The state withdrew from these tasks, which were taken over by the market. Associations of entrepreneurs created organizations that collected, standardized and centralized this credit information. A debtor who was reluctant to pay or insolvent was stigmatized by being entered on black lists. Credit information was sold to other interested parties and this business idea created an international line of business specializing in credit rating.

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Württembergisches Landrecht från 1610.

“Yppighet och lyx”, *Anmärkaren* 1816 10/4 and *Anmärkaren* 1817 30/11.


The Risk of Bankruptcy among German Merchants in Eighteenth-century England

Margrit Schulte Beerbühl

The eighteenth century has generally been seen as a period of success and achievement. It was a period that saw Britain’s rise as the leading imperial and industrial nation of the world. It was, however, by no means a linear success story. The expansion of commercial business was accompanied by birth pangs, setbacks and at times by a disproportionate increase of risks. Success was mixed with failure. Vast fortunes could be amassed within the lifespan of a merchant, but the risk to fail and end in a debtor’s prison was equally high. Hoppit points out that the success of business over the century can only be properly understood when regard is paid to risk and failure, for it “adds detail and substance to the pictures of growth, decay and structural change which have been built up by historians ever since they began to describe the Industrial Revolution” (Hoppit 1987, p 1). The history of setbacks and failures should therefore be seen as an integral part of the story.

At the beginning of the eighteenth century, the law of bankruptcy had already undergone important changes in England. Since the early years of the century, it had lost much of its old moral content. Even among the contemporaries, there was a growing awareness that failures did not always originate from the dishonest, fraudulent or criminal behavior of the bankrupt. The changes that took place, although they were far from complete, may best be summed up with Bruce H. Mann’s remarks that the century witnessed “a redefinition of insolvency from sin to risk, from moral failure to economic failure” (Mann 2002, p 5). Mann’s statement refers to the development of the American law of bankruptcy, but it may be applied to the English one as well.

There are two important studies on bankruptcy in eighteenth-century England: one study is by Julian Hoppit who investigates the level of risk and the occupational composition of the bankrupts and the other is by Ian Duffy who focuses on the law and the crisis of 1810. Based on their research, I will explore the risk of failure among immigrant merchants in this chapter. To focus

* I wish to thank Michael Schneider (University of Düsseldorf), Paolo Di Martino (University of Manchester) and the participants in the workshop at Södertörns högskola, Stockholm (August 2005) for comments and suggestions.
on immigrants may not only highlight the risk they faced in a foreign environment with different economic traditions and different patterns of behavior but also the opportunities and expectations. Risk is Janus-faced: rising or high expectations of success and profit go along with a new readiness in risk-taking, and this in turn multiplies the chance of gain as well as the risk of failure. A study on the unfortunate among the immigrant merchants may therefore shed special light on the economic and entrepreneurial opportunities of the rising industrial and commercial society. The development and causes of risk of failure among immigrants will be demonstrated using the example of German overseas merchants in England.

In the eighteenth century, London was not only the leading commercial entrepôt of the empire, but also became the first financial center of the world by the end of it. The major part of British overseas trade was centered in the capital. Its port accounted for about 80% of the whole turnover of British foreign commerce at the beginning of the century. Towards the end of it, London’s share had declined to some 60%. This was, however, not a decline in absolute figures but in relative ones only, as the outports grew even quicker than the metropolis (French 1992, p 28f.). Because of its commercial and financial dominance, the overwhelming majority of overseas merchants had settled in the capital. They organized an international trade stretching far beyond the Empire into the most remote parts of the world. Since at least the seventeenth century, if not much earlier, the mercantile community of London was largely cosmopolitan. According to Stanley D. Chapman, about three quarters of its merchants were of foreign descent (Chapman 1992, p 30). While in the seventeenth century Dutch and Huguenot merchants dominated the mercantile immigrant community, they were replaced by Germans in the eighteenth century. As the capital was the commercial hub of the country’s international economic and financial activities, any study on the mercantile community of the eighteenth century will be essentially a study on London. The majority of German merchants also settled there. Only in the second half of the century did the quickly growing outports, such as Liverpool or Hull, and the new industrial regions in the north begin to attract more immigrant merchants.

To evaluate the risk of failure among German merchants I will start with a short overview of the size of the German mercantile community in London and their social background. In the following section, I will first deal with the law and frequency of bankruptcy in eighteenth-century England in general, before I explore the risk and causes of failure among the German immigrant merchants. In this section, I will elaborate that bankruptcy among them could not be explained in national terms only. As the eighteenth-century law of bankruptcy for the first time provided an instrument for a new beginning of the unfortunate, I will finally discuss the chances of restarting a business after bankruptcy.
The German merchant community in London

Although the German merchants constituted the largest mercantile immigrant group in the eighteenth century, hardly anything is known about them except for the famous few, including the Barings, the Schroders and the Rothschilds.¹ One of the reasons why they have not been researched is that the majority did not leave any records. Another one is that Britain did not have any immigration laws until the early twentieth century. Therefore, it is not possible to give precise figures on the size of immigration. For the eighteenth century as a whole, only rough guesses are possible about the number of immigrants (Panayi 1995, pp 21f.; Schulte Beerbühl 2001, pp 38-43). However, regarding the foreign community of overseas merchants, some more reliable information can be gathered from the naturalization records. Because of the alien laws and the Navigations Acts, the overwhelming majority of foreign merchants acquired British nationality. Of them, there were about three hundred naturalized British subjects of German birth that could be identified as merchants between 1715 and 1800.² They comprise the sample for the present chapter. They were all of Protestant denomination as the contemporary law of naturalization excluded Jews and Catholics.

To understand the pattern of behavior of immigrant merchants in times of crisis, it is necessary to make a few preliminary remarks on their social and economic status. The naturalized merchants of German birth came from the big mercantile families of the German port and other big cities, as well as from the commercial centres of the proto-industrial textile areas of Silesia, Saxony and the north-western parts of the German States (such as Westphalia, Osnabrueck and the Dukedom of Berg). The German linen producing regions were traditionally export-oriented and after the decline of the old Hanse corporation they had continued to send sons and other young relatives into the leading European trading centers to organize sales. Accordingly, the German families established international commercial networks based on kinship ties, religious affiliations and compatriots. A settlement in the British capital was just one aspect of their expansionist commercial strategy, for at home, the frequent borders and toll-stations hampered long-distance trade.³ Moreover, the German states did not have any colonies and the protectionist policy of the colonial empires excluded foreigners from any direct trade with

¹ This sample also includes merchant bankers and merchant manufacturers (see more explicitly part 4 of this chapter). On the German merchants of the nineteenth century, see Panayi (1995). His chapter on the eighteenth century focuses mainly on the German Jews and the few well-known merchants of German birth.
² The naturalization records generally do not mention the occupation of the naturalized citizens. The occupations of the naturalized persons of German birth have been compiled from a variety of biographical as well as serial sources (see Schulte Beerbühl 2006a).
³ For the later German merchant empires, see Chapman 1977, pp 5-48 and 1992, part 2, chap 5 and for the early eighteenth century German merchant empires, see Schulte Beerbühl 2006b.
them. With the rise of the British Empire, a settlement in London became strategically important to the German merchant families.

The organization of long-distance trade in the expanding world along kinship, coreligionist or compatriot ties helped to keep transaction costs low. Family members or compatriots were believed to be more trustworthy and as Muldrew has highlighted, they did not only build bonds of trust but also bonds of obligation. In times of general crisis such networks also provided support for struggling members. Either they coordinated help to prevent a stopping of payment by keeping up creditworthiness or if a bankruptcy could not be prevented, they tried to assist the unfortunate during the bankruptcy procedure and often supplied the means for a new start. These aspects have to be taken into account when considering not only failure but also the chances of a restart among German merchants in eighteenth-century England.

Bankruptcy in eighteenth-century London

As the eighteenth century was an age of new departures, failures were not an unusual phenomenon. The Enlightenment had brought a new rationality to man and had opened up new horizons geographically as well as physically and mentally. Things became explicable and feasible. Merchants traveled to distant and unknown places to bring back new products for which they had to find markets. Remote regions in the Americas or in Southeast Asia were drawn into an increasingly global network. Merchants also invested in experiments and inventions. Probably at no other time was the incentive to experiment and invent higher than in the eighteenth century. However, overseas trade as well as experiments and inventions needed capital, capital that had to be borrowed from friends, colleagues and other private people. Merchants not only borrowed money but also lent money. Because the outcome of adventures or experiments could generally not be predicted, expected gains could at any time turn into losses. Equally, wars, storms and pirates increased the risk and made the outcome of transactions unpredictable.

Lack of liquidity was another constant problem that merchants had to cope with. In view of the slowness of the contemporary transport systems, it took a long time before they could realize their gains. In the trade to the

4 On the role of trust and obligation, see Muldrew (1998).
5 On the role and importance of network organisation, see Powell (1991) and Thompson (2003).
7 As research by Stanley D. Chapman and Griffith, Hunt and O’Brien have shown, most of the inventions in the textile industry were either not successful or were short-lived (Chapman 1974, pp 21ff.; Griffith, Hunt and O’Brien, ibid.).
nearby Continent and Russia, it took about 6 to twelve 12 months before money was returned; in the trade with the Levant or the Americas, it took even longer, at least 2 to 3 years. Wars also had unforeseen effects on the monetary market. The state often borrowed large sums directly from it and thereby squeezed liquidity. All these factors and the increasing dependence on credit contributed to sudden and sharp peaks of bankruptcies.

As Hoppit has pointed out in his research, the development of bankruptcy figures was closely related to the economic development of the country (Hoppit 1987, chap 4). In the first half of the eighteenth century when economy grew only slowly, the number of bankruptcies was comparatively low. After 1750, however, they started to rise. The acceleration of economic growth and early industrialization provided an increase in opportunities and with them an increase in risk-taking. Hoppit counted 33,000 bankruptcies for the eighteenth century (Hoppit 1987, p 42) though the actual number was probably much higher because the bankruptcy records are rather incomplete and failures could also be dealt with outside the official procedure.

**Chart 1. Trend of Bankruptcy in England 1720-1816**

![Chart 1. Trend of Bankruptcy in England 1720-1816](image)


Before 1750, the average rate of bankruptcy was about 209 per year and rose to an average of 456 per year after the middle of the century. Figures jumped since the early 1770s, reaching a record level in 1793 after the outbreak of the French Revolutionary War. 1,256 cases are recorded for that year alone. After that date, numbers dropped again below 800 to reach a trough in 1799 with only 546 cases. The numbers increased again after the turn of the century. From 1806 onwards, the yearly number rose to more than a thousand
and leaped in 1811 to more than 2,100 cases and in 1826 to almost 2,600 cases (Duffy 1985, p 339).

A striking feature of the geographical pattern of bankruptcy is the dominance of London. In the first 20 years, more than 52% of all cases took place in London (Hoppit 1987, p 63). Towards the end of the century, its percentage had dropped to some 37% and again it was not a drop in absolute figures. The drop only reflects London’s declining share in economic activity. Nevertheless, London remained the dominant center of production, distribution and conspicuous consumption throughout the century. London’s substantial contribution to bankruptcy was also the result of its domination of overseas trade.

In the second half of the century, failures outside the capital also began to increase, especially in the rising outports, such as Liverpool and the new textile regions of the north. Overall, bankruptcy figures were higher in the coastal areas than in the agricultural and traditional wool manufacturing regions.

The law of bankruptcy

The bankruptcy figures by no means include all cases of failure. The contemporary law distinguished between insolvency and bankruptcy. Because merchants generally fell under the bankruptcy laws, this chapter focuses on the individuals that went bankrupt and not on the insolvent debtors. Outside the law, business failure could unofficially be dealt with in several ways: by an agreement between creditors and debtors, e.g., by a letter of license or a deed of inspection. In the former case, the creditors allowed the debtor to continue his business so that he could repay his debts. In the latter case, the debtor continued under the control of the creditors (Hoppit 1987, pp 29-32). Although there were alternatives outside the ‘bankruptcy office’ 8, the number of cases that came under the official proceedings gives a fair impression of the risk of failure in the early period of industrialization.

The law of bankruptcy was confined to traders owing more than £100 to one creditor (£150 to two or £200 to three or more creditors). Debtors who were not traders or whose debts were below the sum in question could not qualify to become bankrupt but stayed insolvent debtors. The legal definition of a trader embraced all those who made a living by buying and selling, which included most artisans. Although some groups (such as farmers) were explicitly excluded from bankruptcy, they can nevertheless be found in the

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8 An official bankruptcy court did not exist until 1831 (Duffy 1985, p 45). Cases were generally dealt with at the Lord Chancellor in Chancery Lane.
They preferred to come under the bankruptcy law because of the harshness of the insolvency laws. Since 1706, the law of bankruptcy provided a regulation whereby the bankrupt could be released from any liability of debts contracted before the act of bankruptcy and start anew.\textsuperscript{10} The insolvent debtor did not have this option. He could not be discharged from his old debts, but remained responsible for them for the rest of his life. As he was subject to common law proceedings, he often faced imprisonment for the rest of his life. With the increase of economic activities and the emergence of new occupations, the definition of who was a trader and who was not became more and more controversial and the distinctions became increasingly blurred.

The process of bankruptcy was a rather simple procedure. It started with the denial of payment by the debtor. Any further proceeding rested with the creditor, because a debtor could not declare himself bankrupt until 1825. The creditor initiated the legal proceedings with a petition to the Lord Chancellor in Chancery Lane for a commission of bankruptcy. With the petition, he had to give a bond of £200 to ensure against a malicious petition. Once the Lord Chancellor had entered the name of the debtor in the docket books, he directed the case to a group of five commissioners that were often barristers or solicitors from the same district as the bankrupt and his creditors. It was left to the latter to decide if the debtor was a bankrupt or not. After they had made their declaration of bankruptcy, they placed an advertisement in the London Gazette and ordered the debtor to surrender himself and his property. Next, a meeting of creditors was arranged and the assignees were chosen from among the present creditors. All further proceedings, the administration and collections of the bankrupt’s property lay in the hands of the assignees. Collection of the assets, especially when overseas merchants were involved, could be a very protracted business and last several decades before the records were finally closed. If the bankrupt person was cooperative in the disclosure of his effects and four fifths of the major creditors agreed, he would be granted a certificate of conformity. This certificate freed him from his past debts and allowed him to start again.

Unlike the insolvent debtor, the bankrupt was at least protected from imprisonment once a commission of bankruptcy was opened until after his final examination.\textsuperscript{11} A critical stage remained after the stoppage of payment until the commission was opened. It depended a great deal on the relationship between the debtor and his creditors if he simply hid in his house, left the town or even fled abroad. As only comparatively few bankruptcy records of naturalized merchants of German birth have survived, not much is known about

\textsuperscript{9} For those occupations that were formally excluded from the bankruptcy laws, see Duffy (1985, pp 18-23).
\textsuperscript{10} 4 & 5 Anne c. 17, 5 Anne c.22.
\textsuperscript{11} 5 Geo I c 24 and 6 Geo I c.22, see more explicitly, Duffy (1985) pp 11f.).
their fate in the early stages of the proceedings. In two cases, they did not escape imprisonment. A few other bankrupts left the country. Others either left town or simply hid themselves in the houses of friends or in the backrooms of their own houses. When Hermann Jacob Garrels of Leer stopped payment in 1799, he found a hiding place at the house of one of the major assignees.

The risk of failure among German merchants in London

Of the total of bankruptcies in England that Hoppit counted, nearly 12% were merchants. For London, where the majority of overseas merchants lived, the percentage was considerably higher. About three-quarters of London’s bankrupts from the wholesale sector were merchants (Hoppit 1987, p 69). As the sample is based on the naturalization records, it may be stressed that those who went bankrupt were almost all overseas merchants. Before the middle of the nineteenth century, there was no strict distinction between a merchant, a banker, a manufacturer or an underwriter, and they often combined several of these activities. Among the naturalized merchants of German birth that went bankrupt, several were merchant-manufacturers, including sugar refiners, a hosier, a watchmaker, a paper manufacturer and bankers. Diversification into these branches could reduce as well as increase the risk of failure. Keeping these aspects in mind, two questions arise: (1) to what extent were the immigrants affected by the general trend of failures in Britain? (2) Were they more liable to failures as compared with their British counterparts?

In the first half of the century, there were very few failures among German merchants in London. Between 1700 and 1750, only 12 bankruptcies could be found. After the middle of century, the numbers increased although only slightly. In the 1790s, however, they reached an unprecedented level. The last year before the turn of the century was a particularly difficult one for the Germans.

Given the low number of bankruptcies among the German merchants during the whole century as compared with the total English figures, it is difficult to draw any conclusions. Hoppit published bankruptcy data for London

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12 Simon Bethmann and Christian August Eschke (B3/208 and 209, for Eschke B3/1523).
13 See below. In quite a number of cases their fate is unknown. In two cases (Peter Hollander after his failure in 1711 and Frederick Voguell after his bankruptcy in 1740) it cannot be excluded that they committed suicide in that their deaths are recorded shortly after their failure.
14 For the small immigrant retailer, shopkeeper or tradesman, there was no need to acquire British citizenship by naturalization. Sometimes prosperous retailers or tradesmen became British citizens by denization, which was a restricted form of citizenship (Parry 1954, p 33; Dummett & Nicol 1990, p 29; Schulte Beerbühl 2006a, part 1).
alone for four decades from 1740 to 1780. The latter one comprises a much higher percentage of merchants than the figures for the country and the fact that the overwhelming majority of German merchants lived in the capital makes an evaluation of the development of risk based on his figures for London more interesting. A comparison between these data and the number of bankruptcies among German merchants reveals an increase of risk over the decades, although not evenly. Among the London businesses, Hoppit found the highest rate of failures in the 1740s, with the risk showing a decrease in the following decades.

Table 1. Rates of bankruptcies among English and German businesses in London\(^1^6\)

<table>
<thead>
<tr>
<th>Decade</th>
<th>No. of businesses</th>
<th>English</th>
<th>German</th>
</tr>
</thead>
<tbody>
<tr>
<td>1740s</td>
<td>2,250</td>
<td>1: 29.5</td>
<td>1: 381</td>
</tr>
<tr>
<td>1750s</td>
<td>3,573</td>
<td>1: 43.7</td>
<td>1: 204</td>
</tr>
<tr>
<td>1760s</td>
<td>4,553</td>
<td>1: 36.8</td>
<td>1: 137</td>
</tr>
<tr>
<td>1770s</td>
<td>6,550</td>
<td>1: 36.2</td>
<td>1: 226</td>
</tr>
</tbody>
</table>

The pattern of bankruptcies among the Germans is a different one. In the 1740s, only 1 in 371 London bankruptcies was a German bankruptcy; in the 1750s, the rate increased to 1 in every 204 and in the 1760s it was 1 in every 137. In the 1770s, the risk declined to 1 in every 226.

To evaluate the risk of failure among German immigrants a comparison between the total number of naturalized Englishmen of German birth per decade and the number of German bankruptcies may be more meaningful. As there exists a fairly complete series of naturalization data for the century, it is possible to present a long-term view on the development of failures among German immigrant merchants.\(^1^7\)

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\(^{1^5}\) Hoppit (1985) collected them for the years 1740 to 1783 (see p 67). The first three years of the 1780s are not included here. They would distort the picture because more German houses stopped payment in the latter part of the decade than in the earlier part.

\(^{1^6}\) Data of the number of businesses and English bankruptcy rate are taken from Hoppit (1985, p 69). Hoppit’s rates are average annual rates per decade. However, because of the low number of German failures, decennial rates are used regarding the German merchants. These differences do not lead to different conclusions.

\(^{1^7}\) The first two decades are excluded here because Anne’s liberal law of naturalization of 1709. The records that have survived the period 1709-1712 are neither complete nor do they give information about the places or countries of birth of the naturalized immigrants.
Table 2. Decennial rates of bankruptcies among German merchants

<table>
<thead>
<tr>
<th>Decade</th>
<th>No. of naturalizations</th>
<th>Bankruptcies</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1720s</td>
<td>41</td>
<td>2</td>
<td>1 : 20.5</td>
</tr>
<tr>
<td>1730s</td>
<td>54</td>
<td>1</td>
<td>1 : 54</td>
</tr>
<tr>
<td>1740s</td>
<td>38</td>
<td>3</td>
<td>1 : 12.6</td>
</tr>
<tr>
<td>1750s</td>
<td>38</td>
<td>5</td>
<td>1 : 7.6</td>
</tr>
<tr>
<td>1760s</td>
<td>51</td>
<td>10</td>
<td>1 : 5.1</td>
</tr>
<tr>
<td>1770s</td>
<td>60</td>
<td>10</td>
<td>1 : 6</td>
</tr>
<tr>
<td>1780s</td>
<td>68</td>
<td>17</td>
<td>1 : 4</td>
</tr>
<tr>
<td>1790s</td>
<td>80</td>
<td>29</td>
<td>1 : 2.8</td>
</tr>
<tr>
<td>1800s</td>
<td>86</td>
<td>11</td>
<td>1 : 7.8</td>
</tr>
</tbody>
</table>

*Source: Compiled from Shaw (1923), the bankruptcy records (National Archives London), docket books, registers of certificates, Gentleman’s Magazine and London Gazette. Before the 1720s, the data are not reliable because of incompleteness of the bankruptcy records and Anne’s law of naturalization between 1709 and 1712.

Although the comparison between the number of naturalizations and the number of failures has some imperfections because of the available sources, they can nevertheless be taken as an indicator of the general trend. Table 2 confirms that the rate of bankruptcy is rather low in the first half of the century and starts to rise after the middle half. The increased rate in the 1740s is only partly the result of the low number of naturalizations. In view of the following decades, the 1740s mark the beginning of a continual rise. While only every 22nd went bankrupt before the middle of the century, in the 1760s and 1770s every fifth or sixth failed; in the 1790s, it was more than every third. In the first decade of the new century, the relationship improved again. For the second decade of the new century, no reliable data can be compiled because the traditional policy of naturalization broke down. Under the conservative ministry of Liverpool, hardly any foreigner could acquire British citizenship. Although evidently the risk for London businesses going bankrupt in general declined between 1750 and 1780, the risk for German immigrants increased continuously with a temporary improvement in the 1770s. Because violent short-term peaks in London accompanied economic development, the question arises as to whether the picture may be a different one from a short-term perspective.

Although the total number of German failures is much too low to allow us to discern a pattern, especially for the first half of the century, it may be worth knowing whether they appeared during times of high levels of bankruptcy. As Ashton, Hoppit and others have elaborated, extremely high levels of bankruptcy occurred in times of financial crises, 2 or 3 years after the beginning and towards the end of the wars, as well as in the immediate aftermath (Ashton 1959, chap 5; Hoppit 1987 chap 7 and 8). High fluctuations in

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18 Several of the reported bankrupts failed more than once.
bankruptcy occurred in 1706 and 1712, with peaks at the end of 1706 and again in 1709-1710. An acute financial crisis occurred in 1710 so that failures remained on a relatively high level until the first half of 1712 (Ashton 1959, p 116; Hoppit 1987 app 4). Between 1725 and 1728, figures rose steeply again. They climbed over 300 per year with a peak of 388 in 1727. The high figures of the 1720s were due to the financial crisis of 1726 and the threat of war with Spain, which was averted only in 1728. In 1711 in the immediate aftermath of the financial crisis, a remarkable number of four German houses stopped payment. In 1727, another house gave up. No records of these houses have survived but in case of the latter one, it is known that it was deeply involved in the Iberian trade. Not all of the bankruptcies of Germans in London coincided with the general trend of bankruptcies in England in the first half of the century. Some German failures are recorded for years when the general number of stoppages was very low, as in 1750. In peak years (such as 1758) when the number of London bankruptcies rose to the highest point in that decade, no German house was closed. A similar irregular short-term pattern can be found in the second half of the century.

*Chart 2. English Bankruptcies 1780-1806*

![English Bankruptcies 1780-1806](chart-2.png)


19 For the total number of bankruptcies, see Hoppit (1987) app 4 and chap 8. The German immigrant houses that failed in 1711 were Peter Hollander & Herman Louis, Francis Heilman, John Jacob van Strasson and Theodore Stahl. In 1727, Paul Amsinck, who came from Hamburg, went bankrupt. Members of the family had settled in Portugal and Spain (see Schulte Beerbühl 2006b).
After 1770, the economy experienced quite a number of extreme short-term fluctuations. These fluctuations were accompanied by exceptional peaks of bankruptcies. In 1772-1773, 1778, 1788 and 1793, London in particular and England in general saw a wave of failures, with merchant houses collapsing like houses of cards. In the peak years of 1772-1773 and 1793, comparatively few German merchants went bankrupt. No German bankruptcies were observed for the peak year of 1778. On the other hand, there were more failures than was usual among the German merchants in 1784 and 1799. The year 1799 saw an exceptionally high number of bankruptcies, whereas for England in general this year had the lowest for the whole decade. The question is: Why did the German pattern not always correspond with the English one and what were the causes for this lack of correspondence?

**Continental causes of bankruptcies among naturalized immigrants**

Bankruptcy causes can be explained from two perspectives: One is the individual perspective of the bankruptcy, which means looking into the structure of the bankrupt individual’s trade and his ability or disability to cope with market changes. It includes a variety of non-economic individual factors, such as his financial and social background or his reputation. The second is from a more general perspective: besides general economic influences, each trade and business has a different level of inherent risk. Merchants who embarked on entrepreneurial or other financial activities might increase their
chances as well as their risk with them. Merchants who traded in sugar, e.g., often invested in sugar refineries, a business that was profitable as well as risky, not only because it was a capital-intensive one, but above all because of the geographical distance between the cultivation areas of cane sugar, the production centers and the customers. In times of war (e.g., the American War of Independence), refineries were temporarily cut-off from their supplies. In the 1770s, more than half of the sugar-refineries in London, which was the leading center of the English sugar industry, either went bankrupt or gave up their business. The opportunities of profit created by this trade induced a considerable number of merchants (also among the Germans) to become either shareholders or owners of sugar refineries. Others, such as Roger Teschemacher from Hanover, invested in inventions. He was a merchant-manufacturer in Nottinghamshire and had just been awarded two patents for his invention of a steam machine and a spinning and roving machine when he went bankrupt in the financial crisis of 1793. Such investments increased risk when they coincided with general crises. Such specific factors as well as general economic trends have to be accounted for when considering failures.

To understand the pattern of bankruptcies among foreign overseas merchants in England, it is necessary to consider the geographical focus or backbone of their trading activities as well as political affiliations, i.e. it cannot be explained within a national or local perspective alone. A review of the German bankruptcies in London reveal that economic fluctuations and crises abroad had similar irregular repercussions as the ones in Britain. For instance, the outbreak of the American War of Independence caused a major disruption of trade in England, with bankruptcies peaking in 1778. Whereas many English houses stopped payments, it had less of an impact on the German houses in London. The financial crisis originated from the refusal of the American colonists to repay their debts. They owed more than 2.3 million pounds Sterling to Londoners only. As Katherine Kellock pointed out, the American War of Independence did not affect all English houses in the same way. Those houses that suffered most were on the side of the loyalists.

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20 The above-mentioned Cornelius Kettler had a refinery in London (Kent’s London Directory 1765).

21 Already, the very first sugar refineries in Scotland were established by sugar merchants. They engaged German and Dutch boilers to run the business (Smout 1961, pp 240-253).

22 Chronological Index of Patents, p 332, No 1808 and p 352, No 1916. The hosiery industry in Nottinghamshire was organized by merchant manufacturers. The second half of the eighteenth century was a period of great prosperity and rapid expansion in the East Midland hosiery industry. It coincided with a major endeavor in the technical development of the stocking industry. Numerous smaller or bigger technical improvements and inventions were made, which, however, did not lead to a breakthrough of the factory system as in the cotton or woollen industries (see Chapman 1974, pp 14-37).

23 The total claim by British merchants was close to five million pounds Sterling (Kellock 1974, p 114).
Hardly anything is known about the partners of the German houses in America and their relationships with the revolting colonists, but it cannot be excluded that they had partners across the Atlantic that were either of German origin or at least sympathetic with the American cause. Moreover, in view of the international kinship and compatriot networks, payment of debts could also be diverted to London via any Dutch or German port city. Such circumstances could have helped them to weather the crisis more easily than many of their English counterparts.

In 1788, not only the bankruptcies among English houses increased dramatically but also more German houses failed than in the whole decade. When Britain entered the war against Revolutionary France in 1793, failures among the German houses were surprisingly low in contrast to the general trend. There were fewer failures than in 1788. The last year of the century ended with a trough in failures for British businessmen, with figures falling to 546. For the German immigrant merchants this year became the worst of the century. Eleven houses went bankrupt, and with the exception of one, they all collapsed within 3 months.

During the eighteenth century, the causes of bankruptcies gained an increasingly international dimension. From the Seven Years War onwards, waves of bankruptcy swept over the channel. After the crash of the Amsterdam exchange in 1763, the Continent experienced a widespread crisis.\(^{24}\) However, this did not lead to a disproportionate rise in England or in Germany.

Apart from the serial sources, a few bankruptcy records of German houses did survive during the French Revolutionary War, which allow a more precise insight into the causes of individual failures. An interesting case is that of Theophilus Blanckenhagen, a Russian-German by birth who failed in 1793. Whereas the upsurge of failures among the English merchants was caused by the financial crisis at home, Blanckenhagen’s records reveal that the backbone of his trade was his country of birth. He did not only trade in naval stores, flax, hemp and other commodities, which he mainly imported from Russia, but he also acted as a banker. His bankruptcy was caused less by the financial crisis in Britain than by the developments in Russia. His two main partners in Russia – Hill, Cazalet & Co and M.G. Trosien – had failed at the end of 1792 and Blanckenhagen had accepted bills for more than £133,000 from them. In December and early January, he had struggled to prevent the bankruptcy but after Britain had declared war against France, he had no other option.\(^{25}\)

\(^{24}\) For the transnational effects of this crisis, see Buist (1974, p 12f.) and Reininghaus (1995, pp 373-77).
The wave of bankruptcies among the German houses in 1799 was also essentially caused by developments across the Channel. They began in Hamburg. The outbreak of the French Revolutionary War had diverted the British trade with the Netherlands to the German port cities, primarily to Hamburg, but also to the smaller ports of Bremen and Emden. They experienced an unforeseen boom that lasted until 1799. That year already started with a bad foreboding on the Continent. During the very first days of the New Year, *The Times* remarked, “bankruptcies have multiplied of late … at Paris, Lyons, Marseille, Bordeaux, Rouen and other Places”. During the following months, the wave swept over Holland. In Hamburg, *Lutterloh & Sons* was one of the first houses to stop payment in February. In April, another house failed and in August, a witness reported that there were small bankruptcies every week. The situation dramatically worsened when several big accepting houses, among them *Milow*, *Henckel & Eimbcke* and *De Dobelder & Hesse* stopped payment at the beginning of September. In Hamburg alone, 152 houses altogether went bankrupt.

About the middle of September, the first London houses were drawn into the Hamburg crisis. Two big accepting houses, *Persent & Bodecker* and *Cox & Heisch*, stopped payment on the 12th and 13th of September (they failed for about £200,000 and nearly £300,000, respectively). Their collapse had a domino effect. Many smaller German houses followed in London in October and November and a number of other houses failed that were deeply involved in trading with the German States. Among them was the big Swiss firm of *Battier & Zornlin* in London. Denmark was also drawn into the Hamburg wave of bankruptcy. By October 15, the number of failures had put a complete stop on all trade in Copenhagen. The first stop in Russia was reported in about the middle of November when the Russian-German house of *Maas & Son* failed for more than 2.2 Million mark banco.

It is not clear from the sources to what extent the earlier crisis in France contributed to the crisis in Hamburg. Contemporaries attributed the bankruptcy wave in Hamburg to two main causes: the glutting of the market with coffee and sugar some months before and the insufficiency of the banking system in the Hanse town. Contemporary observers in Hamburg and London remarked that Hamburg’s banking system had not kept pace with the increase in business since 1793 and that the trade in bills of exchange had gotten out of hand. A correspondent of *The Times* reproached the Hamburg
merchants for their inactivity. They should have foreseen the crisis after the markets had been overstocked with colonial products and could have taken suitable measures to prevent it by the establishment of a public loan or a Discount Society. In September, the Hamburg Senate had established a private fund, but this measure came too late to prevent further collapses.

It is worthy to note that all the German houses that failed in 1799 were young businesses, with none being older than 6 years. The risk of bankruptcy among young businesses was generally higher than among old established ones, but the situation in 1799 was quite unusual. Over the entire century, only about 33% went bankrupt in the first 5 years after their naturalization.

With the embargo of the Elbe in 1803 and the Blockade in 1806, bankruptcies in England reached a new level in the first decade of the nineteenth century. The German port cities were severely hit by these measures and a wave of failures swept over the German States after the renewal of war in 1803. In contrast to the 1790s, however, none of the big German houses in London was drawn into it (only a few smaller ones with little or no capital). The records of some of these smaller firms show that the causes of their failure were neither mismanagement nor that they were operating an unprofitable trade. They were confronted with liquidity problems that were caused by the inability of receiving returns during the Blockade and insufficient capital resources. However, overall they seem to have gotten through the economic difficulties of the Napoleonic Blockade better than many of their English counterpart.

The ‘certificate of conformity’ and the chances of restarting business

The bankruptcy laws of the early eighteenth century for the first time provided an instrument for a new start by granting a certificate. It released the debtors of all liabilities that they had contracted before the bankruptcy. The possibilities of a new beginning depended on various factors, including the causes of the bankruptcy, the general credit or reputation of the debtor within the local mercantile community, the relation between debtor and creditor, the

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31 For this and the following, see Büsch (1800, p 91f.) and The Times, 19 Oct 1799.
32 In face of the development at Hamburg, a group of merchants in London decided to send over 1.5 Million Sterling. The ship “Lutine” with the money and bullion on board left Yarmouth in the beginning of October, but she never arrived in Hamburg. She was shipwrecked near Texel.
33 The decision to open a house generally went hand in hand with the decision to acquire British citizenship, although there are some cases when German merchants went bankrupt long before they became British subjects; e.g., Jacob William Luning from Hamelvorden near Hannover failed in November 1799 but did not acquire British citizenship until 1805 (Private acts of naturalization: 45 Geo III c 15 (HLRO).
34 B3 /2128, 1523.
The willingness of the latter to grant a certificate of conformity, and last but not least, the kinship network of the debtor and its ability to support him.

The bankrupt received his certificate after four fifths of the major creditors had consented to it. In her research, Sheila Mariner elaborated that about 62% of the bankrupts were granted a certificate between 1786 and 1795 and only 57% for the period 1796 to 1805 (Mariner 1980, p 364). In about 50 cases, certificates could be found for German merchants. The actual number was probably higher. This is because in some cases no certificates could be found though the merchants of German origin had restarted successfully after a bankruptcy. As the relationship between debtor and creditors was essential for the granting of the certificate, it is interesting to know how quickly the bankrupts received the certificate. The reason for this is that the time span between the bankruptcy and the issuing of the certificate may not only tell us something about the reputation of the unfortunate among his creditors but may also give information about the changing perceptions of the causes of failures. Because of the imperfections of the docket books and the registers of conformity, entries in both records could only be found in 44 cases between 1733 and 1816. The figures show that between 1733 and 1780, about 56% of the German merchants were given a certificate within 1 year after their failure, and 46% received a certificate later. Two German merchants had to wait 16 and 18 years, but these were exceptions. After 1780, a visible change took place in that creditors became much more willing to issue such a ticket. Between 1780 and 1816, more than 82% of the bankrupts received their certificates within 1 year. Many of the German merchants who failed in 1799 received the certificates within 6 months.

Even if they were given a certificate, a new beginning after a collapse was not easy and hardly possible without the help of family and friends. The bankrupts had to deliver all their assets and personal belongings. If they always did it or if the bankruptcy commissioners and assignees always insisted on it, is a matter that cannot be taken up in this chapter. Nevertheless, quite a number of recorded cases of German merchants who started again: Theophilus Blankenhagen, George William Soltau and Hermann Jacob Garrels or Cox & Heisch all managed to build up new successful businesses within a decade after their bankruptcy.

There were several ways for a bankrupt merchant to start again. The one they chose depended on the financial support they could receive. Those who lacked money could begin again as either a bookkeeper or a factor. Many of the German merchants restarted as partners in another house. Blankenhagen, e.g., became the partner of Thomas Wilson in 1774 and in 1794 he joined the

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35 The registers of certificates, which show gaps, did not start before 1733. The docket books began 1710 but are also imperfect.
36 For a more explicit account, see Schulte Beerbühl (2006a).
banking house of the Dorriens.\textsuperscript{37} During the French wars, persons who went bankrupt increasingly turned to brokerage. Although they could not easily acquire a fortune as a broker, they had at least a relatively secure income from their commissions. According to the laws of the City of London, which controlled this trade, no broker was permitted to deal on his own account. This regulation was widely disregarded and complaints before the Court of Aldermen show that the City was unable to control them. Anthony Ulrich Hinrichs from Jever, e.g., became a broker after his second bankruptcy in 1804 and by 1810 he was again trading on his own account.\textsuperscript{38}

Not all German merchants managed a new beginning in England. Peter Hasenclever who did not get his certificate of conformity for 18 years and received it only a few years before his death, left England and went to Silesia, where he became a partner in a textile business. Justus Blanckenhagen, the brother of the aforementioned Theophilus, went to Riga after their first bankruptcy in 1772 and became partner in the banking house of Blanckenhagen, Oom & Co. Cornelius Kettler from Leer in East Frieseland left England for Russia. Simon Bethman from Frankfurt wandered around through Europe for years after his failure in 1799, until he finally entered the house of his relatives in Bordeaux in 1816 (Henninger 1993, vol. 2, p 529). Others were left in poverty (such as Henry Nantes) after the spectacular bankruptcy of Muilman & Nantes in 1797, where debts amounted to more than £450,000.\textsuperscript{39}

In summary, although in the long term the risk of failure among English and German merchants increased considerably, the bankruptcy curve of German merchant houses did not always follow the general trend in England. Considerable long- and short-term variations can be perceived. Although the sources do not allow a detailed insight, it may be concluded that two causes were responsible for this deviating picture. First, despite the international expansion of their mercantile activities, the backbone of trade of German merchants in England remained in their country of birth. Second, their trade was embedded in a widespread and often international kinship, compatriot and coreligionist network that provided a pool of support in times of crises. At times, these factors made them less prone to economic crises in England. On the other hand, financial crises on the German market had a stronger impact on the fate of the German merchants in England. However, no uniform pattern could be ascertained, not even during the French and Napoleonic Wars. After the financial crisis of 1799 in Hamburg, the German houses in England seem to have coped better with the economic consequences of the war than their English counterparts. Only young houses with little or no

\textsuperscript{37} CLRO, Court of Aldermen Papers, 12 August 1799.
\textsuperscript{38} CLRO, Brokers: Committees. Minutes and Papers of the Committee of the Court of Aldermen Respecting Brokers 1815-1823 (BR/C 1.5 and 1.7) Br /R 2, Register 1787-1815.
\textsuperscript{39} B3/3681-88, Prob 11/1552. He and his family were supported by his uncle Daniel Nantes, who also lived in London.
capital failed in the first decade of the nineteenth century. Overall, about a third of all naturalized merchants of German birth in England went bankrupt. Although this percentage seems high, fewer naturalized merchants failed as compared with the English merchants. Hoppit calculated that about 58% of all London merchants went bankrupt (Hoppit 1987, p. 97).

Risk was high and increased considerably during the last quarter of the century, especially in the rapidly developing areas, such as in the new industries of the North or in the overseas trade. The decision to invest in new industrial and commercial ventures whose outcome could not be predicted heightened the risk. But risk-taking was not only a response to the new opportunities. The English bankruptcy law also contributed to it, as it provided an instrument of debt-discharge that other European countries lacked at that time. It allowed not only the less prudent merchants but also the more prudent ones to seize new market opportunities whose risks could not be predicted. Because large profits could be made, the temptations to embark on uncertain ventures or to expand more rapidly than the cash resources of the business would allow were high. The point here is that there was a prospect of a new start after failure in England, especially for those who could rely on kinship for support. As the above-mentioned examples have shown, the possibilities of a new successful beginning were very promising.

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Credit, Bankruptcy and Power in the Ionian Islands under British Rule, 1815-1864

Sakis Gekas

This chapter demonstrates the ways in which credit accentuated power relations in the Ionian Islands under British rule. The credit/power relation assumed different forms in the towns and villages concurrently with two different credit cultures, one for towns and one for the countryside. The chapter argues that the changes in the relations between creditors and debtors – unequal by definition – occurred during the British period once they were sanctioned by a series of institutional changes, predominantly changes in legislation and banking. Rather than a complete transformation, though, those institutional changes were piecemeal and biased in favor of creditors and failed to promote land reform and debt relief. Contrary to British pledges, liberal-minded reforms did not result in institutional efficiency nor in commercial, social or political progress, developments that would have ultimately rendered British protection of the Ionian Islands redundant. The towns of Corfu, Zante and Kefalonia were heterogeneous, with Jewish communities as well as Maltese and other foreigners. Christians (Orthodox and Roman Catholics) and Jews were tied together in credit networks. This urban setting is particularly important since the establishment or ruination of a person’s reputation was largely mediated through the circulation of information in the form of news in the town and, for the literate portion of the population, through the official newspaper of the State and other media where accounts of insolvencies, auctions and other bankruptcy procedures were published. On the other hand, the countryside was homogeneous, populated only by Orthodox, Greek-speaking peasants, and credit relations with landowners and creditors were much more class-based. The chapter also looks at whether the different religious affiliations of creditors and debtors in Ionian towns affected the

1 I would like to thank Patrick O’Brien for reading and commenting on an earlier draft of the chapter and other colleagues at the Economic History Department for comments and suggestions.
2 The Ionian Islands Government Gazette (hereafter IIGG), extremely valuable as a source, remained the only newspaper until 1849 (when freedom of the press was granted to Ionians). It expressed the attitudes and viewpoints of the central and local governments of each Island and, of course, the opinions of High Commissioners and published all Acts of Government, Senate Resolutions and Criminal Court decisions on cases of fraud.
behavior of creditors when it came to lending and declaring their debtors insolvent.

This chapter forms part of a narrative that traces the emergence of a bourgeoisie on the Ionian Islands during the period of British rule (1815-1864) and contributes to the existing historiography (Hannell 1989; Hitiris 1988; Gallant 2002; Progoulakis 2003). Economic and social relations were reconfigured during the British period with the emergence of a bourgeoisie, and the assertion of power of creditors over debtors in Ionian towns and villages was an essential part of the process. Evidence from credit cases brought before the Commercial and Criminal Courts, petitions of debtors and related studies comprise the empirical basis for the chapter. The legal framework is examined through the Commercial and Civil Codes introduced by the British-Ionian authorities from the 1830s on. Although the two credit cultures in towns and the countryside deserve equal attention, the focus in this chapter is primarily on commercial credit and bankruptcy, where the issue of religion and its impact on credit relations can also be discerned.

The US of the Ionian Islands became a British Protectorate following the Treaty of Paris in 1815. The Colonial Office appointed a Lord High Commissioner that ruled the islands in an autocratic manner until the liberal reforms of 1849. Gradually, the Ionian Islands lost the military and economic importance they held in 1815 and were ceded to Greece in 1864. Corfu, the administrative and commercial capital of the Ionian Islands, served as an entrepôt for the islands and neighboring markets. Kefalonia and Zante, the other main islands, also had important port towns for the export of currants and developed a substantial shipping sector linked with the Black Sea grain trade through Ionian merchants that settled in the Danube, Black Sea and Sea of Azoff ports. The chapter first traces credit relations since the Venetian period, outlines the legal context of business failure in nineteenth-century Ionian Islands and finally provides examples of cases of bankruptcy in order to discern the assertion of power in credit relations in Ionian towns and countryside.

On credit

The creditor-debtor relation is a power relation and a product of the political and legal framework within which credit and debt are historically situated. In pre- or proto-bureaucratic societies, credit relations involved complex networks of personal obligations. As Margot Finn notes, Marx’s outstanding negligence in studying credit, especially the daily credit transactions of workers, left us with ‘an impoverished theoretical framework’ (Finn 2003, p 7). Max Weber argued that the creditor-debtor relations became the basis for class conflict in the cities, where a market for credit developed and serious social conflict emerged not only between urban patricians and urban crafts-
men but also among rural peasants (Weber 1966, p 426; Weber 1968, p 928; Swedberg 1997, p 35). Historians no longer take these statements at face value. Economic historians concerned with institutions and social/cultural historians concerned with power have stressed the importance of reputation in credit relations for medieval and early modern trade and communities (Greif 1989; Muldrew 1998). Fontaine has argued that creditors gained land and privileges but also asserted power over other men. Although this conclusion fails to consider the impact credit relations could have on the debtors’ family members (women and children), 3 Fontaine has argued that “credit is based on power, and deals transacted on the basis of credit were more in the nature of a gift or an obligation (with the exception of the credit relation between merchants)” (Fontaine 2001, p 40). 4 This idea of credit relations enmeshed in deals based on gifts or other forms of obligation is prevalent in studies on credit in the early modern period and goes back to Mauss’ seminal work (Mauss 1970). Finn’s study, dealing with the cultural aspects of credit relations (albeit personal credit), highlights the “configuration of social power outside relations of production”, previously “obscured by both liberal and Marxist paradigms of economic behavior” (Finn 2003, p 7). Similarly, Bourdieu – in a more polemic manner - stresses that credit obligations curtail individual liberty and reproduce social divisions (Bourdieu 1977, p 193).

These works highlight the timeless importance of reputation in the pre-modern and modern world. Moreover, these works subjugate the debtors in a static power-less condition without allowing for explanations that demonstrate the process of empowerment of the indebted at moments of crisis (economic or political), also known in political thought as moments at which the ‘rupture’ of the hegemonic condition is possible (Laclau 2000, Ch 6). From the medieval Maghribi traders to eighteenth-century French retailers, the problem of credit is encapsulated in and, alas, limited to the issue of reputation and/or moral hazard.

In the exploration of credit/power relations in the chapter, these relations are not situated within the typical dichotomy of powerful/powerless following the axiom that regards domination of one group or class over another, i.e. creditors over debtors, as given. Nor is power conceived as a zero-sum game in which one class or group must lack power in order for another one to possess it. Instead, the cases of bankruptcy and indebtedness are used to identify the technologies of power, the techniques and tactics of domination, according to Foucault – i.e. the ways in which creditors and debtors negotiated, or failed to negotiate, the relation between them. This is done by examining institutional changes during the period of British rule. Although Foucault

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3 To be fair, though, the role of women in credit relationships has been stressed by Fontaine in Lemire et al. (2001). Thanks to Giorgio Riello for pointing this book out.

4 For a call for more interaction between cultural and economic historians, see also Hoffman et al. 1999. Their paper, however, is more about the Paris credit market and the role of intermediate notaries in long-term credit transactions than about credit relationships.
considers an analysis focused on the assertion of power through institutions to be a conventional treatment of power, institutions have essentially been spaces where power is exercised in material, physical and imaginary ways.\(^5\)

In this theoretical context, credit relations are particularly pertinent as a field for studying how power was exercised and negotiated among groups of creditors and debtors, merchants, peddlers, craftsmen and retailers in Ionian towns, as well as among tenant growers and their creditors – merchants and landowners – in the countryside. Thus, conceptual uses of power that are top down view power as a countervailing force and victimize the debtors by considering them as merely responsive to the terms imposed by creditors-cum-villains. This does not mean, of course, that credit relations have an egalitarian aspect to them. One is either a net debtor or a net creditor, even if credit webs are complex and people (especially middle ranking income individuals) can be at both ends of the credit chain. Nevertheless, historians and social scientists should be eager to demonstrate the strategies, employment and reconfiguration of power by both groups in a given place and time.

Credit and debt from Venetian to British rule

During Venetian times (1402-1797), the feudal system was kept intact and the islands were divided into baronies, which were gradually subdivided into estates. The peasantry of growers were denied any political or property rights and were subjugated to hardships of feudal obligations as late as the nineteenth century. Gangs of *bravi* retainers managed the estates of the always absent land owners, who resided in the towns. The changes introduced in the latter part of the period of Venetian rule (from the sixteenth up until the late eighteenth century) and developments in the economy of the Ionian Islands determined the mode of agricultural production for the following centuries, practically until recent decades and the advent of mass tourism. The economy of the Ionian Islands became dependent on the production of commodities for export: olive oil, currants and wine. The form of mono-cultivation imposed on the islands in accordance with Venetian mercantilist considerations meant that Corfu was turned into an island producing large quantities of olive oil, which was sent to Venice for internal consumption or for the production of soap and exported to areas as far away as Germany.\(^6\) Merchants from Corfu (some of the wealthiest being Jewish with an extended network of credit relations with the agricultural producers in Corfu) settled

\(^5\) For one of the most innovative – and political - approaches to the study of institutions, see Castoriades (1987).

\(^6\) As was the case with all dominions, the Ionian Islands were subject to the mercantilist principle of *dominante* according to which all goods to and from the Levant had to pass through Venice.
in Venice and Trieste and operated from there. Some of the Jewish merchants profited enormously from moneylending, charging as much as 20 or 25% per month, and were granted the exclusive right to do so by I. Dandolo, the Venetian Proveditore (Hitiris 1982, p 143). However, there has been little evidence to support this argument. A recent work on the Corfu Monte di Pieta contains a great deal more relevant and useful information and is backed up by historical evidence on the credit activities of Jews (Desyllas 2002).

The ‘privilege’ of moneylending granted to some rich Jews must have led to a high concentration of money in the hands of a very few and certainly played on the stereotype of the hated usurer Jew, a stereotype that would have serious repercussions for the fate of the Jewish community as a whole in 1891 and then again in 1944. Despite numerous complaints, the interest rate was not lowered to 6% until 1760 by Proveditore Grimani, who justified his decision by pointing to the substantial loss of land used as collateral for loans by the local aristocracy to moneylenders, a development that worried the Venetian authorities. Certainly, one should not place too much faith in declarations of official interest rates, as even as late as the mid-nineteenth century it was common to charge 10% or more. Corruption was rampant among Venetian Provedditori and the local landowners and tax farmers.

In general, under Venetian rule (1396-1797) credit relations were exploitative, based on the semi-feudal relations of a production and landowning system of the subdivision of property among family members. Above all, it was the system of purchasing produce in advance (profoundly hated by the growers prostichio), whereby merchants and creditors bought the crop in advance at a price they could impose on growers. In return, they advanced money to growers who needed to purchase grain. Agricultural production specialized on commodities for export had created in the Ionian Islands a deficit in cereal production, a common characteristic of insular economies of this kind, and grain did not suffice for more than 3 months (Asdrahas 1988, p 69). This resulted in accumulated debts, dependence on merchants buying the produce at prices they set, and when the debt cycle had to be resolved – and broken - in court, unfair judicial procedures were commonly the rule. The widespread practices of corrupt officials and Venetian administrators turning a blind eye in return for bribes from landowners entailed the complete exploitation of rural debtors, who were commonly tried and convicted in a language (Italian) they could not even understand.

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7 Between 1760 and 1766, Corfu represented more than 50% of the total Venetian oil production (Ciriacono 1998).
8 For the Jews of Corfu and the 1891 anti-Jewish riots, see Gekas (2004).
9 The practice did in fact continue well into the nineteenth century, until Greek became the language of the courts and the administration in general, but not before the 1840s and even 1850s. For the difficulties and the long process of introducing Greek into the administration, see Pantazopoulos (1998, p 99, 117 and 123).
In the seventeenth and eighteenth centuries, articulation and assertion of power by growers (i.e. debtors) took the form of open insubordination. On several occasions during this period, revolts erupted in the islands, revolts that directly - and ultimately unsuccessfully - challenged not Venetian authority per se, but the landowners-creditors’ absolute power over the peasants. During several periods (in 1610 in Corfu, 1628 in Zante, 1640 in Corfu, the early 1640s in Kefalonia and 1652 and 1678 in Corfu), peasants refused to pay their accumulated debts to the landowners. The peasants took up arms and burned the estates of the landowners, who, terrified, remained in the towns until the uprisings were crushed by the more powerful Venetian authorities or simply subsided due to lack of organization. In 1640, one of the most serious uprisings took place in which armed peasants entered Corfu and fired at the palazzio of the Venetian Provedditore. On all of these occasions, the consequences of the insurgents’ actions were dire and led to further impoverishment in that punishment usually involved allowing the landowners to impose heavier taxation (Hitiris, 1988, p.139).

Until the end of the Venetian period and the advent of the Republican French in 1797, collection of taxes was auctioned to members of the islands’ landowning nobility and some influential Jewish olive oil merchants for 3 to 6 years, leading to rampant corruption (Andreadis 1914, pp 96-97). In the subsequent period of the Septinsular Republic (1800-1807) when the Islands formed a Russo-Ottoman protectorate, the legal framework of bankruptcy did not alter the basic structures of the rural economy. The cancellation of agricultural debts enforced by growers who burned debt contracts during the revolutionary days of 1797 was only temporary. The Septinsular Republic re-established the political privileges of the nobility, despite the seemingly liberal Constitutional Charter of 1803. The Imperial French under Napoleon, who occupied the island of Corfu until 1814 (Zante, Kefalonia and Ithaki were occupied by the British Navy in 1810), maintained the same system albeit in a centralized form, aiming at the maximum collection of revenue for military needs. During this volatile period, there were regulations concerning the settlement of debts and bankruptcy conducted through a legal apparatus inherited from the Venetians. This apparatus was based on antiquated Venetian laws and practices, such as the sale of property of bankrupt merchants. Despite the expressed (in the 1803 Constitution) eagerness to abolish feudal obligations of leaseholders in the islands, no such measures were taken, and creditors became more secure as their property rights were more clearly specified and more strictly protected (Prontzas 2001).

Indebted growers were left with the threat of violence as the only means of asserting their collective power towards creditors. The rebellions during the Venetian period did not transform the power imbalance in favor of rural

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10 Concerning the uprisings during Venetian times, see Omada Enantia sti Lithi [Group against Oblivion] (1996, Ch 1).
debtors to any extent. They nevertheless posed a credible and tangible threat to the landowning creditors and later to merchants, a threat realized in 1819 in Sta Maura and in the 1848 and 1849 rebellions in Kefalonia. The threat of more uprisings in 1864, immediately after incorporation of the Ionian Islands into Greece, was so pronounced that it alarmed the government in Athens as much as it did the British Consul and the manager of the National Bank of Greece. In fact, it has been argued that the cancelling of mounting debts by the Ionian Government after the very bad harvest years of 1851-52 averted a possible uprising.11

Institutional changes and the legal context of insolvency and bankruptcy

In the nineteenth century, two parallel developments necessitated a change in the institutional framework of credit relations. Trade growth, on the one hand, and the favorable conditions for the Ionian Islands of the international economy until the 1850s, on the other, led to the emergence of a group of merchants engaged in long distance trade. They, in turn, facilitated the rise of a number of smaller traders, peddlers and shopkeepers in the towns engaged in local and regional trade. Complex webs of credit were spun in Ionian ports. Corfu became the entrepôt for British manufactured goods destined for neighboring markets and an important grain-importing and transit hub. The ports of Kefalonia and Zante maintained their traditional character and role as currant-exporting ports, increasing the dependence of the rural and urban populations on the precious – but also very volatile in terms of prices – fruit.12

Credit relations between landlords and tenants hardly changed with the advent of British rule. In the currant growing islands, produce was purchased in advance with coercive and monopsonistic practices (Gallant 2002, pp 106-110 and Gekas 2004, ch 4). The feudal system of landownership did not change significantly, although the introduction of the first organized credit mechanism in the Ionian Islands promised to improve credit relations and alter the control of credit through usurious transactions and the network of moneylenders who bought the produce in advance for money in return. From the 1830s onwards, successive High Commissioners identified this as the main problem in the Ionian Islands economy. The initial plans for the establishment of a credit institution in the Ionian Islands go back to the early

11 For the 1864 threat of uprising, see Progoulakis (2003, ch 6). His argument for the early 1850s is reviewed later in light of some new evidence.
12 For port activity, entries, clearances, etc., of the Ionian ports as well as exports and imports of the Ionian State during this period, see Gekas (2004, Ch 2 and Appendix), data from Ionian Blue Books of Statistics, CO 136 / 1391-1427, National Archives, Public Records Office (hereafter NA, PRO).
1830s when Adam and Nugent, successive Commissioners, identified the problem of dependence of tenant farmers on the landowners, merchants-bakers and exporters of currants and olive oil. In 1830, Adam wanted the establishment of a fully competent commercial bank to combat the ‘insatiable usurers’ and the ‘small number of speculators’ with ‘ruinous interests that they impose upon the borrowers’. In his address to the Ionian Senate, Adam identified the problem of ‘the absence of a circulating capital’. Adam’s account reveals an economic reality and the harsh conditions involving the subordination of the tenant farmers to the buyers of the agricultural produce who were also their creditors. To this end, Nugent established a state fund for growers in 1833 and, based on its success, proposed the founding of a state bank. The Colonial Office refused to grant the Ionian Islands the privilege of a state bank because they were concerned that this could develop into a pretext for independence.

It was Commissioner Douglas, though, who in 1836 set his mind on establishing a bank in the islands and convinced his superiors to do so. Douglas identified seven reasons as justification for his proposal for a bank ‘upon Joint Stock principles’: (1) the need to provide loans to currant growers and relieve them of the burden of having to sell below market price in order to meet their urgent expenses, (2) the number of applications for advances of money upon mortgage or security of property, (3) the practice of prostichio, the sale of the olive oil and currants in advance, (4) the operation of the pawnshop, or Monte di Pietà, the transactions of which could be conducted by the bank, (5) the need to alleviate the practice of hoarding due to the lack of a safe place for deposits resulting in low circulation, (6) the transport of specie from one island to another, which could be replaced by disposable bills, and (7) the increased needs for credit on the part of merchants and shippers of the agricultural commodities when paying the clearances and export duties at the Custom House. After a thorough assessment of the economic situation, there was now a well thought-out plan devised by the administration to remove inefficiencies through the operation of a bank of issue, deposit and discount and an attempt to break the cycle of indebtedness in which growers were locked.

These initiatives ultimately led to the founding of the Ionian Bank in 1839. The bank was financed by London City merchant bankers, administered by a London board of directors and operated exclusively in the Ionian Islands and the opposite Greek currant-growing areas. With the exception of the years 1852–1854, when bad harvests did not allow high levels of profit, the performance of the bank was successful. But did it fulfill the promises and anticipations of its promoters, the London bankers that claimed the bank would bring prosperity to the people of the islands by relieving them from

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13 Adam to Senate, 5 August 1830, CO 136/1091, NA, PRO.
14 Draft Act, No. 154, Douglas to Glenelg, Corfu, 22 August 1836, CO 136/76, NA, PRO.
the burden of usury? There is no evidence that problems of usury disappeared or became less pressing. In fact, the crisis in the 1850s exposed a continuing circle of indebtedness, and many traders, who apparently had no access to loans from the Ionian Bank, were declared insolvent. Similarly, studies on the economic history of northwestern Peloponnese have shown that the existence of the National Bank of Greece in this area not only did not eliminate usury but also on some occasions aggravated it. The situation in the Morea (Peloponnese), where again English merchants were in charge of exporting currants, present some striking similarities with the Ionian Islands: the merchants situated in the towns, with the help of small-scale merchants in the countryside, were providing money or other goods for the farmers’ needs. As a guarantee, they bought the next years’ produce, getting back in item the small capital they were lending plus an interest of 18-24%. The growers were obliged to give their entire crop to the merchant at a fixed price, which would enable the merchant to sell at a far greater price than the price at which he had bought the fruit (Pizanias 1983). Merchants – money-lenders would borrow from the bank at low interest rates only in order to be able to lend significantly larger amounts of money to growers in anticipation of the produce, at the same exorbitant interest levels. Nugent’s ambition in the 1830s to enable peasants to enter the competition on equal terms with the merchants was well-intentioned but unrealistic. This is because the exports were in the hands of very few merchants and, therefore, there was no possibility for equal competition.

Progoulakis’ study of indebtedness indicates that the practice of usury was so widespread that not only commercial debts but even debts for the lending of money in exchange for the produce bought in advance by merchants led to the imprisonment of debtors from 6 months up to 1 year, depending on the debt. This practice of seizure for debt and imprisonment was widely adopted and maintained until the union of the islands with Greece and the repeal of the imprisonment law. During the period of British rule, there was a transfer to creditors of significant properties for considerably small loans on which interest had accumulated substantially over a number of years. Table 1 shows the geography of credit relations in the island of Corfu. Between 1831 and 1863, there were more than 3,000 prosecutions, almost 100 per year. The claims peaked during the severe crisis in 1850-1852. Seventy percent of the creditors but only 25% of debtors lived in Corfu town. Progoulakis’ analysis provides a very clear picture of the transfer of surplus from countryside to town achieved through the circulation of money as commodity, as 4 out of 5 loans were in cash: of the total number of claims put forward by urban creditors, 1,766 were against rural debtors. The results show an intensified bifurcation of wealth between town and countryside. On the contrary, from countryside to town only 31 claims were made over 33 years, and towards the end of the British period there were 7,800 arrest warrants against 5,485 debtors in the islands’ towns and villages.
This was mostly the result of the complex legislation on credit relations but also of the inability or unwillingness of the British-Ionian administration to reform the laws and the institutional structures governing ownership of property in general and credit relations in particular.

Table 1. The geography of credit in Corfu, 1831-1863.

<table>
<thead>
<tr>
<th>Creditors</th>
<th>Debtors</th>
<th>Creditors</th>
<th>Debtors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Town</td>
<td>2,296</td>
<td>761</td>
<td>73.61</td>
</tr>
<tr>
<td>Suburbs</td>
<td>263</td>
<td>341</td>
<td>8.43</td>
</tr>
<tr>
<td>Countryside</td>
<td>437</td>
<td>1,766</td>
<td>14.01</td>
</tr>
<tr>
<td>Outside Corfu</td>
<td>123</td>
<td>121</td>
<td>3.94</td>
</tr>
<tr>
<td>TOTAL</td>
<td>3,119</td>
<td>2,989</td>
<td>100</td>
</tr>
</tbody>
</table>


The British-Ionian Government cannot be accused of idleness in relation to the problem, having identified it as urgent. The first law aiming to change the status of property relations and promote land reform was passed in 1825, “on the gradual abolition of feuds”.15 Commissioner Ward reflected on this law in his speech to the Ionian Assembly in 1853, and the Assembly responded to the law with “glowing language”, though nothing happened since “the ground was not prepared”.16 In the following decades (1830s and 1840s), the British-Ionian administration introduced a series of laws, decrees and resolutions and codified the Islands’ Civil, Criminal and Commercial legislation in 1841. In the 1830s, High Commissioner Douglas completed the work of his predecessors Adam and Nugent on the codification of legal institutions and practices for the Islands, policies popular with both the Legislative Assembly and the Senate (the Executive).17 This body of legislation followed the Napoleonic Code. It was applied to the Ionian economic conditions for the first time during the period of imperial French rule (1807-1814) in the form of decrees and regulations and then, once translation issues had been dealt with and legal dictionaries had been published, it was translated into the form of Codes. The process indicates the further integration of the Ionian economy into the European economy, not only at the level of commodity exchange but also at the level of transfer of institutions. The Code distinguished between fraudulent and non-fraudulent bankruptcy. As in

15 IIGG, No. 387, 16 May 1825.
16 IIGG, No. 72, 2 May 1853
17 Before 1849, these bodies were subjected to the wishes of the High Commissioners. After the Seaton reforms in 1849, radical elements entered the Assembly in 1850 and began to oppose proposals from British Commissioners and to press for union with Greece. Property as a value to uphold, protect and secure was a recurrent theme in the discourse of the people who made laws in Ionian polity; see, PRO, NA., CO 136/109, “Individuals”. For the Seaton reforms, see Calligas (1994).
France, in the Ionian Islands debtors that had not committed fraud or that went bankrupt because of unfortunate and unpredictable circumstances could continue their trade after reaching a compromise with their creditors (Reynard 2001).

Through new commercial associations, such as exchange offices in Zante and Corfu and the Chambers of Commerce in Corfu, Kefalonia and Zante, Ionian merchants acquired greater autonomy from central authorities, elected their own representatives and advised the government on commercial issues. Above all, the new institutions enabled the merchants registered in the Chamber of Commerce and elected by their peers to assist and even determine terms for settlement of debts in the commercial courts through their functions as assessors. In 1856, “several merchants of Corfu” successfully petitioned the High Commissioner to be appointed as Assessors in the Sittings of the Commercial Courts and Tribunals. The published lists of Corfu merchants for the years 1858 and 1860 included 186 and 187 merchants, respectively, of whom 60% were eligible to be elected for the posts of assessors. Thus, and despite differences and competition among merchants from different Islands, institutional change functioned as a unifying force, which promoted the emergence of a common interest group of merchant creditors in the Ionian Islands calling themselves the \textit{Corpo di Negozianti}.20

The classification of merchants into two classes with a separate one for brokers (the \textit{mezzani}), following the new commercial institutions of the Exchange and the Chamber of Commerce, reflect the scale of business, as well as specialization of commercial operations with separate and distinct activities. One of the principle functions of the classification and registration of merchants was confirming their status in the event of insolvency, distinguishing between traders, merchants, peddlers and shopkeepers. Nevertheless, they were all liable to the same laws on bankruptcy, especially proper bookkeeping and paying for clerks if they were illiterate. The Exchange registered 135 names for all three ‘classes’ of merchants for 1851, which amounts to a fifth of the 667 people recorded as ‘merchants’ (\textit{emporos} in Greek) in the Electoral List of 1864.21 Jewish merchants are absent from the

18 The index of petitions records that the merchants were ‘Complaining against the administration of justice by the Commercial Courts in these Islands for want of knowledge and experience on the part of the judges. It proposed that merchants should be elected as advisors in Commercial matters, as done in all civilized countries. Further, it called upon His Excellency that a similar practise should be introduced in the Ionian States’. Petition No 149, Register of Petitions 1856, CO 136 / 1056, PRO, NA.

19 Only a few of the merchants elected for the post of Assessors in the Commercial Courts in 1858 belonged to well-established merchant houses in Corfu, active 40 years earlier. Progoulakis also found only 2 families of 17 that continued doing business in the 1860s comparing them to an 1818 list; Progoulakis (2003, p 356). Comparing names of merchants for this research between the early (1810s) and mid-nineteenth century (1850s and 1860s) produced similar findings.

20 IIGG, No. 310 3/15 August 1857; IIGG, No 598, 1 September 1862.

21 Electoral List 1864, Eghoria Diaheirisi 1544, IAK. See Appendix, Table 3.
lists of those eligible for the posts of Assessors for the Commercial Courts, published in 1858, 1860 and 1862. The exclusion annoyed Jewish merchants to the extent that eight of them petitioned the High Commissioner in 1857 with regard to their exclusion. They argued that while the laws passed by the Senate did not distinguish between Ionian citizens, the decrees of the Municipal Council excluded non-Christians from the post of assessor. The petitioners, well-established olive oil merchants, after emphasizing the central role of Jews in the town’s trade, asked for protection against discrimination.22 The petition was not successful, however, and Jewish merchants continued to be excluded from posts as assessors in Commercial Courts. This does not mean, of course, that Jewish merchants, especially the wealthy and well-established ones, were excluded from the urban elite or, more important for this chapter, the credit networks and the power relations involved. However, it does mean that they had considerably less leverage in determining which debtors would be declared insolvent by the Commercial Courts and tried for bankruptcy in the Criminal Courts.23

Under British rule a hierarchy of merchants emerged on the Ionian Islands through the formation of ‘classes’ of merchants. The same group - and, towards the end of the period, occasionally the same people - were officially granted the right to regulate commercial debt in the Commercial Courts. This group of merchants included wholesale traders of grain, colonial and British manufactured goods, (the most important Ionian imports throughout the period) but excluded Jewish merchants who traditionally controlled the olive oil trade. This merchant elite advanced loans to smaller traders and shaped credit relations on the Islands.

The letter and the spirit of the Law

Credit is instrumental to commercial activities, and in the Ionian economy credit operated through contractual relations between wholesale merchants-creditors and retailers, sealed by bills of exchange and/or promissory notes.

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22 Petition 400, 8 December 1857, CO 136/857, PRO, NA. This claim for equal representation to the Chamber of Commerce is very similar to the petition of the Jews of Trieste to Vienna to redress their exclusion from the town’s Borsa. It is interesting that the same arguments are used to persuade the authorities on the injustice towards the Jewish merchants: the general good of commerce and the benefits to be derived from the participation of Jews in the regulation of commerce through the institutions established. The argument of the Jews of Trieste was precisely the same as the position of the Jews of Corfu, namely the essential Jewish contribution to the town’s commercial life. See, Dubin (1999, p 34).

23 To be eligible, merchants had to be Ionian subjects and above 30 years old. The involvement of Jewish merchants in the urban hierarchies can be partially discerned according to the first Electoral List after union with Greece in 1865; 286 of 667 recorded merchants (40%) were Jewish. I write partially because not all Ionian Jews chose to become Greek citizens despite the ostensible benefits, such as universal male suffrage, that Greek citizenship entailed.
for a 3-month maturity period. The Commercial Code specified regulations for the circulation of bills of exchange and for commercial transactions previously carried out according to commercial custom. The cases of insolvency and bankruptcy emerge as records referring to times of crisis, i.e. when merchants stop their payments and creditors reclaim their loans. Such a period came in the early and mid-1850s, when credit was suspended as a result of a multifaceted crisis manifested in hunger, the impact of the Crimean war on the islands’ trade and cholera outbreaks; these events brought the agricultural economy and, subsequently, the commercial economy to their knees. Hiotis describes the harsh economic conditions in 1850s Corfu in the following way:

In 1855, the Islands were in an appalling condition. Hunger was raging in the two big Islands of Zante and Kefalonia, cholera was ravaging Corfu and Zante. The Crimean war prohibited the grain production and trade. Hunger, destitution and disease were crushing the Ionians. The Government revenue was short, the produce was reduced, the people were starving….Landowners and tenants earned nothing, capitalists and merchants lent nothing (Hiotis 1877, p 347).

The Ionian Bank report of 1852 noted in a similar tone: “The entire failure of the oil crop and the depreciation of the staple product of the Island, was of themselves sufficient to create commercial and monetary pressure”. 24 The descriptions above provide the context of the business failure many merchants experienced up until the time of union in 1864, when the economy or parts of the economy (but not Corfu’s commerce) had barely recovered.

The cases examined testify to the fact that the procedure specified in the Commercial Code in cases of insolvency and bankruptcy was meticulously followed. The Code granted creditor(s) and the courts the absolute authority of declaring debtors insolvent. The Commercial Court declared a debtor insolvent once it received notification from a creditor or a debtor or when insolvency became public knowledge. This clause relates to the second article of the Code in which merchants were defined as “the ones who practice commercial operations that constitute their usual trade”. 25 The public nature of the procedure means that information on individuals’ creditworthiness was easily disclosed and, given the small and dense population of Ionian towns, widely circulated. Reputation was clearly important to all merchants for maintaining one’s credibility among borrowers; e.g., to brokers who needed to “enjoy the reputation of an honest and useful man, to be proved by the testimony of a witness in the Municipal Council”. 26 Reputation depended above all on fulfilling financial obligations to creditors.

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24 Annual Report 1852, Ionian Bank Archive 2/1, BLPES.
25 Emporikos Kodix [Commercial Code], Book 1 Art. 2, Book 3, Chapter B, Art. 418I.
26 Emporikos Kodix, Art. 64.
Once the status of insolvent debtors and other relevant information on their creditworthiness was verified, the Court ordered the sealing of all movable and immovable property of the insolvent, including business and household property. Decisions concerned with the sealing of property and the call to the team of creditors to claim their debts were published in the newspaper and posted in the market and at the home of the insolvents and their respective churches (or synagogues). Insolvents were either imprisoned or guarded by a police officer to prevent flight.

The Court appointed assignees among the team of creditors, who completed balance sheets of the assets and liabilities, compiled a report in 10 days and then sent it to the Public Prosecutor. The Public Prosecutor subsequently decided on whether insolvents would be tried for fraud in a Criminal or Civil court. When a settlement could not be reached, assignees submitted reports, and the courts tried the insolvent merchants for bankruptcy in conformity with what they considered ‘proper’ commercial behavior. Because moveable and immovable property was sealed as soon as insolvency was declared, the insolvent and his family depended entirely on the assignees for their well-being; creditors, who also decided on the issue of imprisonment, could exercise significant power over insolvent debtors. The Court based this decision on creditors’ recommendations concerning bail. Incarceration for debt had been used in the islands for centuries. Under British rule, power in commercial credit relations, mediated as it may have been through the law-enforcing apparatus of the Ionian State (police authority, judicial procedures and prisons), was clearly evident and exercised more efficiently by the incarceration of debtors, based on presumptions on their credibility and willingness to be present during the trial if no compromise was reached and evidence for fraud was found.

Merchants-creditors, who were elected by their peers at the Chamber of Commerce, held considerable power, acting as Assessors to the Commercial Courts. Debtors pleaded mitigating circumstances by presenting the reasons and circumstances that resulted in the insolvency and were occasionally led to settlement with their creditors under arduous terms. Once the call to other creditors was published, the social and economic stigma attached to insolvency was extremely hard to erase. Given that debtors were men, it has been appropriately argued that their honor was also damaged (Gallant 2002, p 111). Only in cases of compromise and settlement of debts was a debtor ‘restored’ and enabled to retain part of his reputation. Merchants who were not formally declared bankrupt would not be deleted from the official list of merchants and, thus, could continue to participate in the business of their association as members of the ‘Corpo di Negozianti’ (the ‘Body of Merchants’). For those with no means for settlement, the most common recourse
was to flee their island and avoid a sentence for up to 2 years in prison.\textsuperscript{27} The process of drawing up balance sheets of the assets and liabilities of insolvent merchants could also involve their whole families. Only if there was no evidence of fraud could insolvents request money for the needs of their families. Previous reputations clearly became significant for deciding on the claims for a respite. Borderlines between public and domestic/private spheres were crossed.

Doing inventories of the household assets was essentially an intrusive process, which demonstrates the power of creditors over insolvents. The role of the Commercial Court was to oversee the regulation and settlement of cases by the creditors themselves or to arbitrate in disputes between creditors. Negotiations and arrangements took place among creditors, first, when they decided who to assign for each case and, second, when they determined whether there could be a settlement or not in the event there was no evidence of fraud. The law placed creditors in charge of settlements. Agreements had to have the support of a majority of the creditors holding three quarters of outstanding debt.

Under the new and codified legislation, wholesale merchants-creditors granted a sum of money or goods to retailers in the form of a bill of exchange or a promissory note, which had to be paid to the creditor-wholesale merchant in 3 months. This was after all the common practice, even before the codification in the 1840s. The Commercial Code specified rules for bookkeeping for merchants, but practice differed since few merchants acquired numeracy skills and/or the discipline required complex calculations. In the event of insolvency, assignees were appointed among the creditors by the Commercial Court and were responsible for conducting an inventory, auctioning the concealed property of the debtor and distributing the money to the team of creditors. When assignees went through the books of debtors in order to construct the balance sheets, they rarely found books in good order, despite the severe penalty in the Commercial Code for improper bookkeeping. Apparently, not even important Kefalonia currant-exporting merchants kept accounts of their transactions. Books should have included capital, sales, payments, loans and debts. Unacceptable bookkeeping could even result in the rejection by the assignees of claims by insolvents for subsistence.\textsuperscript{28} In one of those, Kournakis, an insolvent merchant brought to Commercial Court by one of his creditors, argued – or rather his lawyer argued on his behalf - that the Law was renegotiated and adjusted:

\begin{quote}
The aim of the law is not to starve the insolvent to death and it is irrelevant whether the assignees are final or temporary. What is essential is if the insol-
\end{quote}

\textsuperscript{27} These stories of bankrupt merchants having to choose between fleeing from their creditors and imprisonment often provide the starting point for the historian of credit (Safley 2000, pp 53-75).

\textsuperscript{28} Case of Kournakis, IIGG, No. 23, 28 May / 9 June 1849.
vent is starving or not. And if the article names final assignees, this is because in France the temporary ones carry out their duties in a matter of days, while in our cases it can take years and sometimes the cases are left in the hands of the temporary assignees, who on most occasions suspect the insolvent being a fraudulent bankrupt….Kourniakis assisted the assignees in their task as much as he could, but starving, and being forced to beg daily by his relatives and friends for some bread, he is unable to spend everyday the whole day helping assignees complete their work.29

Bankrupt merchants and shopkeepers were also told by the Court that they had underestimated the difficulties and risks involved in extending their operations, stood accused of conspicuous consumption and were reproached for lack of prudence.30 Lack of frugality, as well as incompetent bookkeeping, became sufficient reasons for being convicted of fraud.31 Regulation of commercial behavior was not only in conformity with a rather rigid legal code but also conformed to the aims of the creditors, who played a dominant role in its enforcement. Debtors could also declare themselves insolvent, a situation always well received by creditors and the courts. It was market forces and misfortunes and a bad harvest that debtors blamed for their situation and contrasted these circumstances with their own prudence, honesty and good reputation before their business failure.32

In one of those cases, all of the above reasons were marshaled to reach a settlement. Mazarakis’ assets exceeded his debts ($4,418 to $3,580).33 His losses, however, made the payment of his debts and the protection of his commercial credit impossible. Through honesty and hard work, Mazarakis managed to extend his business from humble but profitable baker to aspiring currant merchant. This, in fact, exposed him to risk and indebtedness to several creditors, among which were several of the largest currant-exporting firms in Kefalonia: the Bassian & Co, the Romano & Brothers Co, and John Saunders, Manager of the Ionian Bank in Kefalonia. Mazarakis admitted being overwhelmed by economic forces. In his defense, he positioned himself as possessing all the bourgeois values of a good and successful merchant: honesty, prudence, hard work, thrift and an entrepreneurial spirit. Nevertheless, he failed to rise from baker to currant merchant because of the economic international and domestic crisis of the 1850s.

Another case, trader Teboneras, illustrates the formidable power exercised by creditors through their claims of representing commercial principles but also the defense strategies employed by debtors. Teboneras traded with mer-

30 Case of Vita Cohen in Kefalonia criminal court, IIGG No. 540, 2/9/1861.
31 Case of Protos Bartoloti in Zante Criminal Court, IIGG No. 234, 31/3/1856.
32 Case of Efthathios Mazarakis, IIGG, No.193, 25/6/1855.
33 The common currency of the Islands was Spanish Pillar dollars and Imperial Maria Theresa dollars. If £1 was 20s, and $1 was 4s 4d, then $1 was equal to approximately £0.22. Calculation according to ‘Monies’, Blue Books of Statistics, CO 136/1391, NA, PRO.
chants in Epirus (on the Ottoman mainland opposite Corfu), where he sold wheat and corn and imported cattle. He bought goods on promissory notes from Avgerinos (a grain importer) for $940 and $528 in October 1851 and from Coraggio for $470 in January 1852. When the notes matured, Teboneras could not pay on time. Coraggios obtained a sealing warrant from the Commercial Court on March 3, 1853, and Teboneras pleaded with him for more time to pay. On March 25, both creditors petitioned the Commercial Court to declare Teboneras insolvent, and on May 15 Teboneras was arrested. Topalis and Avgerinos were appointed as assignees, and a notice of insolvency and a call to creditors were published in the Gazette and affixed in the Commercial Court. They were also circulated in the town, the market place and the church of Teboneras’ parish. Four days later, Teboneras was released on bail, which was paid by his father, also a merchant. He sent a report to the court arguing that the entire procedure was illegal, “since, as the assignees know very well, all persons engaged in retail of grain…don’t keep books because it is useless, but only temporary and insignificant book notes.” The assignees replied with a “report in support of their interests and of the team of creditors”, stating their legal obligation and duty as assignees to “defend Commerce and punish bankruptcy”, and thus reading the law as a moral and legal obligation to maintain their personal business interests, as well as to ‘defend Commerce’. For this reason, the assignees asked the court not to allow the release of Teboneras and “opposed the bail of Theodoros Teboneras, father of the insolvent, as untrustworthy, according to information received, and for the security of the interests of all his creditors”. After the Court had decided that he was not a fraudulent bankrupt, Teboneras claimed that it would be impossible to pay his creditors the sum of $2,205 on time. This was because most of his own credit was tied up on the Ottoman mainland and it would take more than 3 months to collect debts due him. 34 Had the assets of Teboneras (including his credit to Ottoman merchants) not been more than his liabilities, he could have been declared fraudulent bankrupt, jailed for 2 to 2.5 years and economically and socially ruined. His subsequent ‘disappearance’ from the lists of merchants published in late 1850s and early 1860s indicates that he was probably financially crippled and never recovered from this episode of insolvency. Clearly, this was a complex network of traders who were creditors and debtors at the same time. Nevertheless, the issue remains: when and why is a merchant, who was part of the credit relations with other merchants, thrown out of the circle of trust? Cases drawn from the Commercial and Criminal Court records yield an answer, as they reveal the three main principles to which creditors subscribed: careful bookkeeping as part of proper commercial practice, the maintenance of an ethical code regarding repayment of debt and the propagation of a commercial life style and a capitalist spirit. Insolvency cases pro-

34 Emporodikeio [Commercial Court] 347, Case of Teboneras, IAK.
vide insights into the value system of the commercial elite. The ethics expressed in the provisions of the Code determined the ways in which debtors were tried. Records of court proceedings for insolvency and bankruptcy, as tried by Criminal Courts, testify to the business ethics expressed by plaintiffs and defendants alike in their attempts to settle and enforce contracts between debtors and creditors.

This logic behind the creditors’ (acting as assessors) and the court’s decision are best illustrated in the case of Vita Cohen from Kefalonia. Once declared bankrupt, he was accused of fraud and his father of complicity. On July 1, 1861, the Criminal Court of Kefalonia stated the reasons for declaring this merchant guilty of fraud. The definition or, in fact, ‘prescription’ of the honorable, trustworthy and therefore credit worthy merchant is re-ascertained in the court, in the case of Cohen, following the sermonizing language of the Commercial Code.35 After Cohen was declared insolvent for the first time in 1859, a settlement was reached with his creditors, which required him to pay 80% of the debt. Vita Cohen had then expanded his small retail store selling handmade clothes and opened three stores in Corfu, Kefalonia and Zante, with turnovers of $19,000 in 14 months. He only spoke Italian and kept clerks to assist him. The accusation that he had ordered his clerks not to keep the books properly appeared valid because the books did not show the actual condition of his assets and liabilities. After reaching a settlement in 1859, he continued to borrow money and occasionally to “sell below market price”, another act deemed by the courts as improper commercial behavior. This particular charge raises questions about who fixed prices, on what basis and on what goods. Cohen’s business, according to his report to the Commercial Court, was adversely affected by bad harvests, which was a common line of defense for all insolvent debtors. Currant shipments remained unsold or sold below market price, and the Commercial Court noted that: “instead of submitting himself to the will of fortune, sort out his books and show that he had to stop his payments and declare insolvency, continued his trade with all his strength, paying only part of the creditors to the disadvantage and harm of the rest of the group”. The court decision did not find Vita Cohen guilty of fraud simply because he did not keep his books properly. Cohen was chastised for being insolvent twice and was accused of “risking the interests of his remaining creditors”.36 He had been ‘redeemed’ by a prior settlement and was bound to the interests of his creditors; thus, he depended on them and could be declared insolvent the day he was unable to fulfill his financial obligations. The court considered Cohen’s case as representative of retailers who did not keep their books in the way required by law, although as we saw this was the norm rather than the exception. Acknowledging that this was not the normal practice, the court nevertheless

35 II GG, No. 540, 2/14 September 1861
36 ibid.
punished Cohen in order to alter the practice, especially “among retailers who are trading goods valued $20,000 or more”. Cohen was convicted of bankruptcy (but not of fraud) and he was imprisoned for 3 months while his father was acquitted.37

Settlement in or outside the courts was one of the possible outcomes of insolvency. In the highly, and by definition unequal relation, the most common recourse and response of debtors who went bankrupt was to escape prosecution and penalties by leaving their island of origin. In some cases, bankrupt merchants escaped at the last minute and disposed of their property at cut prices. Bankrupt merchants tried in absentia were sentenced to 2.5 years imprisonment. In none of the cases examined involving bankrupt merchants who fled was there any mention of the families and their fate, although it is clear that indebtedness, insolvency and bankruptcy could have long-lasting and possibly devastating consequences for debtors and their families. It was only on rare occasions that previously runaway merchants could be convicted of bankruptcy provided they had returned and were present at their trial.38 On May 1, 1862, Spyridon Linardos opened a wine shop together with Georgios Peratinos. They rented one of the many properties of Antonios Kandonis at a very high rent, which was the reason given by Linardos for his failure to pay his creditors. When Peratinos (for unknown reasons) abandoned him and fled Corfu and prosecution, Linardos had no option but to go to court and declare insolvency.39 In this and many other cases, retailers and shopkeepers blamed external factors for their inability to pay debts, as well as the exorbitant rent they had to pay for maintaining a shop in the market. When Dionysios Postolis, who kept a tobacconist’s shop in Corfu, faced a continuous fall in sales because of the “bad conditions of trade in this town”, he was forced to plead with his creditors (Rodocanachis, Avgerinos Co, Ioanni Paramithioti, Coraggio, and Aristoteli Margariti) for an out of court settlement. When they refused, he declared himself insolvent.40 The last two cases of Postolis and Kourniakis are representative of the credit networks between wholesale merchants and retailers who were the first ones to be affected as soon as there was an economic crisis

37 ibid.
38 Case of Spyridon Kapsalis, Zante Criminal Court, 15 June 1863, IGG, 6/18 July, 1863. Kapsalis, ‘a few days before his departure, sold to his servant [who was under age]….all his goods and items of his shop for $330. Their real value, according to the Assessors’ report, was approximately $2,000; Case of Halikakie, IIGG, No 257, 1856.
39 Emporodikeio 349, I.A.K.
40 ibid.
Religion and Credit Networks

To what extent, if any, did religious affiliation affect or even determine the above-documented power relations between creditors and debtors? To answer this question, the credit relations among Jewish traders and between Christians and Jews were analyzed, and some noteworthy findings are discussed. Jewish merchants formed a significant part of Corfu’s commercial community. Table 4 in the Appendix shows the participation of Jews in the sectors of the urban economy. As mentioned earlier, however, they were excluded from the post of Assessor to the Commercial Courts for cases of insolvency and bankruptcy. The exclusion is even more striking when taking into account the range of involvement and/or control of credit networks by Jewish merchants. Table 1 demonstrates the complexity and density of the credit networks in nineteenth century Corfu, the considerable amounts of credit granted by other merchants residing and operating in Corfu and in markets that have traditionally (since the Venetian period) been associated with Corfu. When it came to loans and the amount for which someone could be declared insolvent, religion was irrelevant. The Beso family was not found among those registered in the 1864 Electoral List, an indication that they chose not to become Greek citizens. Although the firm Dima, Kantonî and Seremeti was not the largest creditor of Beso, it was one of the principal creditors and acted on behalf of the group.

Table 2. Name of Beso’s creditors and amount credited

<table>
<thead>
<tr>
<th>No</th>
<th>Name of creditor</th>
<th>Debt (in $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Joseph Coraggio</td>
<td>1,216</td>
</tr>
<tr>
<td>2.</td>
<td>Mordachai Beso</td>
<td>569</td>
</tr>
<tr>
<td>3.</td>
<td>Dima, Kantonî and Seremeti Co</td>
<td>584</td>
</tr>
<tr>
<td>4.</td>
<td>Fels &amp; Co</td>
<td>486</td>
</tr>
<tr>
<td>5.</td>
<td>Kapotzari brothers</td>
<td>320</td>
</tr>
<tr>
<td>6.</td>
<td>Christodulo Kremidis</td>
<td>287</td>
</tr>
<tr>
<td>7.</td>
<td>Rallis &amp; Mavroioannis</td>
<td>231</td>
</tr>
<tr>
<td>8.</td>
<td>Dimitrios Damiris</td>
<td>211</td>
</tr>
<tr>
<td>9.</td>
<td>Patzificos Elias</td>
<td>196</td>
</tr>
<tr>
<td>10.</td>
<td>[illegible name]</td>
<td>150</td>
</tr>
<tr>
<td>11.</td>
<td>Chana Chera, of Moses Elia</td>
<td>50</td>
</tr>
<tr>
<td>12.</td>
<td>Zacharia and Jacob Moustachi</td>
<td>36</td>
</tr>
<tr>
<td>13.</td>
<td>Salomon Bernahim of Ancona</td>
<td>352</td>
</tr>
<tr>
<td>14.</td>
<td>Diner and P of Ancona</td>
<td>188</td>
</tr>
<tr>
<td>15.</td>
<td>Jacob Borines of Trieste</td>
<td>220</td>
</tr>
<tr>
<td>16.</td>
<td>[illegible name]</td>
<td>292</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>5,388</td>
</tr>
</tbody>
</table>

Source: Case of Rafael Beso, Emporodikeio [Commercial Court], 348, IAK.
Beso, however, was a wholesale trader, and his case may not be representative of the credit networks further down the trading scale. The case of Jacob Naxon, who conducted significantly more modest commercial operations, allows us to discern other characteristics of credit relations involving members of different religions and a case in which religious networks may have been important for a debtor’s fate. Naxon traded ‘various goods and merchandise’; he signed four promissory notes after receiving goods from Martin Fels.41 When Fels asked Naxon to pay on October 18, he stated that he was unable to meet his payments. Fels filed a petition with the Commercial Court, which appointed him and another creditor, Sabbatai Tedesco, as assignees responsible for doing the inventory of Naxon’s assets and liabilities and reporting to the Court and to the rest of his creditors. After 2 months (an unusually long time for such urgent business), Tedesco resigned excusing himself for not knowing Greek – a language required for court proceedings - and because he had to travel to Venice to take care of his business there. It became difficult for the Court to find a second assignee among the creditors when Georgios Marketis also resigned because he had been assigned two other cases of insolvency during the same year and because he had pressing family and business obligations. On December 30, Jacob Nacamuli deposited $300, and thus Naxon was finally released on bail. The Court document states that Nacamuli signed in Italian because he, too, did not know Greek, evidence that by the early 1850s business in Ionian towns was still conducted in Italian, whereas Greek was gradually becoming the language of the administration.

Thirteen of eighteen of Naxon’s creditors were Jewish, and of 3,282 tallers Naxon owed, 2,160 were owed to Jewish traders. But it was Martin Fels (a Gentile) who filed the petition as soon as the promissory note expired, and it was the Jewish creditor Nachamuli who bailed Naxon out of jail. Fortunately for Naxon, a settlement between him and his creditors was reached. It was agreed that half of the amount owed to his creditors would be paid within 3 years. The brothers of Naxon, Abraham, Moses and Zacharia guaranteed payments in installments. Installments could not be delayed; otherwise, Naxon would have to pay the whole amount or face the court without any further notice, a term common in most settlements between creditors and debtors. Furthermore, creditors demanded that Naxon’s wife relinquish claims on her husband’s mobile and immobile property. Under the Ionian Civil Code, wives could claim the property of their husband if marriage contracts stipulated amounts given to the husband as dowry by his in-laws. Weddings were also a commercial transaction, as evidenced by the fact that copies of the marriage contracts involving merchants had to be deposited by

41 I.A.K., Emporodikeio 347, Case of Fels & Co against Jacob Naxon p Nasau.
the Commercial Court. Weddings increasingly became a part of extending business networks and accumulating capital among merchants.\footnote{I.A.K., Emporodikeo, 699.}

Table 3. \textit{Name of Naxon’s creditors and amount credited}

<table>
<thead>
<tr>
<th>No</th>
<th>Name of creditor</th>
<th>Debt (in $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Jacob Manermo of Sabatai</td>
<td>850</td>
</tr>
<tr>
<td>2.</td>
<td>Martin Fels</td>
<td>430</td>
</tr>
<tr>
<td>3.</td>
<td>Moses Eliou brother Levi</td>
<td>231</td>
</tr>
<tr>
<td>4.</td>
<td>Panayiotis Kremedes</td>
<td>218</td>
</tr>
<tr>
<td>5.</td>
<td>Sabatai Tedesco</td>
<td>270</td>
</tr>
<tr>
<td>6.</td>
<td>Emmanuel Microulakis</td>
<td>206</td>
</tr>
<tr>
<td>7.</td>
<td>Matathias Gabriel</td>
<td>218</td>
</tr>
<tr>
<td>8.</td>
<td>Georgios Marketis</td>
<td>180</td>
</tr>
<tr>
<td>9.</td>
<td>Patzificos Elias</td>
<td>129</td>
</tr>
<tr>
<td>10.</td>
<td>Joseph Eliezer</td>
<td>104</td>
</tr>
<tr>
<td>11.</td>
<td>Speridon Kremedes</td>
<td>88</td>
</tr>
<tr>
<td>12.</td>
<td>Joseph Coraggios</td>
<td>86</td>
</tr>
<tr>
<td>13.</td>
<td>Mordachai Beso</td>
<td>73</td>
</tr>
<tr>
<td>14.</td>
<td>Perlina Benadi</td>
<td>47</td>
</tr>
<tr>
<td>15.</td>
<td>Rafael Beso</td>
<td>46</td>
</tr>
<tr>
<td>16.</td>
<td>Jacob Beso</td>
<td>46</td>
</tr>
<tr>
<td>17.</td>
<td>Jacob Nachamuli</td>
<td>31</td>
</tr>
<tr>
<td>18.</td>
<td>Rizos Beso</td>
<td>29</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>3,282</strong></td>
</tr>
</tbody>
</table>

\textit{Source:} Case of Jacob Naxon, Emporodikeio, 347, IAK.

Several Jewish traders were peddlers.\footnote{Nine percent of the Jews were recorded in the 1864 Electoral list. Peddlers were classified in ‘Retail’. See Appendix for details.} Abraham Ferro traded in Corfu, ‘maintaining an open trade’, as the court record stated. As a peddler, he received credit from wholesale merchants, one of which, Fels & Co, declared him insolvent when he failed to pay his debt of 211 dollars, the amount agreed by the settlement of December 30, 1851. After a failed attempt to reach a second settlement, Ferro was declared insolvent on January 11, 1853 and Fels and Patzifico Olivetti were appointed assignees. The Court resolution states that all creditors were ‘domestic’, highlighting the fact that Ferro traded locally and thus the procedure should have been brief given that there were no creditors abroad, even in other islands, nor did Ferro have any credit to international markets. Nevertheless, it took another 1.5 years for Fels and Olivetti to present their report to the Court and to other creditors. By then, Ferro’s merchandise was auctioned for 432 Maria Theresa dollars. Almost 2
years later, Olivetti reported that Ferro owed to the following creditors (Table 4).

Table 4. Name of Ferro’s creditors and amount credited

<table>
<thead>
<tr>
<th>No</th>
<th>Name of creditor</th>
<th>Debt ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Samuel Brandenburg</td>
<td>63</td>
</tr>
<tr>
<td>2.</td>
<td>Samuel Roita Levi</td>
<td>81</td>
</tr>
<tr>
<td>3.</td>
<td>Jacob Politi</td>
<td>286</td>
</tr>
<tr>
<td>4.</td>
<td>Fels &amp; Co</td>
<td>211</td>
</tr>
<tr>
<td>5.</td>
<td>Levi brothers</td>
<td>315</td>
</tr>
<tr>
<td>6.</td>
<td>Gabriel Leontzinis</td>
<td>86</td>
</tr>
<tr>
<td>7.</td>
<td>Panayiotis Kremedes</td>
<td>35</td>
</tr>
<tr>
<td>8.</td>
<td>Mandolin Romano</td>
<td>36</td>
</tr>
<tr>
<td>9.</td>
<td>Abraham Ferro p Rafael</td>
<td>37</td>
</tr>
<tr>
<td>10.</td>
<td>Jona Kandoni</td>
<td>240</td>
</tr>
<tr>
<td>11.</td>
<td>Yerak &amp; Olivetti</td>
<td>210</td>
</tr>
<tr>
<td>12.</td>
<td>[illegible name]</td>
<td>128</td>
</tr>
<tr>
<td>13.</td>
<td>Moses Levi and David Olivetti</td>
<td>68</td>
</tr>
<tr>
<td>14.</td>
<td>Rafael Beso</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>1,816</strong></td>
</tr>
</tbody>
</table>

*Source: Case of Abraham Fero, Emporodikeio 348, IAK.*

The amount is no small sum for a peddler. The assignees only managed to collect about a quarter of Ferro’s overall debt, and the settlement obliged Ferro to pay the remaining sum in installments of $150. Most of Ferro’s creditors were Jewish, but it was Fels once again who filed a request for insolvency. It seems from the above cases that religion was not important in granting credit, although the amount credited could vary depending on kinship and religion. Religious affiliation mattered most, though, for the initial declaration of insolvency by a creditor and for the process of bailing debtors out of jail and negotiating the settlement between debtor and creditors.

Debt in the country and the constitution of power by the peasants/debtors

The complicated, Venetian era-inherited land tenure system, which divided ownership between proprietors and cultivators, did not promote investment, was not profitable and became a constant source of discontent between the two parties (Hannell 1988, p 111). Money lending aggravated the finances of cultivators who, if they did not pay a year’s obligations, found themselves, according to Ionian law, further in debt in that the unpaid portion was con-
sidered a loan and interest was charged. These characteristics, as well as the patronage relations between landowners and tenants, gave rise to some sort of a ‘moral economy’ in the country and, as far as credit relations were concerned, a different credit culture.

In 1849, Parliament passed a law particularly disadvantageous to debtors (extending for 8 years the date when property would be freed from ‘old debts’) contracted under Venetian laws and, therefore, no longer valid. As the preamble to the law stated, it was “absolutely necessary to provide some remedy in order to reconcile on principles of injustice the interests of creditors who have lent their money” (Art. 3). Creditors would present their demands to a judge or a notary, register these demands and require from debtors a note of their property. The law gave debtors 40 days to reply to those demands or lose their property. Evaluations of properties would be done according to their produce (different for each island because of the different crops produced and because of the different customary laws). These evaluations were made by valuators whose qualifications would be determined by the Municipal Council of each island.44

According to the 647 Art of the Civil Code, the system of auctioning the property of debtors as a whole, regardless of the amount owed, led to a complex and extreme situation of endless legal procedures, warrants of arrest for insolvent debtors and incarceration on many occasions. It has been argued that the ‘democratization’ of the criminal justice system under British rule resulted in the increased use of the courts as an alternative and non-violent means of resolving cases of slander among women and knife fighting among men in the Ionian islands. However, once the islands became part of Greece and a different judicial system was introduced, the situation reverted to almost pre-British conditions, where cases of slander were resolved again in the streets and homes (Gallant 2002, ch 6). This argument is examined here in the context of credit relations.

Before the advent of British rule and the introduction of a number of institutional changes in the legal system, we saw that the articulation of power by peasants/debtors was primarily expressed through rebellion and violence. In the nineteenth century, the threat of violence maintained its own force and was realized in more than one occasion in uprisings in Sta Maura (Lefkada) in 1819 and in Kefalonia in 1848-9. The rural debtors should not be seen as passively accepting the harsher conditions imposed by the international economy, the failed harvests from the 1850s onwards or the aggressiveness of creditors aiming to acquire rights to the land of sharecroppers and to maximize profits. Instead, the strategy of petitioning provides us with a rare opportunity to address the issue of articulation of the debtors’ interests in a language mediated by but clearly aiming to represent the interests of peasant debtors.

44 IIGG, No 26, 1849.
Less than a year after the law that enforced the sale of the whole property by auction for any amount of debt, a petition was submitted to the Commissioner from the inhabitants of four villages in Corfu. In a long document of more than 3,500 words, they stated their grievances against not only the particular law but also against the practices of creditors and their law-enforcing agents. One gets a very clear picture of indebted sharecroppers’ articulation of interests. Essentially, it is an alternate form of constituting power relations, addressing the High Commissioner to mediate between them and the creditors. The memorial in a language ranging from emotive to expressions of indignation outlines the worsening economic conditions of several years of bad olive crop harvests – on which they were entirely dependent. As a result, they were forced to borrow 4, 5 and sometimes 6 dollars on every barrel of oil, which if they failed to repay in oil within 6 months was charged to them at 10 or 12 dollars per barrel. Similarly, with Indian corn, the real value of which was, according to growers, 80 oboli or ¾ of a pence per bushel: if they failed to repay, they were sentenced by the courts to pay three or four folds the original amount or were obliged to make another contract. The appraisals of their crops were annual instead of biennial, although their contracts stated that it they should be biennial. Above all, it was the measure of sale of property by public auction that proved fatal, as it should always be sold at an equitable valuation, which was not the case. The hated law on the sale of property stated that the whole of the property was subject to sale by auction. The villagers complained of cases in which bailiffs would not inform them of the exact days of the appraisal. This resulted in the growers neglecting their work while waiting for the bailiffs to arrive, only to overvalue their crops. The petitioners did not fail to mention the confiscation of capital (animals and agricultural equipment) that was undertaken for debts incurred. Finally, yet importantly, the petition complained about the bias of the courts in which the country debtors stood no chance. The landowners would bring as witnesses their bravi or retainers to confirm the debts. Even if the debtors managed to avoid imprisonment by getting further indebted, they had lost valuable working days by going to the towns or the countryside courts and had spent large sums of money to pay the lawyer fees. Similar cases of peasant discontent were not rare in the currant producing islands, which is evidence that the landlords sought to maximize the profits from the greater commercialization of the Ionian economy and the currant trade by increasing rents, decreasing the amount of land left to peasants for their own cultivation and consolidating exports in a few hands and even fewer ports.

The 1850s, especially its early years, was a period of particular crisis for the economies of all of the islands. The document above reveals the villagers’ feelings at the beginning of the period: mounting pressures, though, forced the government to cancel all debts in 1852 in order to avoid social

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45 Petition No 1092 ‘From the Inhabitants of Several Villages’, CO 136/801 NA, PRO.
unrest, especially following the uprisings of 1848 and 1849 in Kefalonia. The traditional threat of violence and the form of power mediation worked, though only temporarily, in favor of the rural debtors and thus debts were cancelled in 1852. The document is a rare manifestation of the articulation of interests by utilizing the means available to the tenants, such as petitioning. It is important to note that the villagers did not fail to state that imprisonment - a direct manifestation of exercise of authority on a human - as a punishment was especially harmful to the economy. As Gallant noted, it was equally harmful to the Mediterranean men’s honor, and when the British were gone after union with Greece, hopes were raised that the practice would be abolished. Further, the growers expressed their resistance in culturally symbolic ways by giving horns instead of rent to bailiffs and thus ‘cuckolding’ their masters (Gallant 2002, pp 110-112).

The initial, still timid but successful response of rural debtors in canceling all debts gained momentum during the election campaign in 1862 after the rejection of the proposed reforms made by the reformist political party following Gladstone’s recommendations in his short 6-month term as Commissioner in Corfu. In an unusually radical language rejecting even the call for union (“what are we going to eat? Union?”), a pamphlet circulated in Corfu calling for election only of peasants by the electorate. Given the limited franchise at the time, only one was elected (Progoulakis 2003, p 410). The move was repeated though in the first elections after union in 1864. Although union took place amid high political tension - both the last Commissioner Storks and the manager of the National Bank of Greece feared that the departure of the British garrison would be followed by an uprising in the country – tension was diffused thanks to the elections. The main issue remained, however, namely the cancellation of all debts and the end of imprisonment for those incurring the debts.

It was at this moment after unification with Greece that the same issue of the vicious circle of indebtedness was expressed in political terms. After unification, any hopes that the land issue would be resolved by the Greek parliament soon vanished. The struggle was transferred in the parliament in Athens where the interests of the countryside were pitted against those of the towns, whose elected representatives pledged to defend and “protect the sacred rights of property against the villains of the country” (Progoulakis 2003, p 415). After several decades of British rule and the placing of the islands and their social, economic and political problems under the Greek Kingdom, the struggle was still between countryside and town, and the issue of the indiscriminate cancellation of all debts remained. Yet, political power could now be negotiated through elections and representatives.
Conclusions

The economic and geo-political developments that brought the Ionian Islands under British protection and integrated them further into the international commodity markets led to trade growth and reshaped credit relations accordingly. These relations, indispensable to the operation of any economy, provided few opportunities for upward social mobility, except for merchants who were already in established commercial networks and had enough money to invest in moneylending before as well as after the advent of the organized credit mechanism, the Ionian Bank. The latter had little, if any, effect on credit relations, which were aggravated for the rural debtors after the law of 1849 on the sale of property by auction. The regulations of the Commercial Code and a close examination of cases of insolvency and bankruptcy demonstrate that relations between commercial creditors and debtors resident on the Ionian Islands during the British period were essentially power relations, negotiated through visible procedures based on compromise and less visible ones resting on assessments of creditworthiness established by reputation. These procedures ultimately defined the fate of the insolvent merchant. The law aimed at safeguarding the interests of the creditors and protecting efficient economic exchange from failure and unsuccessful business ventures while punishing inappropriate commercial behavior and establishing ‘proper’ commercial and social behavior for merchants. The criteria or principles were established by the Code and the merchants (assessors of the process), i.e. the creditors themselves. Therefore, it was primarily through legal institutions that the power of creditors over debtors was asserted.

Among those facing the consequences of insolvency and bankruptcy were often the families of debtors after the debtors had been declared bankrupt. When declared insolvent, many debtors fled to avoid incarceration, usually leaving their families behind to face poverty. Most often, they were tried in absentio and, consequently, they were institutionally ostracized, barred from the market and legally excluded from the (merchant) community. This process was not significantly influenced by religious affiliation. Religion was important, as the examples from cases of insolvent Jewish traders show, but it was inscribed in the existing framework of credit relations. Surely, it was easier and more common for Jews to acquire credit and, perhaps more importantly, to receive extensions from other Jews when they were unable to meet their obligations. It is worthy of note that no case has been found in which a Jewish creditor filed a petition for declaring another Jewish trader insolvent. Ultimately, credit relations were influenced by kinship and religion, and bankruptcy as an outcome depended on the reputation of the debtors. Creditors were influenced by the insolvent’s previous business and sometimes social conduct, which included maintaining books and accounts.
properly and not embarking on exceptionally risky commercial operations or leading an extravagant lifestyle.

The volatility of shopkeepers as intermediaries in the chain between merchants and customers has long been acknowledged and noted for its precariousness in the event of a crisis (Braudel 1982, pp 73-75). Being debtors and creditors (in relation to customers as well as other traders), shopkeepers could be easily brought to court for insolvency. Credit might have integrated societies in which people were both creditors and debtors. However, as Fontaine argues, it equally fractured social relations because of the severe penalties and the criminalization of what the creditors and the courts perceived as improper commercial and social behavior. The identification of the organic elements of the ideology of creditors allows the classification of the creditors as a group with coherent interests pursued and enforced through the judicial apparatus of the Ionian State. The structural position of creditors in the Ionian economy as wholesale merchants and importers places them in the creditor end of the chain. The adoption of a coherent ideology that permeated credit relations, praised virtues and condemned vices revealed the elements of a dominant ideology, as shown by both the propagation of creditors and the defense lines of insolvent and bankrupt debtors in the courts. This ideology was based largely on bourgeois principles aimed at advancing the emerging capitalist spirit of the merchants willing to take the necessary credit risks in a very competitive and fluctuating European economy.

The merchants of nineteenth-century Corfu and of the other Islands tried to make sense of and deal with business failure according to the changes occurring around them at the time, which brought as much security as insecurity. In particular, these changes included the establishment of a concrete legal framework as part of institutional developments in the Islands in the form of the Commercial Code, as well as the fluctuations and crises of the European economy. To this extent, nineteenth-century society in the Ionian Islands did not differ significantly in its responses to credit failure from other societies at the threshold of modernity with regard to economic maturity in credit relations and the establishment of an institutional framework.

It has been argued that credit can also create more complex networks of exchange between wholesalers and retailers, shopkeepers and their customers (Finn 1994). Greater instability and potential risk are bound to have affected those who were more susceptible and vulnerable to international crises, or simply to bad weather and harvests that could ruin the entire year’s produce of currants or olive oil and, therefore, upset the whole economy. Reputation was an important element in maintaining one’s credit worthiness, as Corfu and other Ionian towns were still relatively small towns; face-to-face contact was important and frequent, and the complexities of bureaucratic societies were still a few decades away. This means that power relations still operated at a personal level, although institutional factors became increasingly decisive for the way power relations between creditors and
debtors were manifested. The changes in the credit and power relations were ultimately filtered through institutional arrangements, which in turn followed a specific historical development determined by the successive rulers of the islands (Venetian, French and British) and the trade relations between the islands and Western European markets. This is most evident in the adoption of the Napoleonic Code.

The issue of credit relations further marks the fact that creditors gradually acquired legal rights to exercise personal domination over debtors, with the active mediation of the state apparatus. At the same time, debtors, and in particular growers of the cash crops, were denied equal market opportunities even after the union of the islands with Greece and the promised changes in the land system. Effectively, the two should not be seen as separate because the issue was politically charged and was perceived so by growers as well as landowners. Concerning commercial credit, the issue was much more institutional and market-determined, since the few wholesale merchants/creditors could exercise control over supplies of credit and, after the introduction of the Commercial Code, over the terms and the litigation process.

Therefore, the changes in the credit and power relations were the result of more firm organization and regulation of commerce and had the following two-fold impact. First, stricter rules in the regulation of credit and debt and severe penalties in the event of bankruptcy and conviction for fraud were introduced. This had a deleterious effect on the islands’ commercial economy in the sense that fewer traders would be keen to borrow and undertake risk in case they were considered imprudent businessmen, especially in a competitive and unstable economy. Second, the frictions among the merchants and shopkeepers meant that a polarization and re-structuring of urban hierarchies was underway, manifested in the election of representatives for the post of assessor to the Commercial Courts and the consolidation of merchant capital. By not addressing the issue of chronic rural indebtedness and maintaining the feudal remnants in the land system, the Ionian Government allowed the aggravation of living conditions in the country. The strengthening of merchants and landowners was the single result of the policy that ultimately shaped credit and power relations during the British period: active intervention in the institutional environment of town and countryside in favor of merchant and land capital to ensure collaboration and the unchallenged rule of the islands.
Appendix

Towards the end of British rule, the population figures for the Islands’ main port towns of Kerkyra (Corfu), Zakynthos (Zante) and Argostoli and Lixuri in Kefalonia were as follows:

Table 1. *Population Census of the islands, 1857.*

<table>
<thead>
<tr>
<th>Islands</th>
<th>Males</th>
<th>Females</th>
<th>Foreigners</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>CORFU Town</td>
<td>5,711</td>
<td>5,718</td>
<td>4,492</td>
<td>15,921</td>
</tr>
<tr>
<td>Suburbs</td>
<td>3,567</td>
<td>3,211</td>
<td>881</td>
<td>7,659</td>
</tr>
<tr>
<td>Country</td>
<td>22,376</td>
<td>19,434</td>
<td>766</td>
<td>42,576</td>
</tr>
<tr>
<td>Islets</td>
<td>865</td>
<td>890</td>
<td>19</td>
<td>1,774</td>
</tr>
<tr>
<td>ARGOSTOLI Argostoli</td>
<td>4,388</td>
<td>3,657</td>
<td>1,226</td>
<td>9,271</td>
</tr>
<tr>
<td>LIXURI Lixuri</td>
<td>3,610</td>
<td>3,195</td>
<td>90</td>
<td>6,895</td>
</tr>
<tr>
<td>Country</td>
<td>30,662</td>
<td>24,414</td>
<td>694</td>
<td>55,770</td>
</tr>
<tr>
<td>TOWN Country</td>
<td>7,098</td>
<td>6,656</td>
<td>272</td>
<td>14,026</td>
</tr>
<tr>
<td>Country</td>
<td>12,690</td>
<td>10,361</td>
<td>76</td>
<td>23,127</td>
</tr>
</tbody>
</table>


The suburbs (*sobborghi*) of Corfu were residential areas outside the town walls and served as providers of goods and labor to the town. Most of their residents were fishermen, sailors, gardeners, workers at the port and peddlers. One of the suburbs housed nearly a thousand refugees from Parga in the opposite mainland and ex Venetian outpost after its sale to the Ottomans in 1816. There they lived in deep poverty, although this community did include the Vasilas family, who maintained commercial connections with Trieste and Venice and were involved in money lending and the tobacco trade. Konstantinos Vasilas left his sons a prosperous firm, and one son, Xenofon, became Director of one maritime insurance company and served as President of the Clamber of Commerce.  

Corfu was the most cosmopolitan of Ionian towns. In Table 2, the significant number of Jews can be noted. A majority of Jews that settled in the town of Corfu in the sixteenth century came from Apulia, but another smaller Jewish community, the Romaniotes, had predated the Corfu settlement by centuries. Different Jewish communities resided in different parts of the town and attended one or another of its three synagogues. Table 2 depicts religious affiliation in contemporary terms.

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46 Tina Vasilia archive, B, file 4, IAK.
Table 2. Population census, Religious affiliation in Corfu, 1853.

<table>
<thead>
<tr>
<th>Locali della Città</th>
<th>Greci</th>
<th>Protestanti</th>
<th>Latini</th>
<th>Israelites</th>
<th>Totale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forestieri</td>
<td>8,199</td>
<td>13</td>
<td>1,581</td>
<td>2,160</td>
<td>11,953</td>
</tr>
<tr>
<td></td>
<td>1,494</td>
<td>151</td>
<td>2,592</td>
<td>224</td>
<td>4,461</td>
</tr>
</tbody>
</table>

Source: Ektelestiki Astynomia [Executive Police], 1719, 1/91, IAK.

Table 3 provides estimates of the occupational groups during the latter period of British rule (1840s-1864), and Table 4 shows the occupational classification of the Jewish population. The majority of the Jewish population resided in the second district of the town, and this is why only occupations in this district have been classified. It should be noted that the total number of those registered on the Electoral List and the number of Jews in particular, do not include Jews who chose not to become Greek citizens (which means these individuals did not have the right to vote nor register on the Electoral List) after unification in 1864. The exercise yields a picture of the town’s occupational map according to the 1864 Electoral List. When it comes specifically to the groups that are of interest for this chapter (i.e. merchants and shopkeepers), it is clear that they comprised a considerable proportion of the urban population (i.e. 31%). This percentage is probably higher because credit relations existed among wholesale merchants and craftsmen who also sold the product of the labor, such as shoemakers and tailors, and for whom credit was indispensable.

Table 3. Occupational Structure of Corfu in 1865

<table>
<thead>
<tr>
<th>Occupational group</th>
<th>District 1</th>
<th>District 2</th>
<th>District 3</th>
<th>Total</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Craftsmen</td>
<td>142</td>
<td>392</td>
<td>337</td>
<td>871</td>
<td>24</td>
</tr>
<tr>
<td>Merchants</td>
<td>87</td>
<td>432</td>
<td>148</td>
<td>667</td>
<td>19</td>
</tr>
<tr>
<td>Servants, employed</td>
<td>120</td>
<td>145</td>
<td>245</td>
<td>510</td>
<td>15</td>
</tr>
<tr>
<td>Proprietors</td>
<td>114</td>
<td>195</td>
<td>180</td>
<td>489</td>
<td>14</td>
</tr>
<tr>
<td>Retail</td>
<td>51</td>
<td>209</td>
<td>150</td>
<td>410</td>
<td>12</td>
</tr>
<tr>
<td>Professions</td>
<td>81</td>
<td>106</td>
<td>108</td>
<td>295</td>
<td>9</td>
</tr>
<tr>
<td>Labourers</td>
<td>6</td>
<td>110</td>
<td>79</td>
<td>195</td>
<td>6</td>
</tr>
<tr>
<td>Other</td>
<td>2</td>
<td>11</td>
<td>15</td>
<td>28</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>603</td>
<td>1,600</td>
<td>1,262</td>
<td>3,465</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: 1864 Electoral List, Eghoria Diaherese [Domestic Administration] 1544, IAK.
Table 4. Occupational Classification of the Population, 2nd district

<table>
<thead>
<tr>
<th>Occupational group</th>
<th>Total</th>
<th>Jews 2nd district</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Craftsmen</td>
<td>871</td>
<td>194</td>
<td>22</td>
</tr>
<tr>
<td>Merchants</td>
<td>667</td>
<td>268</td>
<td>40</td>
</tr>
<tr>
<td>Servants, employed</td>
<td>510</td>
<td>13</td>
<td>2.5</td>
</tr>
<tr>
<td>Proprietors</td>
<td>489</td>
<td>7</td>
<td>1.5</td>
</tr>
<tr>
<td>Retail</td>
<td>410</td>
<td>113</td>
<td>27.5</td>
</tr>
<tr>
<td>Professions</td>
<td>295</td>
<td>21</td>
<td>7</td>
</tr>
<tr>
<td>Labourers</td>
<td>195</td>
<td>92</td>
<td>47</td>
</tr>
<tr>
<td>Other</td>
<td>28</td>
<td>1</td>
<td>3.5</td>
</tr>
<tr>
<td>Total</td>
<td>3,465</td>
<td>709</td>
<td>20.5</td>
</tr>
</tbody>
</table>

Source: Electoral List 1864, Eghoria Diaherese 1544, IAK.

References


Part II
Micro-oriented studies
Financial Instability in Transition Economies during the 1920s: The European Reconstruction and Credit-Anstalt Insolvency

Michel Fior

This chapter discusses the connection between the reconstruction plans put forth by the League of Nations after WWI and the collapse of Central Europe in 1931.¹ It focuses on the insolvency of the Credit-Anstalt, the starting point of the financial crisis that spread throughout the whole region. Although much has been written on the reconstruction schemes and the 1931 bankruptcy, it remains unclear how the League’s programs interacted with the situation of these transition economies.² The aim is to analyze the link between the involvement of an international organization and insolvency during the 1920s, using a specific conceptual framework – that of institutional sociology.

It is argued here that the reconstruction schemes, far from leading to financial stabilization in transition economies, contributed, from the outset, to the very factors that would lead to the crisis. This chapter challenges the assumption that the Credit-Anstalt insolvency is best explained by domestic factors (dissolution of the Habsburg Monarchy, post-war inflation and failure of multinationalization strategy); instead, it presents this collapse as the very consequence of European reconstruction. Although they sought to restore confidence in national currencies in order to revive a global financial market and a liberal international monetary system (IMS), the schemes brought on destabilizing consequences on three interrelated levels. Budgetary policies constrained investments, monetary discipline inhibited domestic credit and the liberalization of financial flows led to an unbearable short-term indebtedness. With its strong involvement in industry, the Credit-Anstalt became a weak link between Anglo-Saxon financial markets and an Austrian economy in transition and depressed by the reconstruction scheme. While promoting a market-based reconstruction process, the League thus appears as a destabiliz-

¹ I would like to thank José Corpataux and Paolo Di Martino for their comments on an earlier version of this chapter, as well as Sara Cotelli and Tim Di Muzio for their support in its English translation.
ing factor that opened the way towards international disintegration during this period.

The analytical underpinnings of this chapter rely on a definition of the international organization as a social relation expressing a duality of power and legitimacy. Through the application of a combined neo-Gramscian and Foucauldian approach, this chapter focuses on how power relations within society are legitimized and institutionalized through consensual procedures. Following Robert Cox (1996), it considers historical situations as a specific interaction of institutions, ideas and material capabilities that help to define the modalities of legitimacy. This perspective enables us to understand how the League’s philosophy of the reconstruction crystallized in a period of contested social hierarchies and how it could be implemented in transition economies. Institutions are considered here as a central process of social and economic change. They contribute to the convergence of patterns of behavior as well as the legitimization and reproduction of that behavior. As the example of the League shows, transitions in social political economy cannot be understood without examining the role of institutions.

The chapter first discusses and challenges two dominant approaches to the study of international organizations and shows why a critical approach offers a more convincing framework for understanding the link between institution and insolvency. The second section sets the historical context of power and legitimacy in transition economies after WWI. Building on this, the third section summarizes the emergence and nature of the League’s reconstruction schemes, whereas the last part develops their link with the Credit-Anstalt insolvency.

International organization and instability in theory

One can briefly distinguish between two trends in the theories of international organizations.\(^3\) A first trend is premised on rational behavior and the maximization of preferences. This neoliberal institutionalism currently represents the orthodox paradigm in political science. It relies essentially on the tools offered by the theory of collective action, or *public choice*. As Bruno Frey (1991, pp 8–9) mentions, this approach seeks to explain the political processes and the interaction between the political and the economic by means of theories developed by modern neoclassical analysis, which is then applied to groups. A second trend, inspired by constructivism or sociological institutionalism, is concerned with questions of legitimacy and intersubjective definitions of identities and interests.

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For neoliberal institutionalism, institutions in general and international organizations in particular can be understood as an answer to market failures. Accordingly, they represent commitments settled by rational operators with the aim of solving the problems created by incomplete information. Institutions seek to decrease insecurity and risks, as well as to reduce transaction costs. In this perspective, as explained by Keohane – one of the main theorists of this approach – the international organization is the direct consequence of a maximizing will (Keohane 1988). The institution is therefore analyzed through its output— in this case an international public good. Monetary stability, a liberal regime and the prevention of systemic risk are several examples of such public goods that come out of the harmonization of usage and transparency. The international organization is necessarily a positive sum game insofar as rational States would not cooperate if they rationally foresaw a negative output. According to neoliberal institutionalists, then, the international institution represents an essential source of security against financial crisis.

The influence of neoliberal institutionalism on the policies of the International Monetary Fund (IMF) and on research dealing with this organization is considerable, and it does not spare the League sometimes considered as its ancestor. Rudiger Dornbusch and Julio Santaella suggest an approach marked by the theory of rational choices in which the League’s structural adjustment schemes are presented according to their stabilizing virtues on the international monetary system (Dornbusch 1992, Dornbusch and Fischer 1986, Santaella 1992). Both researchers use the experience of the League’s Economic and Financial Organization (EFO) to justify the involvement of the IMF in the adjustment programs designed in the 1990s for the countries emerging from the Soviet bloc. They saw in the European reconstruction of the 1920s – at least in the role played by the League in this period – an example of the success of ‘external enforcement’ in solving credibility problems and in creating a regime of convertibility. Dornbusch and Santaella explain the League’s achievement (mastering inflation, stability of exchange rates and a balanced budget) by two essential factors. On the one hand, the flotation of a stabilization loan acted as a sign of financial rectitude and credibility, as well as financing the stabilization. On the other hand, a stiff political conditionality (full powers to governments and League’s commissioners) enabled the adoption of radical structural reforms. In short, the League acted like a stabilizing mechanism, structurally adjusting ‘non-successful’ economies, producing information and transparency, giving away liquid assets and finally restoring the confidence of investors in the stability of reconstructed countries. Both Dornbusch and Santaella avoid suggesting any connection between external enforcement and the 1931 collapse: the crisis breaks out as a detached phenomenon from the reconstruction schemes. In other words, it is understood as an exogenous process.
It is not the place here to explain in details the problems raised by neoliberal institutionalism for the study of financial crises. In addition to its methodological individualism, its rationalist postulates and the timelessness of the preferences ascribed to the actors, which ultimately deprive the analysis of any historical significance, it develops a restrictive conception of the international sphere. For neoliberal institutionalism, the international scene is essentially composed of States and markets and the cooperative agreements have no social depth: they are a sum of calculations transformed in institutional behaviors. This theoretical perspective thus considerably narrows the study of power relations within society. However, the most problematic aspect in our perspective is the impossibility to grasp the international organization as a source of instability and insolvency. As the institution maximizes the preferences of rational actors in a world now foreseeable, it cannot have the reverse effect; if it were so, states would abandon counterproductive cooperative agreements.4

Sociological institutionalism offers another way of approaching the link between institution and insolvency in a time of transition. Rather than considering international organizations as rational and non-historical procedures created to overcome market failures, the advocates of this approach regard institutions as ‘social facts’ (Barnett and Finnemore 1999, p 703). The emphasis is no longer on the maximization of preferences, but on the normative and cultural aspects that shape international organizations. Legitimacy thus becomes the essential referent through which the institutions are analyzed. Whereas the upholders of the rational choice theory postulate the existence of maximizing behaviors external to social interaction, socio-institutionalists underline the cognitive dimension of institutions. Institutions shape identities and influence behaviors by providing patterns, by creating categories and by spreading cognitive models that are essential to act, as well as to interpret the world and the behavior of other actors (Hall and Taylor 1997, p 483). As social constructions and sources of normative models, international organizations are consequently viewed as social processes living their own existence and developing their own autonomy. They identify with social spaces (‘epistemic communities’) where information and knowledge are produced (Haas 1992). Barnett and Finnemore (1999, pp 707-715) define three main ways through which norms and knowledge are structured. International institutions classify and organize information and knowledge and thus help create categories such as ‘refugee’; they determine meanings, as, for instance, concepts such as ‘development’ or, as far as we are concerned, ‘monetary policy’ and ‘central banking’. Finally, they diffuse norms and models of social organizations, as, e.g., the ‘market’ or the ‘gold standard’.

4 Neoliberal institutionalists handle this problem through the hypothesis of an underlying and unavoidable constraint. From an historical perspective, this analysis seems of course insufficient because it is teleological.
The constructivist approach opens the way to the study of international organization and insolvency. The international organization evolves within its own bureaucratic and cognitive logic and does not necessarily follow a maximizing logic. The institution can thus free itself from its environment, develop an obsession with its own norms and survival and lead to counter-productive behaviors. Concerning this matter, Barnett and Finnemore (1999, p 699) write about their propensity ‘for dysfunctional, even pathological, behavior’.

However, sociological institutionalism presents its share of difficulties when one tries to comprehend the international organization and its link with insolvencies. Even if it is the result of social construction, the international organization – at least for Barnett and Finnemore – reaches autonomy and tends to become an ‘object’. It is endowed with its own qualities, its reactions and its social logic. In other words, although the international institution is the result of a social process, it is not a social process. ‘Many international organizations exercise power autonomously in ways unintended and unanticipated by states and their creation’, the two authors argue (1999, p 699). Influenced by Max Weber’s theses, some socio-institutionalists study international organizations as bureaucracies and underline their organizational and/or rational dynamics. This kind of approach undermines considerably the relevance of such an analysis of international organizations and tends to reduce dysfunctions to bureaucratic features. Finally, even if socio-institutionalists suggest disengaging from the state-centrism typical of classical theories in history and international relations, which leaves no space to actors other than States, they nevertheless study international organizations as actors in a world made up of States.

Overcoming state-centrism in the study of international organizations is one of the main ambitions of historical political economy. The purpose is not to deny the role of States in the working of international institutions; nonetheless, it is important to underline that international organizations cannot be reduced to a state-centered dimension, but that they express issues deeply rooted in fundamental and global social relations. This somewhat arcane definition becomes clearer once its main features are detailed. Rather than the convergence of maximizing behaviors, the international institution is seized here as a process endogenous to social relations in their historicity and their spatiality. Moreover, in order to soften an institutionalism that would end up considering international organizations as nearly autonomous objects, a historical political economy approach considers the international organization above all as a discursive construction. To draw on one of Michel Foucault’s concepts, the institution is understood as the expression of a ‘governmentality’ or a ‘regime of truth’, prevailing at a certain time in his-

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5 On historical political economy, see Langley 2002 and Fior 2006. On its links with global political economy, see Palan 2000.
tory (Foucault 1997). International organizations thus cannot be distinguished from discourse and the constitution of legitimacy.

In this perspective, the international organization is defined along two main lines. First, as a social relation, it is the expression of social dynamics and institutionalized relations within society. An object external to social relations would not determine identities and define, in a quasi-exogenous way, categories of international political economy and their legitimacy. As a social relation, the international organization is primarily a relation of power and legitimacy between different social forces, classes or groups. In a neo-Gramscian approach, power is indeed not conceived in terms of coercion (Cox 1996; Gill 2003) and we try to avoid the risk of ‘false consciousness’ distinguishing some Marxist perspectives. The consensual dimension of power relations are of chief interest here, namely ‘regimes of truth’ (Foucault) or ‘hegemony’ (Gramsci). By these terms, I mean the social procedures by which knowledge becomes power and in which power is connected to an economy of knowledge. As a dual relation of power and legitimacy, the international organization can be understood as a historical process defining a certain economy of truth between social forces on a global level. What is at stake, in other words, is to underline the social and political dimension, which is not emphasized enough by socio-institutionalists who mainly insist on the cognitive procedures between actors that are socially equal when entering the relation. The neo-Gramscian conception of the institution, on the contrary, includes a material aspect of social hierarchy and presents society as a network of legitimized tensions. Legitimacy is thus one aspect of power in the sense that it expresses a consensual adhesion to a series of representations that are not a historical ‘necessity’ but that express a collective choice and asymmetrical effects.

However, if it is a social relation, the international organization is not only a discursive ‘reflection’ of the process of power. Precisely because it is theorized as a social procedure, the institution can be seen (second main line) as the element of a structure: it contributes to the reproduction of ideas, knowledge and production relations. As such, it takes part in the social framework, material as well as normative, which builds a world in which actors evolve, foresee themselves in the future and act at the reproduction and transformation of their environment. The international organization thus helps structure social relations in time, defining expectations and rationalizing inequalities.

These two dimensions of the social relation call for three more comments. First, the international organization cannot be reduced to its legal, formal or

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7 This approach shares some perspectives with the French regulation school. For Aglietta and Orléan (2002), the money as a social institution is best explained as a duality of violence and confidence.
administrative dimension, as it is often the case in the history of international relations or in economic history where the institution is grasped mainly through the administrative papers that she produced. I do not want to refute these aspects inherent to any organization, but on the contrary to define them as *expressions*, rather than *foundations*, of the institution. It is thus in basic social relations, notably in civil society, that we can find the decisive elements for the setting and reproduction of an institution. Such an approach relies on a very wide definition of the international organization, close to the concept of ‘State’ as developed by Antonio Gramsci: this notion encompasses civil society and political society, or rather represents a *relation* between civil and political society. Second, an organization can never be reduced to its first objectives, as institutionalists advocating the rational choices theory would suggest (Thelen 2003). It requires historical processes that go further than the rationality of social actors and expresses deep social temporalities, referred to by Braudel (1958) as the ‘longue durée’. For instance, international organizations that appear in the second half of the nineteenth century are indeed structured around a charter and a set of precise goals: unify communication systems, protect authors’ rights, fight against the propagation of illnesses, and so on. Their historical relevance, however, makes sense in the broader perspective of liberal internationalism that transcends the rationalities of the period, as well as it participates in the plan to create a large integrated market and to reproduce a global capitalist system more and more indebted to international institutions (Murphy 1994). Third, and finally, as an institutionalised social relation, the international organization is embedded in action/structure dialectic. As the expression of a regime of truth at a certain time in history, or in Gramscian terms, as a quest for hegemony, it becomes the institutional and social framework in the midst of which individuals act at the reproduction and transformation of the social order (Gramsci 1971). Following these three aspects, the international organization can be seen as a social relation expressing a set of behaviors, discourses and social networks that congregate, at a certain moment in history, in an institutionalised form able to reproduce and/or reshape certain social behaviors.

Historical political economy, then, sets the basis for the understanding of the link between international organizations and insolvency. Dissociated from maximization logic and seen in relation with social power relations, international organizations will thus be studied in the light of the kind of regime of truth of which it is an expression and to the reproduction of which it contributes. An analysis of the League’s EFO permits us to discover its embeddedness in the project to rehabilitate the gold standard, a project that acts as a powerful vehicle to reach a consensus but is at the same time shaken by insoluble tensions. A historical regime of truth, just as ‘world order’ in the thought of Robert Cox (1996), is indeed a place where contradictions coexist, which allows one to understand historical change. Thus, it is not in the
‘virtues’ or ‘efficiency’ of the international organization that one has to find its ability to stabilize the international system and contain insolvency, but in the dialectic of regimes of truth and the modes of regulation that have been implemented. International organization can therefore be understood in this combination or ambivalence of power and legitimacy. Insolvency emerges from this historical duality through which social forces interact in the making of history, and where institutions are engaged in implementing procedures of representations and in normalizing interests. Insolvency thus appears as an outcome of this historical duality. As Karl Gratzer and Dieter Stiefel argue in this volume, it represents indeed a tension.

International organization and the power/legitimacy dualism after WWI

The conceptualization that has just been presented enables one to analyze the League’s involvement in the reconstruction of Europe, as well as the role of the EFO in the regulation of the IMS after WWI. The organization appears as a social relation when one considers two main aspects: on the one hand, it is embedded in very acute social tensions that characterize the end of the war – revolutionary tendencies and the general contestation of the elites – and that are progressively overcome in the course of the decade.8 On the other hand, the mechanisms that it implements lie, above all, in the field of consensual procedures of power, notably the diffusion of the discourse on the gold standard in its re-examined version (gold-exchange standard). The European reconstruction and the monetary regulation are thus far from being a ‘philanthropic’ action: what matters is the social order, that is to say hierarchies, a regime of accumulation and a mode of regulation. In this section, I show how the social contestation after WWI is transformed in a legitimate model of orthodox financial reconstruction and implemented in the League’s reconstruction schemes.

Financial elites play an essential role in the creation of economic and financial institutions within the League, as well as in the vast procedure of European rehabilitation and reconstruction of a social order. Far from staying inactive when faced with the contestation of the social order and when Europe was experiencing severe financial instability, bankers from several countries – essentially European – gathered several times in Amsterdam as soon as Spring 1919. Their purpose was to unify their positions on the transition towards a peaceful economy and the reconstruction of Europe. These international conferences welcomed, among others, prominent international experts such as Keynes, Bruins and Cassel (Vissering 1920, Silverman 1982,

8 On this subject, see the two classical works of Maier 1975 and Mayer 1967.
The bankers did not part before having set the basis for common action in favor of European reconstruction: the outcome was a memorandum signed by a large variety of famous personalities and submitted to their respective governments in January 1920.9

This bankers’ memorandum focuses on two points: the signatories call immediately for an international conference bringing together financial experts to join forces to define the basis of the international cooperation necessary for the reconstruction of Europe. The urgency is explained by the political and social instability threatening European social structures in 1919. The text, however, does not amount to the proposition of an international conference on the reconstruction: it also sets the basis for the policy to follow in this case. Against the continuing growth of the money supply and State expenses, the suggested therapy promotes monetary and budgetary discipline. Consumption must be reduced while production and taxes are to rise. If these remedies are not promptly administered, continues the memorandum, the financial experts feared that the depreciation of currency would continue, “wiping out the savings of the past and leading to a gradual but persistent spreading of bankruptcy and anarchy in Europe” (quoted in Keynes 1977, p 137).

This appeal did not go unnoticed by the governments to which the text was submitted. The responsibility to organize a large international conference was soon passed on to the League that had just started its activities. At the end of September 1920, 86 delegates from 39 countries, representing three quarters of the world population, gathered in the Belgian capital to discuss the international financial situation. The Brussels conference has been the focus on numerous studies and is sufficiently known so as not to dwell on too many details here (e.g., Eichengreen 1992, p 153sq). However, it exemplifies two important aspects for our problematic: one, the resolutions unanimously adopted and legitimized in Brussels will inspire the League’s reconstruction schemes, and two, the conference will result in the foundation of the EFO, responsible for enforcing the resolutions and their implementation.

In the extremely troubled social dynamic of the aftermath of the war, and in the context of radical contestation of the legitimacy of capitalist elites, civil society became the incitement for establishing the international institutions of the reconstruction. Here, financial elites can be recognized through their active commitment to the setting up of a form of the State and international economic system that was in accordance with their understanding of an ideal regime of governance. However, even if this process inevitably involves a moment of power, we should also understand the role of the League in its consensual dimension. The notion of legitimacy in the process of

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9 See the memorandum and Keynes’ correspondence on this subject in Keynes 1977, pp 136-150.
European reconstruction will be shaped around three main themes: the metaphors of a paradise lost, the mythology of self-regulation and the doctrine of rationalization.

Discourses of bankers and international financiers moving within the League are full of metaphors of a paradise lost, which act as a way to legitimize the reconstruction of a social and economic order ended by the war. The nineteenth century is constructed as a period of peace, comfort and stability and thus operates as a real consensual reference. As Arthur Salter, head of the EFO, later remembers

It was therefore natural that the first effort of reconstruction after the war should have been directed, in nearly all countries, not to changing the main structure of either society or its economic and financial framework, but to repairing and rebuilding on the old foundations and to the old design. By comparison with 1919 the world of 1913 seemed to most of us a paradise from which we had for a time been excluded by a flaming sword. It seemed a sufficient goal for our efforts to win our way back to what we lost (Salter 1961, p 193).

Keynes was not an exception and his *Economic Consequences of the Peace* (1920) presents the war as a fatal blow to a golden age. This myth of a paradise lost entails a vast array of biblical and civilizational references – as shown by Salter’s paradise and flaming sword – conceived as the intellectual cement of an ideal order to be recaptured. One can also read in this a moral discourse on monetary discipline, debts ethics and the healing virtues of financial rigor, which will all appear in the philosophy of the reconstruction supported by the League.

Growing on this nostalgia, the emergence of a mythology on the self-regulating gold standard is best explained in the same context of power legitimized through a discourse of consensus. Even if it is nearly two centuries old, the Humian model of ‘price-specie flow’ becomes the pivot around which the Anglo-Saxon conceptions of price and money unite (Eichengreen 1992, p 32-35). The Cunliffe Committee, in 1918, sets this Newtonian model at the center of its demonstration of the success of the gold standard before the war. This British committee of bankers, in charge of characterizing future political monetary policies, defines it similarly as the mechanism that will assure the stability of a monetary system rebuilt on its old foundations. The gold standard, conceived as a system of gold flows that, as hydraulic circulation, automatically adjusts the prices and the balance of payments, owes much to the spread of this mythology after the war. Contested by some groups, the gold standard and its apolitical metaphors become in the aftermath of the war a very important instrument for financial circles eager to restore favorable conditions to the stability and circulation of capital on a transnational level. The main objective of the reconstruction schemes was
also to seek to restore a universal standard and free international convertibility through structural adjustment.

These references to a ‘paradise lost’ and the mythology of the gold standard coincide with a rationalist discourse, meant to confer a modern and progressive intimation to references that are, for the most part, reactionary. Following the principles of Taylorism, the doctrine of rationalization was connected to a larger trend stating that science and organizations can improve the functioning of the market and even society. In the League’s perspective, the scientific understanding of business cycles supposedly lead to a rationally foreseeable world from which unemployment would be forever banished. The scientific organization of production, as shown notably by the resolutions of the 1927 economic conference, called for an optimal allocation of resources beneficial for all. Even international relations became the object of science whose practitioners intended to identify the causes of conflicts, thus becoming able to eradicate this dark specter in the future. The expert – apolitical and showing universal knowledge – is a central figure, the only person, according to E. H. Carr ([1939] 2001, p 17), to enjoy some respect within the League.

The quest for legitimacy or, following Gramscian terminology, hegemony, is particularly well exemplified by a mythological rhetoric that can be understood through its three functions. First, they appear as a unifying discursive device meant to play the role of a common social foundation at a certain time in history, particularly in a situation of transition such as the reconstruction. The gold standard embodies the idea of a social ‘naturality’, which sets the common rules of value and wealth. It is probably not by chance that the collapse of the gold standard during the war was directly associated with the decline of Western liberal civilization: the materialist society, in search for wealth, suddenly stood deprived of the communal foundations on which it rested. On this account – second aspect – the mythology is a form of power in as much as it erases the divergences inherent to any social order. Its rhetorical procedures operate in depoliticizing the canvas of the social fabric through an idealization of a set of forces or external references: the gold standard is considered as being a part of hydraulic physics, displaying in parallel an extra-social essence. Thus, it should not come as a surprise that the most eminent central bankers sought to give banks of issue an independent status and to assign monetary policy only to financial ‘technicians’. Finally, the consensual and mythical aspect of power is not only meant to legitimize a form of social organization considered as ideal but also to discredit possible alternatives. In other words, one can interpret it as a strategy aiming to reduce the ‘limits of the possible’ to an optimality presented as unavoidable. The myth of progress, as it is expressed in the doctrine of rationalization, generates a form of fatalism that negates the possibility of alternatives and, as it is mentioned by Stephen Gill (2003, p 139), prevents us from analyzing history as the product of collective human actions.
We now have to turn to the way in which this conception of money and finance is implemented in the reconstruction schemes.

The League and European reconstruction schemes

European reconstruction, the rehabilitation of the gold standard and the re-establishment of a global market for the circulation of transnational capital merged into a unique social project after WWI. The reconstruction schemes advocated by the League were intended to function along three lines. The first lays in the fluctuating exchange rates of the post-war years that prevented the development of financial flows and weakened the IMS; the return to a gold standard and its consequence, monetary discipline, thus become the essential objectives of the reconstruction. For the financial conference held in Brussels in 1920 under the patronage of the League, “it is highly desirable that the countries which have lapsed from an effective gold standard should return thereto”.10 This first aim cannot be detached from budgetary unbalance, the second source of crisis identified by the financial experts. The discipline of public finance thus appears as a preliminary condition to reach stability. Finally, exchange control prevents investments from countries with a surplus from using these surpluses to invest in countries in need of capital and is therefore said to hinder the good functioning of international convertibility. According to the financiers gathered at the League’s Conference, “attempts to limit fluctuations in exchange by imposing artificial control on exchange operations are futile and mischievous”.11 Financial liberalism is therefore an indispensable counterpart to a reconstruction scheme based on the premise that free financial flows necessarily lead to an optimal distribution of liquidities in a productive system. Indeed, for the League’s very orthodox experts, the market is supposedly driven to a state of equilibrium by its own ‘natural’ mechanisms. If it enforces these three conditions – monetary stability, budgetary discipline and financial liberalism – any country will be able to join the IMS to attract capital for its investments and it will mechanically enter a period of growth. As the Financial Committee argues in its preliminary reconstruction scheme for Austria, “If the appropriate financial policy is adopted and maintained, the Austrian economic position will adjust itself to an equilibrium by the increase of production and the transfer of large classes of its population to economic work”.12 Thus, the reconstruction is conceived as an automatic process relying on private capital. This ‘market-based reconstruction’ advocates investments along the unique law of supply

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10 International financial conference, Brussels (1920), II/VIII.
11 International financial conference, Brussels (1920), II/XV.
and demand. Rather than a wider reflection on the priorities of the reconstruction, these two concepts of profitability and confidence determine the allocation of capital in transition countries.

According to the financiers, an intermediary step is nonetheless necessary: as the stabilization of the budget cannot be obtained overnight, the League’s reconstruction schemes provided a transitional program of approximately 3 years. During this period, so as not to hinder monetary stability, budget deficits were to be covered by an international loan. This loan is not aimed at financing the reconstruction and its investments; rather, it takes part in a process of structural adjustment – in this instance budgetary.\(^\text{13}\) In this way, only private investments will lead to the rehabilitation of economies ruined by the war. The League’s policies take the form of a reinforcement of measures concerned with the flow of international capital and because capital flow is considered a stabilizing factor, there is no need to embed it in procedures that could control its possible negative effects on the country’s solvency. Moreover, in the whole process, the financial Committee hardly ever worried about the risk of insolvency that could hit a financially fragile country once it is integrated in the new IMS; the only concern of the financial experts regards the deflationist effects of the increase in the purchasing power of gold, but, according to them, this will arise very late: too late, as the crisis of 1931 and the suppression of convertibility will make these quantitative meditations obsolete.

Nine schemes were implemented by the League in six countries: Austria (1922), Hungary (1923), Greece (1923, 1927), Danzig (1925, 1927), Estonia (1926) and Bulgaria (1926, 1928). Moreover, Geneva’s programs closely inspire reconstructions such as the German Dawes plan.\(^\text{14}\) Even if the League is only a secondary actor in the establishment of reconstruction plans in the 1920s, its influence should not be forgotten.\(^\text{15}\) It is notably through its medium that the philosophy of the reconstruction was elaborated and it was the institution responsible for drafting the first plans. Austria, in a nearly desperate situation in 1922, can be seen as a kind of laboratory where the League tested the method later applied to other countries in Europe.\(^\text{16}\)

\(^{13}\) In practice, the loans will be partially used for investments. A quick return to a balanced budget in Hungary and Austria actually made it possible to redirect part of the sums that were not necessary any more to pay deficits.

\(^{14}\) On the LoN’s schemes generally, see LoN 1945; Fior 2006.

\(^{15}\) The LoN’s schemes comprise 44% of the sums drained from international financial centers in the scope of international reconstruction schemes.

European reconstruction began in Austria, and it was in this new Republic that the crisis broke out, leading nearly the whole of Central Europe into insolvency and to the introduction of exchange controls. The coincidence is of course totally accidental, especially because the League took charge of countries (Austria and Hungary) that were particularly weakened in the aftermath of the war, as well as victims of the most severe inflationist phenomena after Germany. The parallel, however, allows us to draw a line between the reconstruction schemes advocated by the League and the bankruptcy of reconstructed economies.

The analysis of the Austrian financial crisis of 1931 completely merges with the crisis of the Credit-Anstalt. It follows two general tendencies. On the one hand, some studies underline the domestic aspects of the crisis and show that the collapse of the first Austrian bank — a real state within the state — is part of an evolution characteristic of the Austrian financial and economic structure since the end of the nineteenth century. Fritz Weber, e.g., suggests three reasons for the collapse of the Austrian financial system after the end of the war: the dissolution of the Habsburgs’ monarchy (and the Austrian banks’ attempt to maintain their positions in Central Europe taking the shape of multinational companies developing a ‘Danubian strategy’), post-war inflation (which considerably thinned out the banks’ equity capital) and the poor performances of the Austrian economy. Dieter Stiefel (1983, p 417) puts emphasis on the failure of a multinationalization strategy and notes that the huge industrial commitments of the Credit-Anstalt that made the company “as much an industrial holding company as a bank”. On the other hand, historians because they are more concerned with worldwide financial history, look for the origins of the Austrian collapse in the pathological functioning of the gold standard at a macro level. Barry Eichengreen (1992) links the Austrian crisis with the propagation of the IMS deflationist effects after the Wall Street crash in 1929. He sees Austria, Hungary and Germany as the weak peripheries of a global financial system drawn to failure because of lack of credibility and cooperation.

I show in this section that the Austrian bankruptcy deserves to be analyzed in a global perspective, i.e. in the interaction between domestic and international levels. The League’s reconstruction scheme plays an essential role in the crisis because its logic was in contradiction with the domestic

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17 On the Credit-Anstalt crisis, see among others, Rathkolb et al. 2005, Schubert 1991 and Stiefel 1983. On a formal level, one cannot talk about the bankruptcy of the Credit-Anstalt. Schubert argues that the Credit-Anstalt failure started as a solvency crisis because of losses and immobilizations. Then, it evolved to a liquidity crisis when deposits started to be withdrawn. The confidence crisis spread to other banks (financial crisis) and then ended with a currency crisis when international lenders massively withdrew their credits (Schubert 1991, p 32sq).

18 For more on this approach, see Weber 1995; one can also refer to Stiefel 1983.
specificities of Austria – and the Hungarian case is not different from this. Without entering into the large debate about the origins of the Credit-Anstalt’s insolvency and illiquidity, I will merely focus here on the link between the philosophy of the reconstruction, based on the logic of global financial markets, and its effects on the economic system characterized by a strong commitment of the banking system to industry.

Capital flowed to the countries in reconstruction. Thanks to monetary stabilization and the liberalization of capital circulation, the League worked in favor of the financial community and its aspiration to rehabilitate a large global financial market. The League will note a few years later that “the Austrian reconstruction scheme, from 1923 on, followed a year later by Hungary’s led to stabilization, and [...] turned these two countries into an active field for investment and short-term lending” (LoN 1944, p 150). However, rather than strengthen the financial and productive system of Central Europe, capital contributed from the very start to its insolvency. Two main causes explain this.

First, it is well known that capital meant mostly short-term assets that (predominantly) Anglo-Saxon banks lent to Vienna or Budapest. Following Nötel’s evaluations, which are, however, not without contestation, on average 70-80% of capital flows are short-term liabilities; in Hungary, too, where the estimations are more accurate, this phenomenon covers more than half of the liquidities present in the banks’ statement of account. It seems unnecessary to note that such commitments, which do not obey a logic of long-term reconstruction, are very risky for an economic system in transition: either they are used in the short term and their effect is consequently reduced or they are invested in the long term and they put the entire financial system at risk. Moreover, in such a situation they are liable to generate systemic risk. The countries reconstructed through the League evidently followed the second option. Lacking capital in the long term, which investors did not provide, Austria and Hungary had to resort to short-term credit facilities. Two League’s experts, Layton and Rist (1925, p 127), note in their 1925 report that banks in these two countries had no difficulties in finding liquidities in amounts larger than could possibly be put to use.

The second problematic aspect of the reconstruction by the market lies in the cost of indebtedness: until 1925, foreign assets in Austria were paid up to about 12%, commissions included. Domestic credit was even more expensive than international facilities and amounted to up to 14% during the second half of the decade, at a time when rates tended to fall in comparison with the first half of the 1920s (Layton and Rist 1925, p 127; LoN 1925, p 95; Stiefel 1988, p 300). In this situation, new credits were frequently subscribed.

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19 Nötel 1984, p 156; for Hungary, see Péteri 2002, p 138, 145. A part of Nötel’s calculations rely on estimations according to the balance of payments; this method is problematic as other financial elements can have an influence.
to abroad in order to repay interests owed on another credit, or to pay back a credit limit that had not been renewed.

These financial facilities are not for the direct use of financial houses like the Credit-Anstalt. Instead, credit is ultimately extended to productive enterprises. What this means is that financial institutions in central Europe played an intermediary role between Anglo-Saxon investors and the productive enterprises of central Europe. It is hardly surprising, then, that Austrian financial institutions (not to mention Hungary and Germany), extended these credits to their own industrial sector because they had a history of frequently supporting their own companies\textsuperscript{20}. Alice Teichova (2005, p 153) argues that Central-European banks – and especially Austrian ones – had to keep their industrial debtors afloat in order to sustain their own credit worthiness and thus concealed losses. In some cases, as Dieter Stiefel (1989, p 101-103) points out, the Credit-Anstalt even directly managed the financial department of its industrial companies. The control exerted by the Viennese banks over the Empire’s productive system since the end of the nineteenth century has often been underlined:\textsuperscript{21} in 1921, the big universal banks of the former imperial capital controlled 44% of companies in the field of Austrian metallurgic industry, as well as 45% in the electric industry. Sixty-seven percent of the paper production and 38% of the sugar industry belonged to financial institutions (Berger 1995, p 411). Each of the large Viennese banks owned a substantial industrial portfolio and actively partook in administering the companies via their board of directors. The example of the first Viennese bank, the Credit-Anstalt, speaks for itself: while the flagship of the Austrian financial system controlled 102 companies before the war, it controlled 136 in 1923 (März 1981, p 536sq.).\textsuperscript{22} As the crisis began, the Credit-Anstalt network owned about 40% of the Austrian industry.\textsuperscript{23} This dependency of industry towards finance is also a dependency of finance towards industry: to protect themselves from hyperinflation, banks had taken refuge in equities; further-

\textsuperscript{20} Out of the total number of the Credit-Anstalt’s capital and credit participations, 11% consisted of capital participations only, whereas 40.6% had both capital and credit participations. Thirty-two per cent of the Austrian debtors had taken up credits from the CA in excess of their own equity (Teichova 2005, p 154).
\textsuperscript{22} For Mosser and Teichova (1991, p 140), who base their study on a report of the Ministry of Finance, the Credit-Anstalt controls 163 companies at the end of 1929. Weber (1985, p 128) reports 192 in 1931.
\textsuperscript{23} Weber (1985, p 128). According to Mosser and Teichova (1991, p 140), who draw their numbers from different estimations, the share of the Credit-Anstalt in the entire cumulated capital of Austrian companies could amount to more than 60%. Alice Teichova’s (2005, p 154) calculations show that the companies ‘in the sphere of influence’ of the CA represented 18.6% of the total number, but 68.8% of the total capital of Austrian joint-stock companies. This doesn’t mean, however, that the CA controlled such a proportion of the Austrian economy.
more, they often converted credits in capital participation to avoid being paid back in depreciated money (Weber 1985, p 126).

This specificity of the Central European financial and industrial system confronts us with a problem in view of the reconstruction schemes designed by the League: as a consequence of their industrial networks, the banks – and most probably above all the Credit-Anstalt – never dithered about financing companies that belonged to them. Assets were indeed requested for reconstruction and to face international competition. As only short-term liquidities were available on foreign markets, these volatile assets were tied up in the long term. The Credit-Anstalt presents a good illustration of foreign indebtedness on the financial system of reconstructed countries. The proportion of debts compared with the bank’s equity capital was on the rise between 1924 and 1930. Depending on various evaluations, between 36 and 50% of all its credits at the time of the collapse come from abroad (Schubert 1991, p 34, 44.). The debt equity ratio of the Credit-Anstalt reveals very clearly the bank’s growing indebtedness after the monetary stabilization and the implementation of the reconstruction program: whereas on January 1, 1925 the ratio was under 6%, it kept on growing until the summer of 1923 when it nearly reached 11%. Indeed, as mentioned by Schubert, this ratio bears witness to the failure of the banks to restore adequate capital endowments in the aftermath of the hyperinflation in 1922. But the quick rise of illiquidity mostly shows the short-term indebtedness during the years of monetary stabilization.

Table 1. Debt equity ratio of the Credit-Anstalt

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<th>1913</th>
<th>1924</th>
<th>1925</th>
<th>1926</th>
<th>1927</th>
<th>1928</th>
<th>1929</th>
<th>1930 (June 30)</th>
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<tbody>
<tr>
<td>Ratio</td>
<td>3.64</td>
<td>5.68</td>
<td>6.86</td>
<td>9.28</td>
<td>7.90</td>
<td>8.98</td>
<td>8.82</td>
<td>10.9</td>
</tr>
</tbody>
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*Source: Schubert 1991, p 34*

As noted by Aurel Schubert, this structure of the banking sector and its industrial network made the banks (the Credit-Anstalt in particular) subject to a double pressure on its solvency: ‘one emanating from the losses that were due to frozen loans, another that was due to the deterioration of the value of their very extensive portfolio holdings’ (Schubert 1991, p 39).²⁴ As the League’s reconstruction plans and their market-oriented philosophy took effect, the Austrian financial sector became the weakest link in the system. Once Anglo-Saxon capital becomes scarce, nothing could prevent the Austrian financial system from exposing the extent of its unsound debt structure and lack of liquidity.

²⁴ On the total of the Credit-Anstalt losses, 10% are due to losses on industrial holdings and more than 40% on Austrian debtors, of which a ‘considerable amount’ was due to firms owned by the CA.
The form and the magnitude of foreign indebtedness in the Austrian industrial and banking system do not explain on their own the move towards insolvency and the 1931 crisis. Other elements of the logic of reconstruction by capital markets are also relevant, namely monetary discipline and ‘sound budget’ policies, both closely linked to the project of rehabilitating the gold standard and a global financial market. Regarding monetary discipline, high rates of interest attracted foreign capital and thus helped to maintain a strong currency, at least until 1931. In this perspective, the Austrian National Bank systematically maintained its rate above the Reichsbank’s rate. But the deflationist tendency noted in the wholesale price, as well as the handicap of having a strong currency in a European environment still characterized by the floating of some currencies, facilitated the aggravation of the economic depression and helped weaken industrial companies already fragile because of their indebtedness. As was already noted regarding the Austrian context, companies’ financial problems have a deep influence on the Credit-Anstalt solvency; all the more, because the industrial network run by the Viennese bank includes in its numbers some of the most fragile firms (Stiefel 1989, p 18).

Regarding the budget, very few public investments were possible because of Geneva’s philosophy of financial orthodoxy.25 According to the Minister of Finance at the time of the reconstruction, Victor Kienböck, this aspect was not even mentioned during the negotiations with the financial Committee in 1922 (Kienböck 1925, p 128-129). However, right after the war, the coalition government had admitted the role of public spending aimed at encouraging some economic development and the reduction of unemployment. In January 1919, it had launched a program of investments focusing on the renovation of public buildings, the extension of the communication network and the electrification of railway and tramways in Vienna. This venture had even gained the support of the conservative Minister of Finance, Joseph Schumpeter. However, after the League, plans had come into effect and until 1926 at least, public investments are subjected to very strict limits, owing to the corset imposed by the League on budgetary spending. Until the end of the decade, only the surplus of the League loan was allocated to investments, such as the electrification of railways. Still, the Austrian government had to face the opposition of the financial Committee for which the loan should be assigned to reductions in the budget or to repay the floating debt to the central bank.

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Conclusion

In contrast to classical institutionalist approaches, historical political economy provides an ideal alternative to the understanding of the link between institution and insolvency in a transition economy. It also allows one to go beyond current neoclassical orthodoxy and its propensity to consider any external intervention on the functioning of the market as an obstacle to general equilibrium. The heterodox approach, which conceptualizes international organizations as a social relation, places emphasis on the historical dynamic of power characteristic of each social system and each international order. Moreover, it particularly underlines consensual processes of convergence on a dominant mode of regulation. International organizations thus appear as an ambivalent relation between power and legitimacy. As the expression and the reproducing agent of a ‘regime of truth’, the international organization is indissociable from the social order from which it stems and which it helps to maintain.

In the case of European reconstruction and its ties with the 1931 crisis, the League was analyzed here in the light of a ‘regime of truth’, which legitimizes the reconstruction of a global financial market and the circulation of transnational capital. The League therefore plays a role in the reproduction and diffusion of the classical view, which states that free circulation of capital and the market mechanisms allow an optimal allocation of liquidities in the production system. As a result, European reconstruction takes the form of the rehabilitation of international private investments. In a center-periphery dynamic, the international organization highlights a power relation between the creditor and its debtor. In the perspective of the dynamic between social forces, it underlines the influence of transnational financial elites on social sectors more concerned with productive activity, state intervention and the interests of organized labor.

Accordingly, legitimacy is the way through which this power relation appears in the political economy of the reconstruction. Thanks to its illusion of exteriority, neutrality, apolitical stand and expert knowledge, the international organization partakes in the creation and diffusion of a consensus. Rather than the ‘creation of information’ and the solving of dilemmas involving uncertainty, we refer here to a mimetic behavior: as it legitimizes discourses and knowledge, the organization is active in helping operators converge on a mode of regulation and in discrediting any alternative. The gold standard and its mythology owe much to the League’s scientific aura, just as the myth of the self-regulating virtues of capital flows and their favorable consequences on the reconstruction. As a result, capital flows to Central Europe developed into a speculative bubble.

As a social relation embedded in a duality of power and legitimacy, the institution makes sense in the light of contradictions – cognitive, social or macroeconomic – that are found in each social order throughout history and
that help explain social change; it is thus in the propensity to overcome these tensions that lies a potential source of relative stability. The IMF during the period of ‘embedded liberalism’ contributed to such an issue while authorizing countries to maintain exchange controls to protect their national policy autonomy and productive capacity against external shocks. In the case of the European reconstruction by the League, one notices a key tension between short-term capital surpluses in core countries and the financial needs of transition economies in long-term assets. More broadly, the reconstruction process involves further tensions such as a contradiction between, on the one hand, the reconstruction of an international monetary system and, on the other, the disruptive effects of capital mobility. Moreover, one also notices an asymmetry between the stabilization of currencies in the perspective of a liberal international monetary system, involving deflationary tendencies, and the quest for more expansive monetary policies by social groups preoccupied by the domestic level of activity and employment. Finally, budgetary discipline collides with the demand for public investments in transition economies. These contradictions are at the heart of the League’s programs that advocate a reconstruction based on private capital and that confuse the rehabilitation of global financial markets with that of Europe. All these contradictions contribute to our understanding of the collapse of the Credit-Anstalt and the development of a global financial crisis.

In the case of Hungary and Austria, the high demand of capital, combined with a marked commitment of the banking system in the industrial sector, made the economic system particularly vulnerable. The banks, as the example of the Credit-Anstalt shows, acted as intermediaries between western financial places and the Central European economic apparatus and thus appeared as the ‘weak link’ in a reconstruction process primarily directed through financial markets and their propensity for liquidity. The capital inflow in the short term, which was moreover granted with unfavorable conditions, made the economic system even more dependent on new liquidities meant to settle previous credits and execute interest payments. From 1929, the decrease of short-term deposits by American investors in Europe marks, for a bank such as the Credit-Anstalt, the beginning of a crisis that would take on global proportions.

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In a recent article, Patrick Fridenson called for more research into corporate failure. Not only can business failures easily outnumber successes, but also for any failed firm a period of success usually precedes failure. The life and death of firms should be a major research area for the business historian. If failure progresses as far as bankruptcy, we need to explain the process of receivership, what transactions take place during that period when a firm ‘navigates’ failure and what role is played by internal and external stakeholders such as financial institutions and other bodies including government.\footnote{Fridenson, P. (2004), “Business Failure and the Agenda of Business History”, Enterprise \\& Society, 5, pp 562-582.} In addition to studies of large enterprises, we need to consider small- and medium-sized business, where the transience of many firms, although empirically established, has never been adequately reflected in the business history literature.\footnote{For a review of some of the evidence on the birth and death of firms. see “An Economic Survey, 1971-1991”, in Stanworth, J. and Gray, C. (1991, eds.), Bolton 20 Years On: the Small Firm in the 1990s, London: Paul Chapman Publishing; Jeremy, D. (1998), A Business History of Britain, 1900-1990s, Oxford: Oxford University Press, pp 28-38.} This chapter draws upon unpublished business records and the financial and trade press to provide a case study that addresses some of the issues raised by Fridenson. It also contributes to our limited knowledge of post-1945 regional policy at the firm level, including the role of government in assisting the growth of, then ultimately brokering a rescue deal for, a substantial manufacturing enterprise.

tween 4000 and 5000 people. Originally, a private limited company with just two shareholders and a capital of £70,000, 10 years later when it became a public company with a workforce of 3500 its authorized capital had grown to £2.5 million, and this in a sector of UK industry where employment was falling significantly on trend. When Cyril Lord went into receivership in November 1968, with debts of £7 million, the firm was a household name and his corporate failure was one of the most highly publicized in the country since the end of the Second World War. In the UK, Lord had major manufacturing capacity in Lancashire and in Northern Ireland, both areas with structural problems caused to a significant extent by a secular decline in their traditional textile sectors. As far as Northern Ireland was concerned, Cyril Lord was the region’s most prominent failure between the end of the war and the collapse of the short-lived car producing plant of former General Motors’ Vice President John Z. De Lorean in 1982.

Cyril Lord was established as a private limited company in Northern Ireland in June 1945. Lord himself, born in Lancashire in 1911, had worked for Ashworth Hadwen Ltd., cotton spinners and weavers in Manchester during the late 1920s and attended night school classes on dyeing, printing and finishing. In the mid-1930s, he added to his experience through employment with Scott and Son, one of the first London firms to combine textile wholesaling with merchant converting. Before the war, he worked with Mitsubishi and Mitsui on textile technology and gained valuable expertise in the German worsted industry. He had gone to Belfast during the Second World War as Technical Adviser to the Cotton Control Board at the request of Sir Thomas Barlow, then Director General of Civilian Clothing, to help resolve technical problems of spinning and weaving rayon on flax machinery. Lord’s pre-war and wartime experience established his reputation as a creative technical specialist and, most importantly, provided him with entry into manufacturing, mercantile, financial and government networks in Belfast. His association with Thomas Barlow, Chairman of the cotton firm Barlow and Jones, a former President of the Manchester Chamber of Commerce and Chairman of the Manchester-based District Bank between 1947 and 1960, was to be of very considerable financial advantage to him after the war.

By 1954, the company was described as “spinners, weavers and converters of cotton, rayon and synthetic fibres”. As contemporaries noted, Lord’s reputation rested not only on the exceptionally rapid growth of his business, underpinned by product innovation in natural and synthetic textiles, but also in the high public profile he maintained. Much of the latter was fuelled by

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4 Lord’s debts of £7 million were set out before the High Court in Belfast in January 1969: Belfast Telegraph, 13 January 1969.
5 Cyril Lord to J. Summerscale, British Embassy, Washington, 22 March 1946, PRONI COM/63/1/166
6 The Times, 14 May 1954. City Notes.
his political obsession to protect UK textiles against cheap imports. Lord acquired several mill properties in Lancashire where all his manufacturing units were located. These acquisitions were part of a merger activity that was the dominant characteristic of British textiles in the 1950s and 1960s. Among many financial consequences of this movement, two were of great importance. First, as companies changed hands, banks found themselves with new customers who in different circumstances they would not necessarily have chosen to support. Second, the period saw the creation of many new textile groups, where growing organizational complexity meant that accounting practices made it correspondingly difficult for outsiders, or even shareholders, to make a judgment about financial information, raising some fundamental questions for corporate governance. The scope for opportunism and information asymmetries was correspondingly increased. Moreover, the precise relation between constituent companies in a group was not always clear, and this was particularly important when government or banks required financial guarantees from a ‘parent’ company, or when a company ran into serious trouble.

In May 1954, Cyril Lord Ltd became a public company with an authorized capital of £2.5 million. In the first instance, only £1 million in preference shares was offered to the public. All the equity was retained by Lord (£900,000) and his business partner since 1945, and fellow director since 1948, William McMillan (£100,000), which guaranteed Lord decisive control of the company. This pattern of equity ownership continued until the ordinary shares were offered to the public in 1964, so there was no real separation of ownership from control.

Innovation and advertising

Although registered as a Northern Ireland company, Cyril Lord did not begin to develop manufacturing capacity in that region until the mid-1950s. Unlike most other UK regions after 1945, Northern Ireland had failed to achieve full employment and normally had a considerable excess of male unemploy-

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The generation of work for men thus became a top economic and political priority for the devolved government that operated in the region. Lord and McMillan were well placed to use their network of government and business contacts to take advantage of Northern Ireland’s relatively generous financial assistance schemes to develop the next phase of Lord’s business expansion. McMillan was a Belfast solicitor who had strong connections with the Bank of Ireland and this bank became Lord’s principal financial support in the crucial early years of expansion, while McMillan himself provided much of the expertise in negotiating financial assistance with government. Moreover, given the localized nature of devolved government in Northern Ireland, it was relatively easy for businessmen to gain access to senior civil servants and ministers.

Shortly after the successful preference share issue, Lord applied for a grant of £32,500 from the Northern Ireland government towards the cost of a new factory to make specialist quilted products. Each application for assistance had to be considered by an Advisory Committee and be supported by both the Ministry of Commerce and the Ministry of Finance. Between the first application in May 1954 and the spring of 1955, Lord made radical alterations to his development strategy and decided to move into carpet manufacturing. It was typical of him to make a press announcement about this decision before informing the Northern Ireland Ministry of Commerce, and characteristic that he formed a new company, Cyril Lord Carpets Ltd., to undertake the business. Lord’s diversification into carpet manufacture was unquestionably decisive for his business career and for the UK carpet industry in general, and it was prompted by a major technological innovation – the introduction into the UK of ‘tufted’ carpets from spun yarn rather than manufacture by traditional weaving techniques. The tufting process originated in the USA and its rise in market share had been impressive. It revolutionized carpet manufacture and opened up for the first time the prospect of a mass market not least for lower income households.

The government officials who handled Lord’s application for assistance sought advice from a number of sources as to whether they should proceed. One of these was a local senior banker and former Chairman of the Industrial Finance Company (Northern Ireland) Ltd., the regional equivalent of the ICFC that operated in Britain. In this advisor’s view, Lord’s balance sheet was “poor in showing borrowings up to the hilt against assets of doubtful value (old cotton mills useless for any other purpose; stocks which for banking practice are considered at 50% of their book value, and outstanding debts usually accepted at 80% of their book value”). Lord’s application was thus

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11 PRONI COM 63/1/466A, Notes of a meeting on Cyril Lord, 21 November 1956.
an example of opportunism based upon the physical asset-specificity of mill properties which, when offered as security, were often of great concern to bankers and to government departments involved in industrial support.

Lord and McMillan argued that their overdraft with the Bank of Ireland then stood at £750,000 and that with the Midland Bank at £550,000; the former was pressing for a reduction of £150,000 and the latter for a reduction of £100,000. The credit squeeze and the uncertainties in money markets created by the Suez crisis meant that a plan to float Lord’s equity capital in order to fund bank borrowing could not take place. They were confident that they would do this over the next 5 years; in the meantime, his company intended to reduce stocks and sell their retail shops. After further, sometimes difficult, negotiations Lord took advantage of the improvements in government financial assistance available under the Capital Grants scheme from 1954 and, after promising to do his best to employ 200 mainly male workers, was provided with a new factory in Donaghadee, County Down, costing £320,000 as well as a grant of £35,000 towards machinery. Lord assured a Ministry of Commerce official that once the business was established, it would ‘develop like a prairie fire’. The factory opened in 1957 and had the immense advantage of being not only new but also purpose-built. This distinguished it from most UK textile mills that were old and often ill-suited to technical innovation and organizational change. Built and equipped to Lord’s specifications the new factory would form the basis of his carpet business over the next 10 years, during which period it became for a time the largest of its kind in Europe and the fourth largest in the world. The factory itself was extended three times between 1960 and 1966, each time with Government support, and the Ministry of Commerce provided further assistance to Lord to enable him to operate factories at Carnmoney from 1959 and Rathgael from 1966. In addition, the Ministry provided substantial capital grants towards new plant, machinery and equipment. Eventually the assistance he received totaled some £7 million.

If technological change threatened the established structure of the industry from the mid-1950s, so, too, did competition policy in the form of the Restrictive Trade Practices Act of 1956. The industry had become increasingly cartelized from the end of the Second World War with two agreements, operated by the British Carpet Manufacturers and the Wholesale Floor Covering Distributors’ Association to regulate production, distribution and sales. These wide-ranging agreements stabilized the industry before, and in the early years immediately after, the introduction of the tufting process. However, under the 1956 legislation, they were open to legal challenge. When the

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12 Ibid., Cyril Lord to H.E. Jones, 29 January 1957. The Northern Ireland Capital Grant Scheme covered plant, equipment and buildings. In Britain, buildings were excluded from the legislation: Harris, *Regional Economic Policy*, 36.
case was heard in 1958 and 1959, the court struck down the agreements and dismissed the industry’s arguments that quality and exports would decline, distribution would suffer, joint advertising would stop and promotional costs increase.14

In March 1965, Lord finally decided to offer equity to the public. Lord had suffered net losses in three of the years since 1956 and the equity issue of 2.4 million shares at 10s. handled by Old Broad Street Securities was undersubscribed by 5 per cent, although the shares quickly began to attract a premium as group pre-tax profits hit a record level of £1.3 million in the year ending June 1966. This in turn helped with the successful offer of £1.5 million 7¾% debenture stock in March 1967, in retrospect one of the last occasions when Lord stood a reasonable chance of raising capital from the public.15 During this period, however, it is possible to identify two particular weaknesses in Lord’s business expanding business operations that would damage the company’s reputation: a lack of market research and inadequate testing of new products, both of which derived from Lord’s insatiable desire to expand and innovate.

When the South African government was becoming increasingly active in seeking to develop industry in the ‘homelands’, Lord moved in quickly and decided to set up another company, Cyril Lord (S.A.) Pty Ltd., to operate a new factory costing £750,000 at East London in the largest homeland, the Transkei, for the manufacture of poplin. In 1963 in a blaze of publicity, he stripped out three of his mills in Lancashire and shipped all the machinery, much of it quite old, to the new factory, a move underwritten by the South African Industrial Development Corporation in its pursuit of industrial decentralization.16 Some of the employees and their families went as well in specially chartered aircraft. But the market for poplin had been exaggerated by the South African government. Moreover, Lord had not given sufficient time to market research or competition from local producers or imports, which resulted in stockpiling. Over the next few years, despite successfully lobbying for tariff protection, Lord reduced his stake in the venture, handed more control over to the South Africans and switched production to coarser calicoes and linen.17 Again, in 1963 Lord was one of 168 businessmen taking

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17 *Sunday Times*, May 11, 1969. The Industrial Development Corporation of South Africa provided substantial further assistance to Lord’s venture during 1965, and The South African
part in a goodwill visit to the Soviet Union organized by newspaper proprietor Roy Thomson. After this visit, Lord took an abrupt decision to buy two machines for the manufacture of artificial astrakhan, having apparently undertaken no market research and having put no sales organization in place. This venture, too, was a failure.\textsuperscript{18}

Lord’s passion for rapid innovation, his self-confidence in overcoming technical problems, coupled with a massive appetite for publicity seeking could be a dangerous combination. After a visit to the Astrodome in Houston, he had the idea of producing his own version of Monsanto’s Astroturf. With the brand name of ‘Cyrilawn’, it was made on the tufted principle, rather than woven as Astroturf was. He thought all the production problems had been solved, and the debut was arranged at the London Hilton in April 1967 when the entire ballroom was covered in Cyrilawn and decked out to look like Wimbledon at a cost of £6000. But however much publicity this generated, the product was seriously defective and insufficient time had been given to product testing. It not only turned from green to blue, it also developed a slime that made it almost unusable. As a result, the first and only 100,000 square feet of Cyrilawn had to be given away. It may be that these two high-profile failures contributed to the forced resignation in October 1967 of William McKee, a joint manager at Cyril Lord Carpets and regarded as the “technical wizard behind the company”.\textsuperscript{19} Also, in 1967, Lord purchased the entire chain of loss making paint and wallpaper shops trading under the Kyle brand. The problem here was that most of these were simply too small to be suitable as carpet retail outlets because potential customers could not unroll the carpet to see what it looked like. Moreover, many of the shops were not easily visible, being ‘tucked away in the corners of under-used shopping precincts put up by over-enthusiastic developers’.\textsuperscript{20}

Lord’s pathological optimism began to look questionable in the spring of 1967 as the gap between projected and actual profitability became enormous. Lord and McMillan had assured a firm of London brokers that pre-tax profits for the half year ending May 1967 would probably be £636,000 and would not fall below a ‘guaranteed minimum level’ of £412,000. The actual pre-tax profit for this period was £46,000, some 93% short of the expected figure despite that sales had only declined by 6%. Profit forecasting at Cyril Lord was indeed a ‘rather hit-and-miss affair’\textsuperscript{21} because, as explained below, there was no full-time financial controller in the group until spring 1968. To put this in perspective, in the record year of 1966, profits of £1.3 million had been made on a turnover of £10.8 million; in the next 3 years, while turnover

\textsuperscript{18} Ibid., May 4, May 11, 1969.
\textsuperscript{19} Ibid., November 17, 1968.
\textsuperscript{20} Ibid., May 18, 1969.
\textsuperscript{21} Ibid.
declined by just £500,000, profits fell by £1.8 million. Turnover had been built on the massive advertising campaign. In 1958, Lord’s advertising budget ran to £50,000; 8 years later it was almost £800,000, more than four times that of his nearest competitor (Kosset).

Crisis

The fall in net profits of almost two thirds during the period 1966-67 resulted in both Lord and McMillan taking a 50% salary cut and waiving their rights to dividends. This was the first public acknowledgement that actual performance had fallen well short of expectations and the start of a period of decline from which Cyril Lord never recovered. It is difficult to know whether the long-established business relation between Lord and McMillan withstood the increasing pressure on the group. One indicator that suggests Lord may not always have consulted with his Deputy Chairman came in February 1968 with the announcement in the *Estates Gazette* that one third of Lord’s retail shops, some 91 properties, were being offered for sale with vacant possession. McMillan denied he did not know anything about this drastic move, nor had it been mentioned in Lord’s half-year statement the previous week. How many of these shops made a profit is an open question but most were leasehold and sited in expensive locations. Rents on them must have contributed significantly to the increasingly unbearable costs that Lord faced. Thus, the rent on the London Oxford Street shop amounted to £22,500 per annum and that on Birmingham’s Corporation Street to £12,000. Later that year one widely-quoted estimate put the total annual rental cost of Lord’s shops at c.£600,000.

By March 1968, however, under pressure from the government, bankers and shareholders and apparently on doctor’s advice, Lord was forced to retire as chairman and managing director, going to the Bahamas, a location more suited “to his blood pressure and taxation problems”. One important immediate result of Lord’s departure was the appointment of a full-time financial controller, something that, surprisingly, the company had never had before. Julian Richardson, financial controller at AEI Switchgear Division and before that accountant at Price Waterhouse, took up his post in April. As late as April 1968, the strengthened management, together with a pre-budget consumer boom and the impact of devaluation, were all seen as making the

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22 Ibid.
23 *Sunday Times*, November 17, 1968.
26 Ibid., February 17, 1968.
prospects of recovery good. The lack of financial control within the group had, however, allowed costs to rise to critically high levels but by the time Richardson, who had a particular interest in cost accounting and computerization, took over it was too late to pull the company out of its crisis.

The scale of the crisis at Cyril Lord became clear over the next 5 months. A first draft of group accounts to June 1, 1968 indicated a loss of £196,000. This would have been serious enough given the optimism of Lord’s statement in February. However, the auditors’ second draft set the loss at £491,000, which is summarized in Table 1. The major item in the revised set of accounts was the writing back of a £163,000 credit from Lord’s two main yarn suppliers, Courtaulds and British Enkalon, who had paid Lord for advertising their brand names on his carpets. Moreover, as sales fell, these two suppliers were no longer prepared to continue special price discounts negotiated by Lord.

An analysis of turnover from January 1966 to summer 1968 indicates that apart from exceptional discount promotions, sales had a tendency to be below the levels of the corresponding month the previous year. While sales did not collapse, they stagnated compared with their competitors, many of whom were experiencing boom conditions. Lord’s relatively poor performance in sales was attributed to three key factors, all of which reflected the chairman’s strategy and style. First, the company’s products were, according to Richardson, in the wrong price and color range, “matters of this kind were decided by Mr Lord and his hunches were wrong in relation to recent decisions”. Second, Lord had managed to alienate all the key elements in his sales force. By purchasing the Kyle chain of shops, those agents who had traditionally been responsible for most of the sales felt their market was being taken away. The significance of this should not be underestimated. Lord depended on the effectiveness of both part-time and full-time sales agents, the former included some 6,000 teachers, local government officials and even clergymen, and the latter comprised 200 full-time representatives. His innovative sales techniques enabled him to bypass the wholesaler, sometimes seen as a weak link in traditional marketing practice in this industry. Once it became known that Lord was planning to sell the shops, then this clearly had a negative impact on the sales staff working in them. Third, productive capacity in Northern Ireland had been further increased in 1966 but given declining orders, underutilization increased and so did unit cost. Moreover, Lord’s rather cumbersome arrangements for warehousing and distribution,

29 The Economist, April 6, 1968.
30 Cyril Lord had been able to negotiate favorable terms with Courtaulds for the supply of ‘Courtelle’, which became significant as a fiber in tufted carpets. See Coleman, D.C. (1980), Courtaulds, An Economic and Social History: Volume III – Crisis and Change, 1940-1965, Oxford: Clarendon Press.
31 PRONI COM 63/1/466B, Note of a Meeting between J.E. Hawkins and Julian Richardson, 22 August 1968.
coupled with the distance of Northern Ireland from British markets, meant that orders could take 6 or 7 weeks to reach the customer. As competition increased this began to diminish Lord’s competitive edge.\textsuperscript{32}

The firm had to negotiate continuing assistance from its four bankers who began to press for a reduction in accommodation. Some data on bank overdrafts and finance house accommodation in August are provided in Table 2. In addition, the company had written some £500,000 worth of unpresented checks that, had they been presented, would have pushed bank borrowing to about £2 million.

As its difficulties increased, the Cyril Lord group belatedly sought professional advice and approached Rothschilds to act as their merchant bankers and advisers, but Rothschilds declined the business.\textsuperscript{33} Hill Samuel did accept but only on condition that Cyril Lord himself played no further part in the group’s activities. Before considering the role of Hill Samuel, it should also be noted that a further pressing need was to explain the group’s change of fortunes to institutional investors, and especially to the Commercial Union Insurance Company that acted as trustees for Lord’s debenture holders. One of McMillan’s fears was that if any of the company’s cheques were dishonored, then Commercial Union would be likely to place the Lord group in the hands of the Receiver.\textsuperscript{34}

Given the large financial commitment that the Government of Northern Ireland had made to Cyril Lord, it was only to be expected that government officials would be closely involved with all parties who might be able to prevent the complete collapse of the group. Indeed, not unlike the very much larger crisis that began to unfold at Rolls Royce from 1968, where shareholders were reassured by an optimistic chairman’s statements, which gave little hint of the company’s problems, government officials and financial institutions began to assume responsibility for the future of the company.\textsuperscript{35}

The Ministry of Commerce made it clear to Hill Samuel that the following minimum conditions would have to be met before they could consider further assistance: the appointment of new and competent top management; some type of government control over the group of the kind that had recently been applied to Harland & Wolff shipbuilders; a viable business plan with an indication of when profitability might be restored; and commitment of continuing support from the banks because “there could be no question of Government assistance being used merely to bail out the banks”.\textsuperscript{36} At one level, these stipulations were both logical and politically defensible. There was

\begin{footnotes}
\item\textsuperscript{32} Ibid. See also Lord’s obituary in \textit{The Times}, June 4, 1984.
\item\textsuperscript{33} Ibid.
\item\textsuperscript{34} PRONI COM 63/1/466B, Ministry of Commerce Note on Cyril Lord, September 13, 1968.
\item\textsuperscript{36} PRONI COM 63/1/466B, Note by HE Jones, 18 October 1968.
\end{footnotes}
always the danger, however, that drift would set in and a rescue become impossible. Good fortune and skill were required to get the pace of any rescue bid just right, especially given the number of interested parties and the speed with which circumstances changed from day to day. Both Courtaulds and Hill Samuel had expressed the view that if the Ministry “did not intervene, anyone who might be interested in the undertaking will wait in the hope of picking up bargains after liquidation”. Lord’s two principal raw material suppliers in the region were Courtaulds and British Enkalon, who also supplied carpet manufacturers in Britain. Despite their status as competitors, both firms were initially receptive to the idea of joint intervention to keep their major customer in business.

In a wider context, the collapse of Cyril Lord needs to be viewed against the simultaneous rise in profitability in the industry as a whole during 1967-1968. Blackwood Morton (BKM), Homfray, AW (Securities), Thomas Bond Worth and Shaw Carpets were examples of firms that all turned in impressive figures in 1968. The improvement in profitability was especially marked among traditional producers, which had been slow to invest in new plants and therefore did not suffer the same kind of overcapacity that was evident in the tufted carpet sector.

Hill Samuel’s report, compiled using data from Lord’s accountants, Peat Marwick and Mitchell, is essential to understanding how the outlook for the latter became critical in November 1968. The increasing losses revealed by successive draft accounts have been shown in Table 1. The company still traded at a loss, and Hill Samuel calculated breakeven point on carpet sales of £12.5 million, a figure that seemed quite unattainable in the short term. The key recommendations of the report can be divided into four sections, three of which would provide substantial additional finance. First, the Ministry of Commerce should defer rents due in 1968 and 1969 on the Donaghadee and Rathgael factories until after 1977 and thus effectively providing the company with a loan of £280,000. A new Executive Chairman should be appointed, but the Ministry should have the power to vet the appointment and to “appoint, remove or replace any Director” after consultation with the Chairman. Second, additional support to the extent of £430,000 was sought from the banks: an extra £250,000 from Coutts and an extra £90,000 each from Bank of Ireland and Williams Deacons. Third, both Courtaulds and British Enkalon were asked to increase their credit limits for raw material supplies to between £500,000 and £800,000 each. A fourth section was designed to prevent Cyril Lord from attempting to control the group through his still substantial shareholding.

37 Ibid.
38 Swann et al., Case Studies, 130.
What the report demonstrated was the interdependence of all the parties concerned – raw material suppliers, banks and government. Because this was so, it was unlikely that the rescue plan could have withstood refusal of any one of them to participate fully. It soon became clear, however, that such a positive outcome was not feasible. Having discussed the report, the Courtaulds board unanimously agreed that they could not possibly provide the additional credit facilities sought, but if a firm were to take over the Lord group and introduce new management and an improved sales network then they might reconsider. Courtaulds’ initial response was, however, a severe blow to the Hill Samuel proposals and led the Ministry of Commerce to declare that in the circumstances they could not agree to defer rentals as proposed. The Ministry did say that they might revisit the decision if all parties except Courtaulds agreed to the Hill Samuel proposals. As for the banks, a joint meeting of the Bank of Ireland, Coutts and Williams Deacons on November 5 concluded that although they would not agree to the proposals, they would bring about the collapse of the Lord group. Rather, they were inclined to hold the position until the end of the year during which time negotiations with possible buyers could continue.

From the Ministry’s point of view, the key political imperative was to protect the 1700 jobs it had nurtured at the Cyril Lord factories. Workers from the factories led by the general manager marched on the parliament buildings in Belfast. After difficult meetings following the completion of the Hill Samuel report when for the first time the scale of the crisis had become apparent, and the refusal of key parties to provide the requisite assistance had become known, the Belfast government decided to ask Courtaulds to make a bid for the group. The accounts still had not been published, but small- and medium-sized creditors were increasingly pressing the Lord group and a bid from Courtaulds would at least bring in a large firm with an established commitment to the region. Initially, Courtaulds agreed to a nominal offer of 7½% unsecured loan stock equivalent to 1s per share, a cash injection of between £1-£1.5 million and new management. This bid valued the group at some £400,000, or £7 million less than the stock market valuation of a year before. Lord’s shares had continued to trade at around 6s until the accounts had been published on November 15, after which they declined to 2s 10½d, but the offer gave the shareholders stark choice of “a nominal sum from Courtaulds or nothing following liquidation”. Among the shareholders who had seen the value of their investment in Cyril Lord collapse were Pilkington Brothers Superannuation Fund, Imperial Tobacco Pension Trust and the Hoover Trust. One potential problem was that, given

40 PRONI COM 63/1/466B, Ministry of Commerce Note on Cyril Lord, 6 November 1968
41 Belfast News Letter, 22 November 1968.
42 Daily Telegraph, 16 November 1968.
43 PRONI COM 63/1/466B, Cyril Lord Ltd, Note for the Minister, November 15, 1968.
the crisis the company faced, shareholders might legitimately raise questions about the optimistic circular distributed by Lord in February. Hill Samuel’s view was that because Lord himself made the statement and that because he was no longer in charge of the company, this particular difficulty could be sidestepped.44

If Courtaulds had gone through with the bid, they would have become the largest business employer in Northern Ireland. However, the bid ran into immediate opposition from British Enkalon that claimed that it contravened an earlier gentleman’s agreement with Courtaulds that neither would bid for the Lord group.45 Moreover, the prospect of Courtaulds’ entry into the carpet manufacturing business clearly distressed many established producers.46 Only three days after their nominal bid, Courtaulds withdrew, stating that the assistance required was much greater than they believed. The same conclusion was reached by British Enkalon that, having discussed the Hill Samuel report with Courtaulds, admitted that the financial position of Cyril Lord was much worse than both had feared so that neither could “with any degree of commercial prudence take part in any rescue operation”.47 At this point, the entire position of the Cyril Lord group changed because within 24 hours of Courtaulds’ announcement, Commercial Union called in the Receiver, in the person of Donald Chilvers of Cooper Brothers accountants.48 One of Chilvers’ first tasks was to organize drastic cut price sales at Lord’s shops just to raise enough money to pay wages and keep the factories open.49 He also had to arrange emergency supplies of fiber from Courtaulds to supply Lord’s Lily Mills near Oldham where stocks were almost gone.50 By late November 1968, however, there was not even enough money to maintain a share list so trading ceased and the company disappeared from the Stock Exchange List, on which it had been quoted since 1954.51 The final ‘deathbed’ share prices were 3½d for ordinary shares and a mere 1½d for preference shares.52

The impact of Lord’s factories in Northern Ireland was enormous, especially given that they were established in small towns. Not only were they relatively labor intensive but they also provided employment for a largely male workforce that was otherwise unemployed or underemployed. In Donaghadee, e.g., more than half of the 800 employees lived in this town of

44 PRONI COM 63/1/466B, Note by J.E. Hawkins of the Ministry of Commerce, October 6, 1968.
45 Ibid., Cyril Lord Ltd, Note for the Minister, November 15, 1968.
46 Financial Times, 16 November 1968.
47 PRONI COM 63/1/466B, Adrianus de Zeeuw to H.E. Jones, November 8, 1968. De Zeeuw was Executive Deputy Chairman of Leicester-based British Enkalon.
49 Ibid., December 3, 1968.
51 Daily Telegraph, November 27, 1968;
3700 people and its surrounding area. They were also in an overwhelmingly Protestant area, which would provide work for employees who were likely to be unionists rather than nationalists and this would no doubt have been a material consideration for the Unionist government, under pressure from its own supporters and a civil rights campaign. In 1968, when the company went into receivership, the political implications of closure were disproportionately great. In that sense the government was in a similar position to Lord’s bankers – the choice was to shut down and get nothing back or to carry the firm in receivership for as long as possible hoping for a buyer for the business as a going concern. It was also the case that in the struggle to attract and retain employment, Northern Ireland now had to face more competition from British regions because the Labor Government had placed greater priority on regional policy in Britain from 1966. At the same time, its own attractiveness as a host for inward investment was declining because of growing political unrest, uncertainty and violence. The political imperative to save the Lord factories could not have been stronger, and Brian Faulkner, the Minister of Commerce, made it clear that he would be available ‘day and night’ to talk to any prospective buyer recommended by the Receiver.

After weeks of uncertainty, Lord’s three factories in Northern Ireland and his Lancashire mills were bought by Viyella International, then led by its aggressively acquisitive chairman, Joe Hyman. Viyella already had three shirt factories in Northern Ireland, all in County Londonderry, and among their products were the strong brand names of Peter England, Evvaset and Rocola. For the government of Northern Ireland, Viyella’s decision was the best possible outcome. During the crisis, it had rejected calls from some local politicians to take Lord’s factories into public ownership and had defended its substantial financial assistance because Lord’s profitability and employment had justified the financial assistance. The cost per employee had been within the normal range for government-aided enterprise. No other firm in the UK textile sector was willing or able to takeover these two key parts of Lord’s business. Viyella did not, however, buy either the shops or the direct selling operation. Hyman argued that textile manufacturers should be independent of both fiber producers and of retailers and that forward integration into retailing put manufacturers at a ‘grave disadvantage’. The view that Lord had made a major strategic error when he integrated forwards into retailing was a common one:

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To succeed these days retailers need a wider range than one manufacturer could provide and Lord was caught between two stools, since its production was based on a range too wide to be economic. To get the profits it needed an extremely high throughput and to get the throughput it advertised at hefty cost on TV. But the conglomeration of tufted manufacturers and the upsurge of small, specialised retailers made that impossible….Cyril Lord got left behind in a market which it had itself created.  

In the end Lord’s unbridled innovation, inadequate product testing, lack of market research and uncontrolled advertising budget contributed enormously to the firm’s collapse.

Even when Cyril Lord was a large public company, Lord took all the key decisions himself, and the history of this company emphasizes again the crucial role of the individual, not only in successfully establishing and building the firm, but in being largely responsible for its decline and failure.

Conclusions

As was the case with Cyril Lord, some of the UK enterprises that grew to prominence but subsequently failed within a single generation during the 1960s and 1970s were very closely identified with the founder. Two other examples were John Bloom of Rolls Razor, which failed in 1964, and Kaye Metrebian of Brentford Nylons, which collapsed in 1976. Both of these shared the same Receiver, Kenneth Cork of Cork Gully, whose verdict on the former, that the “company concentrated on sales and production to the exclusion of finance and the lack of up-to-date knowledge of the serious position was only realized when it was too late”, could be applied to the other two. Like Lord, Bloom took on established manufacturers, such as Hoover and Hotpoint, and built and supplied twin-tub washing machines via massive direct advertising. Again, like Lord, in the face of renewed competition from established firms, Bloom diversified from the core products: in his case into areas ranging from cosmetics and central heating to Bulgarian holidays and television rental. None of these proved unsuccessful. In fact, only a few months before the receiver was called in, Bloom announced his intention to develop a chain of some 500 television rental shops. Brentford Nylons was a private company with almost all the equity owned by the Metrebian family. It created a huge domestic market for nylon sheets with a heavy initial emphasis on mail order, backed by massive advertising, which combined to

60 The Times, February 27, 1976.
61 Ibid., February 1, 1964.
write “a highly original chapter in textile marketing”.62 As had been the case with Lord, Brentford became the most advertised firm in its sector, with an advertising budget of £3.3 million on profits of just under £1 million 2 years before failure. Like Lord, Brentford developed high-street retail shops stocking their own products, where some 70 of these were in operation on the eve of the company’s collapse. The skepticism that had accompanied Lord’s own-brand retailing was seen again in the case of Brentford, questioning once more the strategy of forward integration into retailing, especially where it was difficult if not impossible for any one manufacturer to provide a sufficient range of own-brand goods to attract custom in sufficient volume. A longer-term problem for Brentford was that nylon, which accounted for half of the UK shirt market during the 1950s, declined in popularity to reach only a fifth by the mid-1970s, forcing the firm to move into polyester cotton manufactured in a costly new factory in Northumberland. The heavily qualified accounts by Price Waterhouse showed that between 1973 and 1974 the amount owed to creditors rose from £6.79 million to £9.28 million, while in the same period bank overdrafts increased from £1.9 million to £5.1 million.63

Bloom, Lord and Metrebian were largely responsible for both the rise and the decline of their extensive businesses. Each showed significant entrepreneurial flair in exploiting new markets by developing innovative products and in selling techniques; each placed great, but ultimately unwarranted, faith in advertising to sustain sales in the face of growing competition. None paid sufficient attention to cost control or to financial management more generally. It is arguable, if entirely plausible, that in each case corporate failure might not have occurred had “the extraordinary, if temporary, marketing flair and salesmanship of (these) “entrepreneurs been balanced by rather more traditional financial skills”.64 Whatever the verdict in these cases, business historians should follow Fridenson’s suggestion and produce case studies and comparative work on corporate failure. Research into very large enterprises and old-established firms needs to be supplemented by work on the much more typical small- and medium-sized enterprise with a relatively short life-cycle. Work on such enterprises, in both their successful phases and in their decline, should yield much that is new about the interaction of entrepreneurship, innovation, marketing and finance in modern economies.

63 Financial Times, February 26, 1976
64 The Times, February 27, 1976
Table 1. Revised losses of Cyril Lord Group, 1967-1968 (£’000)

- **First Draft of accounts**
  - 196

- **Second Draft**
  - 491
  
  includes:
  
  Credit for advertising and selling contribution from Courtaulds and British Enkalon now written off 163
  
  Increase in provision for cost of collecting debts (error in original calculations) 67
  
  Reduction in stock valuation (Kyle Group stock) 26
  
  Miscellaneous adjustments 39

- **Third Draft**
  - 766
  
  Includes reduction in stock valuation 210

Table 2. Bank and finance house support to Cyril Lord Ltd., 31 August 1968 (£000)

<table>
<thead>
<tr>
<th>Bank overdrafts</th>
<th>Finance houses</th>
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<td>Bank of Ireland 160*</td>
<td>Cyril Lord Finance Ltd. 1,100+</td>
</tr>
<tr>
<td>Williams Deacon’s 160*</td>
<td>Lloyds &amp; Scottish 750+</td>
</tr>
<tr>
<td>Coutts 435*</td>
<td>Lombank 321+</td>
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<tr>
<td>Lloyds 500**</td>
<td>British Bank of Commerce 100++</td>
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<td>Credit Lyonnais 100++</td>
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<tr>
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<td><strong>2371</strong></td>
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Down Many Times, but Still Playing the Game: Creative Destruction and Industry Crashes in the Early Video Game Industry 1971-1986

Mirko Ernkvist

The early, formative years of many industries are often shrouded in mystery, with a paucity of information and highly exaggerated stories providing the basis for historically grounded accounts of industry dynamics. This has been the case with the video game industry as well, where many - often contradictory - factors have been suggested as explanations for what many regard as the most extraordinary event in the history of video games, namely the 1983 crash. The event forced a majority of the US video game companies out of business and was accompanied by a subsequent change in industrial leadership from the U.S. to Japan. In the U.S. and Europe, the event is usually referred to as “the 1983 video game crash”, or simply “the video game crash”, while in Japan it is referred to as “the Atari shock” (a name that emphasizes the unexpectedness of the event and the downfall of the dominant video game company at that time).

In general, seven explanations for the crash have been put forward. Early explanations of the 1983 video game crash suggested that it was the result of: (1) the end of a teenage fad (Friedrich 1983); (2) the mismanagement of a single firm, Atari (Cohen 1984); (3) the public criticism that video games received (Williams 2004); (4) overproduction in terms of the number of games produced together with price competition (Cambell-Kelly 2003); (5) the market failure of some notable major games (Kent 2001); (6) saturation of the market for home console systems (Cambell-Kelly 2003); and (7) the introduction of a new platform for playing games - the home computer (Cambell-Kelly 2003, Herman 2001).

Some of these explanations are not mutually exclusive, and they are referred to in the literature without any more detailed discussion and with little empirical research of the events that led to the crash.

1 I am grateful to Jan Jörnmark for his helpful comments on various versions of the manuscript.
Despite the familiarity of the 1983 crash, no study has elaborated on the fact that crashes and shake-outs were a recurrent structural phenomenon of the video game industry during its first 15 years, with a number of severe crashes or major firm shakeouts occurring in every game platform after short periods of high growth. Subsequently, from the end of the 1980s and onwards, the video game industry entered a relatively more stable period without the same turbulence on an aggregated level as before.

This chapter reassesses existing explanations of the 1983 crash and then provides a coherent structural explanation of the turbulence that characterized the first 15 years of the video game industry, arguing that all of the early crashes and shake-outs shared similar structural characteristics. Without such an explanation, unrelated and limited explanations of these dynamics (such as the seven mentioned above) will remain nothing more than icing on the cake.

Method
This chapter presents a long-term historical account of the video game industry in which all of the early crashes and shake-outs during the period 1972-1985 are compared and contrasted, using the entire population of firms active in the market for various game platforms when possible. Two crashes and two major shake-outs are covered: the arcade shake-out of 1975, the dedicated console crash of 1977, the 1982 shake-out of arcades and the programmable console crash of 1983.

In this chapter, the term ‘video games’ refers to all forms of electronic games on various platforms (arcade, console, PC, handheld, etc.), unless otherwise stated. The term ‘industry crash’ refers to an event in which the majority of the firms in an industry exit within a short period of time (one or a few years) and the overall market for the industry is greatly reduced or eliminated during that period. The term ‘shake-out’ refers to a less dramatic event than an industry crash in which a large number of firms in an industry exit an industry within a period of a number of years and the decline in the industry (if any) is less rapid and less steep than in a crash.

Research Questions
This chapter addresses the following main question:

Was there a structural dynamic behind the turbulent period of crashes and shake-outs in the video game industry during 1972-1986?

This question is then related to two other questions:

If so, which factors were the primary driving forces behind this structural dynamic of crashes and shake-outs?

Were firm exits a necessary structural adjustment to new market conditions and a prerequisite for further growth in the industry?
Video game industry and firm failures

Firm failures can be depicted in many ways. This chapter will concentrate on a firm exiting an industry, which in the video game industry led in many cases to firms terminating business activities and, in some cases, to insolvency and/or bankruptcy. It could be argued that firm exit is not a good indicator of a failure, since there may be other motives behind firm exits than that of a perceived failure in the market (e.g., ventures into other more profitable industries). However, the detrimental and severe effects of the crashes in the video game industry make such claims less relevant in this context. Moreover, it could be argued that in a high-tech industry (such as video games), with highly demanding manufacturing and development practices, the reorientation of a firm towards other types of products would involve such a major transformation that it would be impossible to call it the same firm.

Other problems emerge for studies connecting firm failures with other types of measures, such as bankruptcy and insolvency. Each measure represents a different sub-process and is related in different ways in terms of both time and meaning to the concept of firm failure and, thus, varies in explanatory stringency, depending on what kind of failure related process we are interested in studying (Carroll and Hannan 1995; Hannan and Carroll 1992).

One of the benefits of using firm exit statistics as a measure of firm failure is that it is closer in time to the actual process that led to the failure of the firm in a certain industry than, e.g., bankruptcy, which may occur a long time after the firm has actually been involved in the market. By using firm exit statistics rather than bankruptcy statistics, there are better opportunities for studying how the changing structural conditions in a certain industry impact the population of firms that are active. This increases the opportunity for studying the impact of industry-wide structural events, such as “creative destruction”, which in some studies have been difficult to relate to the occurrence of bankruptcies (e.g., Grazer and Sjögren 1999).

In the literature that attempts to explain firm failures, two major perspectives dominate: firm-internal and firm-external perspectives. Firm-internal perspectives often emphasize the crucial role of management inefficiency, whereas firm-external perspectives point to the role of a number of changes in political, technological, social or economic factors beyond the control of the firm. Both perspectives take opposite positions on the old, but still disputed question of the extent to which managers have the capacity to affect the success or failure of a firm in periods of changing market conditions. Organizational ecology and many strands of strategic management are two examples of schools of research that represent opposite poles along this spectrum. However, as has been pointed out (Lindgren 1999), the two perspectives do not exclude each other, and studies that combine industry-wide dynamics with qualitative studies of the firms involved have the potential of...
shedding some light on the interaction of selection due to structural factors external to the firm and the ability of a firm to dynamically change its capabilities (Dosi et al. 2001).

To understand the factors behind industry crashes and firm failures in the video game industry, the specific growth dynamics of industry must first be elaborated on.

Entertainment Industries and Video Games

Innovations in the form of new experiences are the backbone of most entertainment. Entertainment that is more traditional (e.g., music, movies, television, gambling, comic books, pinball and theme parks) has always been highly dependent on the constant introduction of new experiences (Vogel 2004). Video games as an entertainment form is characterized in particular by this constant urge for new variation in player experiences, where this is more closely connected to the exponential progress in digital technologies than most other entertainment industries. Throughout history, video games have always been able to make use of what new hardware has offered in terms of storage, processing and network capacity and to transform it into new player innovations.

This exponential trend in digital technologies had brought with it increased complexity of video games and of the development process.

Similar to other entertainment, video games compete for the consumer’s free time. This creates opportunities for growth in that every moment of a consumer’s life outside actual work involves a potential market for entertainment consumption. However, this free time is highly competitive and, to a certain degree, video games do not only compete with other video games but also with every other type of entertainment that is available. If one entertainment form stagnates for any reason, there is a risk that another form of entertainment will step in and take its place among consumers.

The uncertainties over demand that characterize a number of entertainment industries (Vogel 2004) are also characteristic of the video game industry, in which past successes can, to a limited degree, explain or be the key to future success.

Literally born out of the transistor logic and digital technology both in the production and exhibition stage, video games have had a unique ability to evolve and diversify in conjunction with the rapid evolution of new disruptive technologies that have characterized digital technology (Jörnmark et. al. 2005). Since its inception, digital technologies have been subject to rapid, exponential trends of increased capacity. The most famous of these trends is Moore’s law, which, in its most common form, stipulates that there will be a doubling of the processing capacity (for the same price) every 18-24 months, also implying the halving of price for integrated circuits with a certain capacity during the same period (Moore 1965, Jörnmark et al 2005). Similar rapid
exponential trends have historically been common in many other digital technologies, including memory, storage and network technology.

For companies in the video game industry, this dynamic has meant that they have had to operate in an environment of constant innovations in which new hardware and software have inexorably driven previous versions out of the market in a process of creative destruction (Schumpeter 1943). New disruptive S-curves have constantly emerged (Christensen 2003), making industrial leadership in the video game industry difficult to sustain. New firms and firms from outside the industry have constantly built disruptive business models around new disruptive technologies that have had an advantage over inertia-plagued incumbents (Jörnmark et al 2005). The fast technological development has created numerous opportunities for firms to reap Schumpeterian quasi-rents through innovation, but the periods of time during which these have been able to be used as a competitive advantage has decreased. There are many examples of firms in the video game industry that have made huge profits in one year, only to have them turned into major losses the following year. As a result, the rise and fall of firms has been extensive.

Video game crashes and 3D: (1) Disruptive technologies; (2) Delimited differentiation; and (3) Decreased entry barriers and destructive liabilities of newness and smallness

While this chapter argues that disruptive technology has been a major source of restructuring and firm failure in the video game industry, disruptive technology by itself was a necessary though not sufficient structural condition for the more widespread crashes in the industry that within a short time forced a majority of the firms out of the market. Only when disruptive technologies were accompanied by delimited abilities for firms to differentiate themselves from other firms, a decrease in entry barriers and liabilities of newness and smallness that were destructive for the industry did such extraordinary and widespread events as industry crashes occur (Figure 1). When some of these factors were less prominent, lengthy shake-outs and restructuring efforts among video game companies made the connection between creative destruction and firm failure less direct. However, this does not mean that the process of creative destruction was not present in those cases; they could be instances of the less dramatic, normal case in which the process “takes considerable time in revealing its true features and ultimate effects” (Schumpeter 1943, p 83). Industrial crashes are those rare cases in which the effect of creative destruction becomes compressed in time, competition becomes cutthroat, restructuring efforts are critical and losses for firms are of a magnitude that make it impossible to wait for better times by relying on strong financial resources.
In the following sections, the impact of these 3D factors and their relation to the video game industry will be described in detail.

*Figure 1.* 3D factors that in combination caused the video game crash, and that were factors underlying industry shake-out when not all were present to the same degree.
Disruptive technologies

For Schumpeter, the relation between firm failure and creative destruction through innovation was explicit and straightforward of competition. Although plausible, there are a number of problems in conducting empirical studies on the basis of this assumption. One is that the innovation process itself is so varied: there are numerous types of innovation in Schumpeter’s definition of the term, all of which are very different in nature. When multiple forms of innovation are at work at the same time, the combined effects are far from straightforward. Another problem is that the entrepreneurial function in Schumpeter’s later view was a function that could appear on multiple levels (the individual entrepreneur, firms, etc.), necessitating consideration of combined effects of multiple levels of analysis.

One single type of innovation -- technological innovation -- has dominated the evolution of video games, and it is mainly through new opportunities created by technology that new disruptive business models have been made possible (Jörnmark et al 2005). The simultaneous rapid obsolescence of established business models has made it difficult for many firms to adapt to the new circumstances.

In their study of the dynamics of technological innovations, Anderson and Tushman (1990) showed that in a number of industries radical innovation was often followed by a longer period of incremental innovation. They argued that these radical innovations, which they labeled technological discontinuities, could be either competence enhancing or competence destroying in relation to existing competencies and capabilities in the industry. Through struggles between rival designs, a dominant design often emerges (Anderson and Tushman 1990).

Clayton Christensen (2003) continued to study the effects of competence-destroying innovations on business models. He showed how common it is for established leading firms to fail when new technological innovations are disruptive in the sense that they (1) create new growth opportunities, (2) attract customers away from the core of the mainstream market and (3) make it difficult for incumbent firms to respond by developing a different value chain (Christiansen 2001). In the video game industry, disruptive technological innovations were experienced so frequently in the period under study that longer periods of incremental innovations were an exception rather than the rule.

Delimited differentiation

One of the most remarkable features of the video game industry is how increasingly differentiated it has become in the past 30 years. This increased differentiation has not only affected products but the distribution, marketing and service surrounding the products as well. Despite this, few have studied how this remarkable increase in differentiation relates to the growth dynamic
of the video game industry. In this regard, the video game industry is far from the perfect market of homogenous products characterized by equilibrium that Schumpeter criticized as being only a special case, but rather a market in which firms through differentiation constantly create special markets for themselves:

Each firm in any sector of the system in which monopolistic competition prevails offer products that differ in some way from the products of other firms in the sector, and thus supplies a special market on its own. This product differentiation must be interpreted with reference to its rationale, the creation of such a special market, hence very broadly: it comprises not only ‘real’ but also 'putative' differences, not only differences in the product itself, but also differences in the services incident to supplying it (atmosphere and location of shops included) and every device that enables the buyer to associate the things he buys with the name of a particular firm Schumpeter (1939, p 63).

It is the ability of the video game industry to constantly break down barriers to increased differentiation, both in terms of hardware (Jörnmark et. al. 2005) and software (Jörnmark and Ernkvist 2004), that has been one of the major driving forces for growth in the video game industry and that has allowed it to avoid innovative lock-ins. However, this process of increased differentiation has not been smooth throughout history. In the early video game industry, there were fewer opportunities for firms to differentiate themselves from each other and, thus, technological lock-ins were common. The result was a turbulent period with rapidly changing opportunities for differentiation in which commoditization and crashes followed brief periods of rapid growth. Some platforms for games were better able to continue differentiation, and this - along with the fast pace of technological innovation - made them the focus of a continuous process of creative destruction.

Contemporary video games could be differentiated along a large number of dimensions, real as well as putative. In terms of product features, there is differentiation in both game hardware and game software. More putative differentiation exists in terms of brands, licenses, distribution channels and marketing. With such diversity, contemporary video games have been able to adapt to a large number of different tastes, and the diversity has increased the stability of the industry. However, this was not always the case (as argued later in this chapter).

**Decreased entry barriers and destructive liabilities of newness and smallness**

Barriers to entry have shifted considerably in the early video game industry. The erratic pattern of entry barriers has been the result of the combined effects of two tendencies: (1) increasing development costs and complexity; and (2) degree of modularity of production.
Increasing development costs and complexity. One side effect of Moore’s law is a steady increase in development costs. As the processing capacity and the performance of other components have increased exponentially, the complexity of the production and development has resulted in increasing costs as well. This has been evident in both the hardware and software elements of the industry. Integrated circuit components are the most expensive material parts in game consoles, accounting for over half of the material costs (iSuppli 2005); For these parts, R&D costs, testing, factory and equipment costs have increased considerably, which has only been possible to manage through increasing economies of scale (Jones 2004). The same is true for game software, for which the increased complexity has resulted in a four-fold increase in game development costs for each new generation of consoles. Simultaneously, the number of persons involved in AAA game development projects has increased from one or a few people at the end of the 1970s to today’s teams of >50 persons. Although the increasing development costs and complexity in hardware and software have increased entry barriers for new firms in the industry over the long term, sudden changes in the degree of modularity have rapidly decreased entry barriers in certain parts of the value chain in the short run, making it possible for new firms to enter the industry.

Degree of modularity. One common way to manage increased complexity is by breaking down a complex process into a number of interacting subsystems, which has been labeled the decomposability principle (Garud et. al. 2003). The basic problems with the degree of decomposability of a system are the problems and costs associated with coordination (Garud et al 2003). The costs and advantages of different degrees of modularity did have an overwhelming impact on a number of video game firms, since it created possibilities for a number of firms to enter the market in a previously closed part of the value chain. Subsequently, the increasing development costs and complexity that followed Moore’s law put pressure on a number of these new, small firms in the market.

From the beginning, video games involved a system in which the complete design of hardware and software was so closely related that both operations were performed by the same video game firm (e.g., Magnavox and Atari), but then a number of changes in the degree of modularity made it possible for firms to enter certain parts of the value chain. The ‘pong in a chip’, the programmable console and the home computer are all examples (described in more detail later) of changes in the degree of modularity that affected entrance barriers in the industry.

Apart from development costs and degree of modularity of the system, the financial market and the expectations surrounding video games as a phenomenon have affected entry barriers as well. The financial market and its growth projections for the video game industry fuelled the
creation and growth of video game firms during certain periods, while it inhibited them during other periods. As argued later, the venture capital market in the U.S. was important for the number of U.S. game software firms entering the industry in the beginning of the 1980s and was also indirectly one important factor that contributed to the effects of the video game crash of 1983 being more severe in the U.S. than in Europe and Japan.

**Destructive liabilities of newness and smallness.** Organizational researchers have studied the lower survival rate of new (Stinchcombe 1965) and small firms (Aldrich et al. 1986) in many industries. The liabilities of newness have been explained by several factors, including lack of consumer trust in a new firm and the ability to support planning given the experiences, routines, fame, relationship, interaction and history of a new firm. For the liability of smallness, limited financial resources, human resources, skills, market presence and power have been suggested as factors of vulnerability.

When entry barriers rapidly decrease through the opening of a previously closed part of the industry (e.g., by increased modularity), the demographic of new and small companies increases, and many new entrants initially tend to be generalist firms rather than specialist firms (Aldrich 1999). A situation in which a large part of the industry contains firms that are both small and new is indeed a very fragile one that could be at high risk for firm failure in times of harsh business conditions. The effect could be even more damaging if the withdrawal of firms does not lessen the competition for those firms left in the industry but instead is destructive and makes conditions even more difficult by, e.g., firms dumping prices in an effort to sell out their entire remaining stocks of products at discount rates. This is what happened during both video game crashes (1977, 1983) and, as a result, market conditions became even harsher in the short term for the remaining firms in the industry.

**Industrial crashes and shake-outs in the early video game industry**

**The 1975 arcade shake-out**

Initially, many of the large established companies that made electromechanical pinballs and other amusement machines were reluctant to enter the electronic arcade market. Instead, two small California based companies, Nutting Associates and Computer Recreations, were the first to enter the market in 1971. However, due to premature technology, poor understanding of the market and unsuccessful game concepts, both endeavors failed. One year later a former Nutting Associates engineer, Nolan Bushnell, co-founded
Atari and took the simple Pong concept to the arcade. With its simple but enticing game play, it became an immediate success in the end of 1972. Pong was a true disruptive technology in relation to pinball and other electromechanical games. It earned more money, required less service and involved a different development process. At the time of its breakthrough, the electromechanical arcade business had been dominated by five Chicago-based companies (Gottlieb, Williams, Bally/Midway and Chicago Coin). They conducted business in a relatively stable environment with many incremental but few radical innovations. With the disruption of Pong, the whole market structure changed. A number of new companies started to develop Pong games and were soon followed by the older electromechanical game companies that tried to adapt their organizations to the new market. The arcade industry that involved one region, one technology and five companies in 1970 became a tale of two major regions (Illinois, Chicago and California, Silicon Valley), two technologies and twenty-seven companies in 1974 (Table 1 and Figure 3).

Initially, all of companies that entered the market made more or less similar imitations of the original Pong. Technologically, it was easy to make these imitations, and Atari itself even increased the incentive for the creation of such a market when its production capacities were far below the demand. Atari had the Pong market to itself in only a few weeks, and in 1973 seventeen imitators produced Pong games (Table 1 and Figure 3). When the traditional pinball manufacturers Williams and Midway/Bally entered the market, it became apparent that their superior manufacturing capabilities and developed distribution networks were a major advantage in the homogenous market. At the end of 1973, they had each sold as many Pong games as Atari (around 10,000 each, Baer 2005, p 95). The limited manufacturing capabilities and distribution network among many of the new Pong imitator companies constrained most of them from selling more than a few hundred Pong games. Interestingly, intellectual property protection did little to hinder a large number of companies from entering the market (see Baer 2005, p 130).

A study of the majority of the arcade games sold in 1972-1975 shows that the dominance of tennis-type Pong games in percentage of units sold was 87% in 1973, 38% in 1974 and 21% in 1975 (derived from Baer 2005, pp 10-13).

The reliance on a single concept was the result of a lack of innovative capabilities among the firms in the market combined with technological constraints. Many firms had no capacity to do other than imitate and manufacture games and at the same time technology placed such constraints on what was achievable that it was difficult to diversify into new game concepts that could compete with Pong. Atari and its fully owned company Kee Games was the first company to try to introduce new games in the arcade environment at the end of 1973. However, they initially failed to compete with the success of Pong (Cohen 1984, Kent 2001).
Table 1. *First electronic arcade game manufacturers 1972-1974*

<table>
<thead>
<tr>
<th>Manufacturer</th>
<th>Year of entering the market for electronic arcade games</th>
<th>Place of origin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computer Recreations</td>
<td>1971</td>
<td>California</td>
</tr>
<tr>
<td>Nutting Associates</td>
<td>1971</td>
<td>California, Mountain view</td>
</tr>
<tr>
<td>Atari</td>
<td>1972</td>
<td>California, Los Gatos</td>
</tr>
<tr>
<td>For-Play</td>
<td>1972</td>
<td>N/A</td>
</tr>
<tr>
<td>Allied Leisure</td>
<td>1973</td>
<td>Florida, Hialea</td>
</tr>
<tr>
<td>Amutronics (c/o PMC 1974)</td>
<td>1973</td>
<td>N/A</td>
</tr>
<tr>
<td>BAC Electronics</td>
<td>1973</td>
<td>New Jersey, Cherry Hill</td>
</tr>
<tr>
<td>Brunswick</td>
<td>1973</td>
<td>Illinois, Stokie</td>
</tr>
<tr>
<td>Chicago Coin/Chicago Dyn.</td>
<td>1973</td>
<td>Illinois, Chicago</td>
</tr>
<tr>
<td>Kee Games</td>
<td>1973</td>
<td>California, Santa Clara</td>
</tr>
<tr>
<td>Meadow games</td>
<td>1973</td>
<td>California, Sunnyvale</td>
</tr>
<tr>
<td>Midway MFG</td>
<td>1973</td>
<td>Illinois, Shiller Park</td>
</tr>
<tr>
<td>Mirco games</td>
<td>1973</td>
<td>Arizona, Phoenix</td>
</tr>
<tr>
<td>PMC</td>
<td>1973</td>
<td>Pennsylvania, Sothamton</td>
</tr>
<tr>
<td>RAMTEK</td>
<td>1973</td>
<td>California, Sunnyvale</td>
</tr>
<tr>
<td>See-Fun</td>
<td>1973</td>
<td>N/A</td>
</tr>
<tr>
<td>SEGA</td>
<td>1973</td>
<td>Japan</td>
</tr>
<tr>
<td>Taito</td>
<td>1973</td>
<td>Japan</td>
</tr>
<tr>
<td>US Billiards</td>
<td>1973</td>
<td>New York, Amityville</td>
</tr>
<tr>
<td>Williams (Seeburg)</td>
<td>1973</td>
<td>Illinois, Chicago</td>
</tr>
<tr>
<td>Bailey International Inc.</td>
<td>1974</td>
<td>N/A</td>
</tr>
<tr>
<td>Computer games</td>
<td>1974</td>
<td>Massachusetts, Hingham</td>
</tr>
<tr>
<td>Digital Games Incorporated</td>
<td>1974</td>
<td>California, Corina</td>
</tr>
<tr>
<td>Electra games (division of universal research lab)</td>
<td>1974</td>
<td>Illinois, Elk Grove Village</td>
</tr>
<tr>
<td>Electromotion Inc.</td>
<td>1974</td>
<td>N/A</td>
</tr>
<tr>
<td>Exidy</td>
<td>1974</td>
<td>California, Palo Alto</td>
</tr>
<tr>
<td>HID/Visco Games</td>
<td>1974</td>
<td>N/A</td>
</tr>
<tr>
<td>JRW</td>
<td>1974</td>
<td>California, Sunnyvale</td>
</tr>
<tr>
<td>UBI</td>
<td>1974</td>
<td>New Jersey, Union</td>
</tr>
<tr>
<td>Volley Industries</td>
<td>1974</td>
<td>Canada, Montreal</td>
</tr>
</tbody>
</table>

*Sources:* International Arcade Museum, Arcade History Database, Ralph Baer etc.

As long as there was a homogenous product market, consumers’ appetite for new entertainment experiences could not be quelled. By the end of 1973, the first signs of harder times in the industry appeared. In a memorandum from the November 1973 MOA (Music Operators of America) expo, the “father of
video games’, Ralph Baer (2005, p 96), described the lack of differentiation in the market:

Right about time of show, business takes nose dive – Why ? – General panic in industry – little guys starving – Midway Mfg only making about 50 units/week – ATARI “struggling’, I’m told…– Best guess as to cause: Everybody copies each others game – basically ATARI’s design – creative engineering practically non-existent – public suddenly fed-up with 28 x same damn thing! Moral: Nobody knows for sure; but best guess is GAMES WILL SELL BIG, IF they’re different, challenging – must provide ‘hand-to-hand combat’ between players, lots of action, noise, not readily ‘learnable’ games.

During the following years, a shake-out occurred in the arcade industry in which a large number of small manufacturers were forced out of the market. The number of firms entering the industry declined during the 1974-1977 period; at the same time, the number of firms exiting increased (Figure 3).

When the capability to develop new innovative games became crucial in the competition, none of the smaller imitator companies that had entered the market survived in the business. Although statistics over the early arcade industry are unreliable, marketing data from the major industry magazine of the time indicate that the arcade industry decreased by more than 50% between 1974 and 1975 in terms of units sold (Baer 2005, p 10-13). As a result, in 1977 the number of competing firms actually decreased in the industry (Figure 3). It was a clear case of the structural inertia of companies and their inability to adapt to changing market conditions

Of the 3D factors, low entry barriers and a lack of differentiation were present in the market. The liability of newness and smallness made many of the smaller companies vulnerable when market conditions became more competitive. Being small, generalist companies could not adapt to the change from a homogenous to a diversified market that required innovative specialist companies. The exits that followed were not destructive but rather increased the possibilities for the innovative companies that were left in the market to regain growth and profit margins. The absence of a disruptive technology meant that not all of the elements necessary for a crash to occur were present, but enough for a major shake-out of firms with an organizational form ill-suited for adapting to the new capabilities that were required. In the new diversified market reliant on a larger number of game concepts, the capability to constantly innovate new games became a competitive advantage.

The shake-out in the arcade industry was a necessary adjustment to the changing requirements in the industry. The exit of the imitators from the market did not only increase the pressure to innovate, but it also opened up a resource space that could support companies with innovation capabilities (such as Atari and Midway) as their main competence in the market. The
result was a new wave of firm entrances from 1978 to 1980 in which a larger number of firms with a combination of manufacturing and innovative capabilities entered the market (Figure 3). At the same time, the number of firm exits in relation to firm entrances was considerably lower during the same period. Most of the innovative firms in this new entrance wave were Japanese firms (Konami, Namco, Nichibutsu, Irem, Data East [DECO], SNK and Banpresto all entered the industry during 1978-1980). Whereas many of those innovative Japanese companies would have considerable success in years to come and produce a large number of arcade titles, most of the new U.S. companies that entered during this period were less competitive and were, thus, forced out of the market during the arcade shake-out in 1982. The constant diversification into new game concepts from 1978 to 1981 by numerous Japanese companies together with Atari, Williams and Midway intensified the process of creative destruction that facilitated the highest growth period in the history of the arcade industry, depicted as “the golden years of the arcade”.

Figure 3. Entrants, exits and number of competitors in electronic arcade games from 1971-2000

Source: Author’s analysis of Arcade History database, KLOV database, PlayMeter, Baer 2005.
The 1977 console crash

...the appearance of General Instrument’s AY-3-8500 game chip in March of 1975 changed everything – forever. Suddenly anybody would soon be able to produce a high quality Pong-like video game for home use.

Ralph H. Baer, inventor of the video game console, (Baer 2005, p 92)

The early console industry had a similar dynamic of delimited differentiation and decreased entry barriers that characterized the early arcade industry. However, the subsequent introduction of disruptive technologies in the form of programmable consoles and handheld games was a decisive change that contributed to a full-scale industry crash in 1977.

Magnavox Odyssey (1972), with a simple Pong-type game as its major game, was the first video game console. The technology that was used (a large number of analogue discreet components) constrained it in several ways: it contained no sound and no scoring, had blurry graphics and involved a costly, labor-intensive manufacturing process. As a result, it never became a profitable business for Magnavox (see Baer 2005, p 91). Subsequently, the rapid progress in digital technology made it possible for the whole Pong game concept to be incorporated into a single integrated circuit chip with the benefit of considerably lower manufacturing costs and increased game quality. In a market effect similar to that with the introduction of single chips in the personal calculator market (Braun and Macdonald 1982), sales skyrocketed when Atari entered the market and released the first single chip Pong in 1975. As with Pong, Atari’s manufacturing capacity was limited, and demand far surpassed supply by Christmas of 1975. A large number of the available U.S. chip manufacturers at that time swiftly developed their own Pong chip, which they introduced during 1976 and 1977 and sold on the open market for 5-10 USD. With the help of the chip, basic assembling capabilities were the only thing necessary for firms that wanted to enter the lucrative market for Pong consoles. Throughout 1976 and 1977, established and newly started companies rushed into the market to manufacture Pong consoles. As a result, the Pong console market went from a market of 7 companies introducing pong consoles in 1975 to 34 in 1976 and 82 in 1977 (Table 2): The growth was almost entirely based on the introduction of the ‘Pong in a chip’. The number of systems introduced using Pong in a chip increased from 1 (Atari) in 1975 to 54 in 1976 and a record high 162 systems in 1977 (Table 2).

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2 These numbers only include those Pong systems with identifiable manufacturers and introduction year; the actual number of manufacturers in 1976 and 1977 was probably higher. One source estimates the total Pong market to over 500 models from 300 manufacturers (see Winter 2006).
Table 2. The rise and fall of the Pong console market

<table>
<thead>
<tr>
<th>Year</th>
<th>Manufacturers releasing a Pong console</th>
<th>Pong models released</th>
<th>Systems introduced using analogue technology or a large number of digital components</th>
<th>Systems introduced using dedicated Pong chips</th>
<th>System released in North America</th>
<th>System released in Europe</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972</td>
<td>1</td>
<td>4</td>
<td>4</td>
<td>0</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>1973</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1974</td>
<td>3</td>
<td>5</td>
<td>5</td>
<td>0</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>1975</td>
<td>7</td>
<td>10</td>
<td>9</td>
<td>1</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>1976</td>
<td>34</td>
<td>62</td>
<td>8</td>
<td>54</td>
<td>50</td>
<td>12</td>
</tr>
<tr>
<td>1977</td>
<td>82</td>
<td>162</td>
<td>0</td>
<td>162</td>
<td>60</td>
<td>101</td>
</tr>
<tr>
<td>1978</td>
<td>29</td>
<td>36</td>
<td>0</td>
<td>36</td>
<td>8</td>
<td>27</td>
</tr>
<tr>
<td>1979</td>
<td>6</td>
<td>8</td>
<td>0</td>
<td>8</td>
<td>0</td>
<td>8</td>
</tr>
<tr>
<td>1980</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1981</td>
<td>3</td>
<td>3</td>
<td>0</td>
<td>3</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>1982</td>
<td>4</td>
<td>4</td>
<td>0</td>
<td>4</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>1983</td>
<td>2</td>
<td>2</td>
<td>0</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Derived from Pong Story Rarity Database (Winter 2006).

Despite the success of dedicated consoles in 1976, the market crashed in 1977 when all 3D factors were present and together led to the dedicated Pong console crash. In terms of differentiation, it was a highly homogenous market in which every company relied on the same Pong game concept and few product features distinguished the companies. In 1977, an increasing number of consumers in the U.S. had grown tired of Pong consoles. At the same time, the programmable console (introduced in 1976) and handheld games (introduced in 1977) were two disruptive technologies that both had distinctive advantages over the dedicated Pong consoles. Whereas handheld games offered the opportunity for cheap, simple games at a lower cost and ubiquitous playing possibilities, programmable consoles offered a diversity of new types of game. When these new disruptive technologies started to make their impact on the market in 1977, production and stocks among the manufacturers of dedicated pong consoles were record high. At Christmas of 1977, supply far exceeded demand. The market crashed, and during the course of a few months, the market for Pong consoles completely disappeared (Table 2). A cutthroat price war followed in which Pong manufacturers sold off their stocks far below manufacturing costs (Herman 2001, Cohen 1984). With few exceptions (Atari, Coleco and Magnavox), almost all of the U.S. manufacturers of dedicated consoles left the video game market in 1978 and never reappeared. The same pattern was repeated almost identically in the European market, with the exception that the market became saturated a few months later in some European countries. The large number of firm failures in the 1977 crash was closely connected to the decreasing entry barriers in the industry and the liability of smallness and newness among the firms.
There was a mismatch between the capability endowments among the companies in the population of firms in the dedicated home console market and the innovative capabilities needed for long-term growth in the console industry through further innovations. Most of the Pong manufacturers had only basic assembly capabilities, while the semiconductor manufacturers that made ‘Pong in a chip’ had neither the knowledge of the game market nor the capabilities to develop new game concepts. In the short-term free riding on the success of the Pong concept and production increases gave firms competitive advantages, but for long-term growth new innovative concepts had to be developed. Driven by the introduction of the programmable consoles, there was a shift of this kind in the market from the imitators to the innovators, with accompanying advantages, but most companies could not make the transition. In statements that were similar to those that would later be made in conjunction with the 1983 crash, many contemporary analysts claimed that the 1977 crash was the end of a short video game fad, similar to the problem that other digital consumer industries experienced at that time (Braun and Macdonald 1982). Initially, the price war had a negative impact on the market for programmable consoles as well, and only two (Atari and Coleco) of the five companies that released programmable consoles in 1976-1977 were able to stay in the business (Table 3). Atari could remain in the video game market despite heavy losses due to the financial stability of Warner, which had bought the company in 1976 and continued to believe in a future for the disruptive programmable VCS console that Atari had released in 1977.

The combined effect of various disruptive aspects of the programmable console and the handheld game made the crash even more severe. Whereas the cheap but simple handheld games provided considerable advantages in terms of cost and ubiquitous gaming in the short run, programmable consoles provided considerable quality advantages through differentiated gaming opportunities in the long run.

Handheld games were made possible because of the opportunities created by the rapidly declining costs of integrated circuits and LED display technology. By showing that it was possible to play electronic games on other screens than television and by providing cheap game playing opportunities anytime and anywhere, handhelds created new markets for digital games and showed the adaptability of the game medium to new technologies originally developed for other purposes. Toy companies from the U.S. (Mattel, MB) and later Japan (Nintendo, Bandai, Tomy) dominated the market (Gielens 2000). Although handheld games were able to capture new market segments, the inseparability of hardware and software stifled innovation in software and created a rather homogenous product market. That did not change until

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3 The first handheld games were greatly influenced by the handheld calculator technology. Both the LED display and the chip used in Mattels first handheld games had those effects.
the Nintendo Game boy was released in 1989. Instead, new possibilities for creative destruction in hardware and software were made possible with the development of programmable consoles that brought video games back on a path of growth that lasted for five years.

Table 3. Programmable console systems released from 1976-1982

<table>
<thead>
<tr>
<th>Company</th>
<th>Name</th>
<th>Nationality</th>
<th>Year introduced</th>
<th>Number of games produced</th>
<th>Games developed until</th>
<th>Number of units sold (million)</th>
<th>Companies other divisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fairchild</td>
<td>Channel F</td>
<td>USA</td>
<td>1976</td>
<td>26</td>
<td>1979</td>
<td></td>
<td>Integrated circuits</td>
</tr>
<tr>
<td>Bally</td>
<td>Astrocade</td>
<td>USA</td>
<td>1976</td>
<td>50</td>
<td>1983</td>
<td></td>
<td>Amusement machines, gambling machines</td>
</tr>
<tr>
<td>Atari</td>
<td>VCS/2600</td>
<td>USA</td>
<td>1977</td>
<td>500</td>
<td>1992</td>
<td>30</td>
<td>Arcade games, home computers</td>
</tr>
<tr>
<td>Coleco</td>
<td>Telstar Arcade</td>
<td>USA</td>
<td>1977</td>
<td>4</td>
<td>N/A</td>
<td></td>
<td>Plastic products, leather articles</td>
</tr>
<tr>
<td>RCA</td>
<td>Studio II</td>
<td>USA</td>
<td>1977</td>
<td>N/A</td>
<td>N/A</td>
<td></td>
<td>Radio, TV</td>
</tr>
<tr>
<td>Interton</td>
<td>VC 4000</td>
<td>Germany</td>
<td>1978</td>
<td>40</td>
<td>1982</td>
<td></td>
<td>Family business making hearing aids</td>
</tr>
<tr>
<td>Magnavox (US subsidiary of Philips)</td>
<td>G7000</td>
<td>USA/Holland</td>
<td>1978</td>
<td>50</td>
<td>1984</td>
<td>2</td>
<td>TV manufacturer</td>
</tr>
<tr>
<td>APF</td>
<td>M1000 Intellivision</td>
<td>USA</td>
<td>1978</td>
<td>12</td>
<td>1978</td>
<td></td>
<td>stereos, calculators</td>
</tr>
<tr>
<td>Mattel</td>
<td></td>
<td>USA</td>
<td>1980</td>
<td>125</td>
<td>1990</td>
<td>3</td>
<td>Toys</td>
</tr>
<tr>
<td>GCE/Milton on Bradley (CBS)</td>
<td>Vectrex</td>
<td>USA</td>
<td>1982</td>
<td>25</td>
<td>1985</td>
<td>4</td>
<td>MB:Toys</td>
</tr>
<tr>
<td>Coleco (CBS)</td>
<td>Coleciversary</td>
<td>USA</td>
<td>1982</td>
<td>100</td>
<td>1985</td>
<td>4</td>
<td>Plastic products, leather articles</td>
</tr>
<tr>
<td>Entex</td>
<td>Adventure Vision</td>
<td>USA</td>
<td>1982</td>
<td>4</td>
<td>1982</td>
<td>0.05</td>
<td></td>
</tr>
<tr>
<td>Emerson Radio corp</td>
<td>Arcadia 2001</td>
<td>USA</td>
<td>1982</td>
<td>35</td>
<td>N/A</td>
<td></td>
<td>Radio, TV</td>
</tr>
<tr>
<td>Hanimex</td>
<td>HMG 2650</td>
<td>Asia</td>
<td>1982</td>
<td>30</td>
<td>1983</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Atari</td>
<td>5200</td>
<td>USA</td>
<td>1982</td>
<td>70</td>
<td>1986</td>
<td></td>
<td>arcade games, home computers</td>
</tr>
</tbody>
</table>


Although programmable consoles were released in 1976-1977, it took a few years for their true innovative potential to reveal itself, i.e. not until a large number of diversified innovative software products had emerged and created a positive upward spiral, most visible for the Atari VCS/2600 (Table 3). The programmable consoles separation of hardware and software into two separate modules (console and cartridges) spurred the creation of the differenti-
ated software market and provided a way out of the destructive 3D factors behind the Pong console crash.

The new business model for the programmable console has often been compared to that of Gillette razor blades, in which the razors themselves (the console hardware) provide the less profitable (or even loss generating) but more long-lived part of the business while the razor blades (the software) provide the profitable but more short-lived part of the business. One of the results of the business model was that it involved considerable network externalities for the hardware, and sales tended to be increasingly concentrated to one or a few console systems on the market. The R&D costs, marketing efforts and software capabilities required comprised some of the entrance barriers to the programmable console hardware market of the late 1970s, distinguishing it from dedicated consoles. As a result, in 1976-1982 only 15 programmable systems were released, a major difference as compared to the many hundreds of dedicated console systems (Tables 2 and 3). Of those 15, Atari’s unit sales were more than seven times that of its closest competitor Mattel.

With the separation of software from hardware, the successful operation of a software development project was not dependent on the performance of hardware development. The modular system of the programmable console enjoyed all the potential benefits that research has provided to modular systems (Garud 2003), such as increasing speed, scoop and reach of innovations, the continuous reuse of system parts and a higher degree of stability (Table 4). The programmable console could also reap the benefits of the prolonged learning process involved in game development. As the hardware became more complex, learning what the hardware was capable of in terms of games increasingly became a discovery process for game developers, a process that unfolded over time. Many new innovative game concepts were discovered several years after the first programmable consoles were introduced. Nonetheless, the variety and innovative games that were possible on these first, technologically very constrained systems, were remarkable and an important source of growth for the industry. Such a differentiation in games had not been possible if it had not been for the malleability of software in relation to hardware, accurately described by the legendary game developer John Carmack:

Software is so wonderful in a unique way. The people who set up for a physics experiment spend a year of preparation time, tooling around doing things. And then you spend another year analyzing it. With software you can have an epiphany and just sit down and hash it out. You can make it happen right there. It's the most malleable media to be working in for any kind of intellectual pursuit.

John Carmack (Colayco 2000)
Table 4. *Different systems of innovation: dedicated consoles, programmable consoles and home computers*

<table>
<thead>
<tr>
<th></th>
<th>Dedicated consoles (1972-1978)</th>
<th>Programmable console (1976-)</th>
<th>Home computer (1977-)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Degree of modularity</strong></td>
<td>One module consisting of both hardware and software. Initially many discreet components, but in 1975 Atari introduced the first ‘pong in a chip’.</td>
<td>Two freestanding, compatible modules: console hardware and software (cartridges)</td>
<td>Two freestanding, compatible modules: console hardware and software (magnetic cassettes and disks).</td>
</tr>
<tr>
<td><strong>Business model</strong></td>
<td>Profits from the sales of the console. Market concentrated to Christmas sales.</td>
<td>Razor and Blade ‘Gillette model’, low or no profit margins on the hardware (console), high on the software (cartridges). Market increasingly year round.</td>
<td>Profits on both the sales of hardware and software, but no Gillette model. Year round market.</td>
</tr>
<tr>
<td><strong>Market characteristics</strong></td>
<td>No network externalities. Homogenous market characterized by price competition. Decreasing entry barriers spurred firm entries.</td>
<td>Considerable network externalities. Positive feedback loops between hardware and software favored the creation of one dominant hardware company (Atari). Subsequently (1979-), many software companies entered the market.</td>
<td>Network externalities in hardware. A large number of firms initially, but only a few were left after a few years. Homogenous hardware market, but heterogeneous and diversified software market.</td>
</tr>
<tr>
<td><strong>Reuse of system parts</strong></td>
<td>No reuse of system parts</td>
<td>Reuse of the hardware (console) for several games. No possibilities to reuse the software (cartridges)</td>
<td>Reuse of hardware for several games and other programs. Possibilities to reuse software medium (disks and tapes) as well.</td>
</tr>
<tr>
<td><strong>Stability and risks</strong></td>
<td>Reliance on single concept increases the risk. Innovation in new software is risky: if a new game concept fails the total production of the game console suffers.</td>
<td>Lower risk of innovation. If a new game concept fails, only the cartridges fail. Diversity in software decreased the risks involved in reliance on a single game concept.</td>
<td>Production risk of game disks and game tapes lower than for game cartridges (they do not have to be produced in batches, but on demand). The large number of incompatible systems initially involved the risk of supporting the wrong system.</td>
</tr>
<tr>
<td><strong>Innovations (speed, scoop, reach)</strong></td>
<td>Imitation of successful game concepts. Reliance on single game concepts makes for a less risk-taking market where it is more difficult for difference.</td>
<td>Enhanced speed, scope and reach of innovations. Innovations occurring continuously in software. Game software development becomes a profes-</td>
<td>High speed and scoop, moderate reach of innovations. User-created software makes possible a huge variety of tastes close to actual demand.</td>
</tr>
<tr>
<td>Development Process</td>
<td>Entrance Barriers</td>
<td>Differentiation</td>
<td></td>
</tr>
<tr>
<td>---------------------</td>
<td>------------------</td>
<td>-----------------</td>
<td></td>
</tr>
<tr>
<td>Only a few companies did any software development; successful concept was imitated by chip manufacturers and sold to a large number of assemblers.</td>
<td>Low entry barriers in 1976 when the core component (Pong in a chip) containing the game became available on the open market. No need for any substantial capabilities in either hardware or software for manufacturing.</td>
<td>Homogenous market. The only differentiation appears in marketing and appearance of the products.</td>
<td></td>
</tr>
<tr>
<td>Initially software development in-house by the hardware manufacturers. Subsequently (1979-), a large number of independent software developers joined the market. Programming knowledge difficult to acquire.</td>
<td>Initially low in software. A skilled user could develop and distribute self-made games as the home computer was programmable. Later on, marketing capabilities and financial strength became more important. Higher and increasing entry barriers in hardware.</td>
<td>High differentiation in software, less in hardware.</td>
<td></td>
</tr>
<tr>
<td>Heterogeneous software market, but the home computer had less market reach because of its high price and relatively complicated use.</td>
<td>Initially, high entry barriers because of a more complicated development process and the need to initially have capabilities in both software and hardware development. At the end of the console cycle, entry barriers decrease in both hardware and software.</td>
<td>Very high differentiation in software. Initially, the market consisted of both console games and new adventure games.</td>
<td></td>
</tr>
</tbody>
</table>

### The Video Game Crash of 1983

This most visible aspect of the computer revolution, the video game, is its least significant. But even if the buzz and clang of the arcades is largely a teen-age fad, doomed to go the way of Rubik’s Cube and the Hula Hoop, it is nonetheless a remarkable phenomenon.


Among video game historians, 1983 has been synonymous with the video game crash. For many, the crash was viewed as an exceptional event requiring equally exceptional explanations. However, the same 3D dynamics of disruptive technologies, delimited differentiation possibilities, decreased entry barriers and destructive liabilities of newness and smallness of the industry that characterized the 1977 crash were the main driving forces behind the
1983 crash in video game consoles. The US arcade market also decreased around the same time that the programmable console market crashed, but the decline of the arcade market took longer, was less deep and was not as rapid. It is, therefore, better depicted as a shake-out than a crash (Figure 2).

In the course of the two last months of 1982, the general perception of video games in the U.S. changed from being the future of entertainment to a teenage fad (Marbach 1982, Friedrich 1983).

*Figure 2. U.S. home game vs. arcade sales (millions of dollars, inflation adjusted to 1983 year’s value)*

The fall of the arcade market

Of the 3D factors, declining entrance barriers, delimited differentiation and destructive liabilities of newness and smallness characterized the arcade industry in the beginning of the 1980s.

By 1980, the arcade market had grown bigger than the pinball industry. It was a process of creative destruction in which the old electromechanical pinball market in the arcade halls was destroyed and new markets for arcade video games were constantly being created. As arcade games promised high
returns and easy maintenance, they soon became attractive for far more venues than the original pinball venues (penny halls and bars) and invaded restaurants, liquor stores, gas stations, shopping malls, motels, convenience stores and various other locations.

The declining entrance barriers did not only attract new venue owners but ordinary people as well. A number of firms emerged in the beginning of the 1980s, offering small-scale investment opportunities to individuals to buy or lease a few arcade games at various locations. However, a number of frauds plagued the market, and when it was legal, less attractive locations and arcade games were often offered (Changing Times 1982). Among operators, the risks of liability of newness increased. In 1982, signs of over saturation emerged in the arcade market as an increasing number of operators reported decreased profits or even losses. In most parts of the U.S., arcade games had expanded into virtually all desirable public places and, thus, a further differentiation into new public places could only be achieved through less competitive venues. The number of video game arcades doubled between 1980 and 1982, but the average revenues from coin-operated games decreased from 140-150 USD/week in 1981 to 109 USD/week in 1982 (Thomas 2005).

Not only did differentiation opportunities in operation stagnate in 1982, but differentiation in relation to the essential foundations of the arcade business - the arcade machines and the entertainment experience they offered - also stagnated during this time. The ‘golden age’ (i.e. 1978-1981) of arcade games had been a period of increased differentiation characterized by continuous innovation of new arcade games. Some of the most successful and innovative arcade games from Japanese and U.S. companies emerged in 1980 and 1981: Space Invaders (Atari, 1980), Pac Man (Namco, 1980), Defender (Williams, 1980) Donkey Kong (Nintendo 1981) and Ms. Pac Man (Namco/Midway 1981). By 1982, the development of new innovative games had already started to decline, and growth in the arcade market was “stymied by an unexpected halt” (Business Week 1982). Operators hoped that new technologies in the form of laser disc arcade games would revitalize the market in 1983. However, for several reasons (most notably lack of interactivity, maintenance problems and the expense of the products) they turned out to be a technological dead end, and consumers lost interest in the new technology within a year.

During the 1982-1984 period, revenues in the U.S. industry dropped nearly 50% (Figure 2), and the total number of arcade manufacturing firms decreased worldwide (Figure 3). Unlike the more vigorous Japanese arcade market, the arcade industry in the U.S. had some subsequent (brief) periods of upswing but never again of growth (Figure 2). For U.S. manufacturers and distributors, the large quantity of unsold equipment in 1983 and 1984 proved fatal. Operators were squeezed out of the market by both a declining number of visitors and the price war that followed when a number of operators offered game playing at greatly reduced prices. Japanese arcade companies
with a healthy domestic market, high degree of operational efficiency and larger quantity of innovative games managed to survive and even increase their market share in the U.S. Today, there is no U.S. company manufacturing arcade games on a large scale.

The largest U.S. arcade companies at the time of the crash were Atari (mainly manufacturing) and Bally/Midway (operation and manufacturing). Their development during the shake-out shows how difficult it was, even for the largest U.S. companies, to survive during this period. Because of financial difficulties, Warner sold the arcade division of the company to Namco (Japan) in 1984. In contrast to Atari, Bally tried to stay in the business throughout the arcade shake-out, but the price was high. Staggering losses in the amusement game division of the company in 1983 and 1984 forced it to implement a 122 million USD restructuring plan in 1984, through which the division - after considerable downsizing and inventory write-offs - became profitable again in 1986 (Table 5). But the restructuring plan could only halt the financial losses and not create opportunities for growth. The revenues of Bally’s amusement game division continued to decrease rapidly during the period from 1983 to 1988, when the company sold the division to WMS Industries.

Table 5. Bally Amusement games and services division

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues (million USD)</td>
<td>327.5</td>
<td>264.2</td>
<td>177.0</td>
<td>127.7</td>
<td>121.1</td>
<td>109.3</td>
</tr>
<tr>
<td>Operating income/loss before restructuring provision (million USD)</td>
<td>-56.5'</td>
<td>-92.0'</td>
<td>-1.2'</td>
<td>19.7</td>
<td>23.4</td>
<td>20.5</td>
</tr>
<tr>
<td>Provisions for restructuring amusement game business (million USD)</td>
<td>0</td>
<td>-121.7'</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Operating margin, percentage (excluding restructuring provision)</td>
<td>-17.2</td>
<td>-34.8'</td>
<td>-0.6'</td>
<td>15.4</td>
<td>19.3</td>
<td>18.8</td>
</tr>
</tbody>
</table>

Source: Bally Annual reports

The fall of the programmable console market

The events surrounding the 1983 programmable console crash displayed all of the 3D factors: disruptive technologies in the form of home computer games, delimited differentiation as more and more similar games were made for the ageing Atari VCS game machine, decreased entry barriers and devastating liabilities of newness and smallness.

The 1979-1981 period in programmable consoles was a very innovative one, with an increasing number of differentiated games of high quality appearing each year. Until 1979, Atari was the only company making games for its VCS console. There was a severe shortage of skilled game designers
in the industry, and by 1979 Atari had only twelve game developers, according to one of its game designers (Dolan 2001). When four of these left Atari in 1979, they created Activision, the first independent video game company to develop game software exclusively for the consoles of other companies. Atari threatened with litigation, but the parties settled on a (still existing) business model, according to which independent game developers had to pay a percentage of their game sales in royalties to the platform manufacturer.

One result of the litigation was a rapid increase in new independent game developers in 1981 and 1982. According to the most complete database, 158 companies released games for the Atari VCS (AtariAge 2006). Most of these companies only released a few games before the market crashed. The rapid entry of firms in the U.S. was fuelled by a vast amount of venture capitalist funding that witnessed all of the elements of a lucrative market in video game development: potentially high growth, relatively low entry barriers and an opportunity for quick, high rewards (Riley 1982). There were, however, risks with the liability of newness and smallness among the many new video game developers. Because of the lack of talented game programmers, most of them did not have the capabilities to compete on the same mass-market game genres with Atari. Their financial situation was also very fragile in that venture-capital financed companies were without a long-term commitment to the industry. When the market shifted, most of the small independent video game companies were forced to out of business and sold off their remaining stocks of game software at prices far below original prices (see, e.g., Herman 2001, Kent 2001, Cohen 1984).

In the increasingly crowded and competitive market, diversification was necessary in order to avoid commoditization. However, real as well as putative differences were increasingly difficult and costly to achieve. A number of companies tried to differentiate their products by relying on famous licenses from movies, music and other entertainment industries. Other companies tried unsuccessfully to exploit new niches, such as adult games. When manufacturers of other programmable consoles started to release games for Atari VCS as well because of its dominating market position (Table 2), the market for Atari VCS games became even more saturated. The majority of the new video game software firms released games of substandard quality, but even Atari lost much of it previous innovativeness (Cohen 1984). The increased competition and the demand for video game companies to differentiate their products increased licensing costs in the video games industry dramatically. The peak of this development was when Atari licensed a game based on the movie E.T. from 1982 for around one million USD, a game that became the single largest commercial failure for a game in Atari’s history (Cohen 1984, Herman 2001, Kent 2001). Entry barriers for hardware also decreased, and it became possible for Coleco in 1982 to release the ColecoVision console that could play Atari VCS as well (Herman 2001).
Because of the crash, average prices decreased for both video game hardware and video game software in 1983. (Table 6), and the market for video games continued to decline until 1986, when the market is claimed to have reached a record low of 100 million USD (according to Nintendo of America, Figure 2).

Decreased entry barriers, diminished opportunities for differentiation and liabilities of newness and smallness might not have created a full-blown crash if it had not been accompanied by disruptive technology in the form of the home computer. When programmable consoles failed to innovate, the home computer was able to continue the process of creative destruction. Initially, the introduction of the home computer in 1977 had no large influence on the video game market, but as Moore’s law continued and the market grew, the home computer had more and more of an effect on the video game market. In many ways, the home computer represented a completely different business model (Table 4). One important difference was that it was possible for individual talented users to program their own games. As a result, the number of game titles released for home computer systems initially far exceeded the number of games released for video game consoles (Forster 2005). Production on magnetic tapes or disks could be made on demand and did not require large stocks of expensive cartridges. Many believed that the general-purpose home computer would completely take over the market for consoles. In fact, the market trend in the beginning of the 1980s seemed to support this view. Whereas cartridges and hardware sales for consoles declined between 1982 and 1983, sales of entertainment software for home computers more than doubled during the same period (Table 4).

Despite the innovative lock-in, consoles had a future as a playing machine. In 1985, Nintendo introduced in the U.S. their NES/Famicom console, which could do nothing but play games. Nintendo had a strategy of comprehensive quality testing and put all their effort into a few, well-developed titles (Sheff 1993). In contrast to the Atari VCS, it could play new innovative games in the form of long adventures (such as Super Mario, Final Fantasy and Zelda). NES became the most successful console system to date, with sales of almost 63 million units worldwide, twice as many as Atari VCS (CESA 2005). It is worth noting that a crash never occurred in the market in Japan in 1983. In contrast to the U.S. market, the 3D factors were not present to the same extent. The population of firms was larger and more stable, differentiation was sustained by the successful introduction of Famicom in 1983 and the home computer never had the same disruptive effect.
Table 6. Retail sales of video game consoles and home computers

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<tr>
<th></th>
<th>1981</th>
<th>1982</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Video game consoles</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Units</td>
<td>4,620,000</td>
<td>7,950,000</td>
<td>5,700,000</td>
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<td>Value, USD</td>
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</tr>
<tr>
<td>Value/units USD</td>
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<td>95</td>
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<tr>
<td>Video game cartridges</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Units</td>
<td>34,500,000</td>
<td>60,000,000</td>
<td>75,000,000</td>
</tr>
<tr>
<td>Value, USD</td>
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<td>1,500,000,000</td>
<td>1,350,000,000</td>
</tr>
<tr>
<td>Value/units USD</td>
<td>23</td>
<td>25</td>
<td>18</td>
</tr>
<tr>
<td>Home computers</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Units</td>
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<td>2,261,000</td>
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<tr>
<td>Value, USD</td>
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<tr>
<td>Value/unit</td>
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<td>619</td>
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<td>Entertainment software</td>
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<td>Value</td>
<td>18,000,000</td>
<td>157,000,000</td>
<td>405,000,000</td>
</tr>
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</table>

Source: Derived from Campbell-Kelly (2003, p 276).

Atari’s fall

As the leading video game company of the 1970s, Atari experienced such a high growth rate (Figure 4) that it was labeled the fastest growing company to that point in US history in 1980 (Herman 2001). In the crash 3 years later, Atari made several attempts to restructure its business, adapt new strategies and change ownership, but none of these attempts was able to get the company back on a path of growth. As the dominant company in the industry, Atari had enough influence not only to react to changes in the industry but also to use its dominant position to try to change the structure of the industry to its advantage. In the beginning of the 1980s, Atari began to monopolize the market, and the company came to be mismanaged both internally and externally. Internally, there were conflicts between management and the creative personnel of the company. As a result, many key game developers left the company and started their own business when the opportunity arose. In order to retain its talented personnel, increasingly high bonuses were paid to those that stayed, which proved to be a substantial burden once the market experienced a downturn. Externally, Atari had started to mismanage its distribution in a way that made it more difficult to match supply with actual demand. One result of this was that retailers had to sell stocks of lower quality games in order to receive new ones (Dolan 2001, Cohen 1985). More important, however, was Atari’s decision in 1981 to force retailers to order the entire stocks of games in advance for 1982 (Cohen 1985, Kent 2001). Having experienced shortages in previous years, retailers placed huge orders for the following year. When the demand did not meet the supply at the end of 1982, distributors were faced with huge inventories of unsold cartridges.

When the price war over games software started in 1983, Atari initially tried not to follow suit. However, the >500 million USD loss of the Atari division of Warner in 1983 (Figure 4) put the entire Warner Communications into financial difficulties and forced it to sell Atari’s home video game
and home computer division to Jack Tramiel in 1984. Before the transition, Warner dumped huge stocks of unsold software on the market, which exacerbated the crash (Activision 1985, p 1). For several reasons (Kent 2001, p 230), Atari also failed with the introduction of its predecessor to the Atari VCS in 1982, the Atari 5200 (Table 3). Although Atari under Jack Tramiel’s ownership first tried to concentrate its efforts on the home computer market and later recapture the video console market, both of these endeavors failed, and today only the name and the physical assets of the former company remain.

Figure 4. Operational results, Atari and other consumer electronics division of Warner

![Operational results, Atari and other consumer electronics division of Warner](image)

Source: Warner annual reports

Concluding remarks

The history of the video game industry can be described in relation to two periods: an unstable one (1970-1986) in which industry-wide crashes occurred in an immature industry and a more stable one (1987 onward) during which a more mature industry did not experience industry-wide crashes.
Industrial crashes that force an entire population of firms to exit an industry within a short period of time are rare in most industries. In the video game industry, this was the characteristic recurrent feature during the first period (1972-1985) of the industry. This chapter has argued that all of the four crashes and shake-outs that characterized this turbulent era shared a similar structural dynamic and can be explained on the basis of the combined effect of 3D factors: disruptive technologies, delimited differentiation, decreased entry barriers and destructive liabilities of newness and smallness. When all of these factors are present, they reinforce each other in a vicious downward spiral, which, in turn, results in a crash. The decisive impact of those 3D factors on the video game industry can be explained by the permeating influence of the process of creative destruction. Driven by a rapid pace of new technological innovations in the industry, a constantly new and differentiated playing experience was necessary for growth in the industry. It was by constantly creating special markets on their own through real as well as putative differences that firms could avoid commoditization. In the early video game industry, opportunities for differentiation were limited and innovative lock-in common. However, whenever one game platform stagnated, another one often emerged and continued the process of creative destruction. There were constant discrepancies between the capabilities of the majority of the firms and the capabilities needed for further growth. When an industry crash occurred, firms had little opportunity to change their capabilities, and failure was inevitable for most of the firms in the industry. In many regards, the crashes were a necessity for the industry to return to a pattern of growth.

References


Richard D. Gritta, Bahram Adrangi, Sergio Davalos, Don Bright

Airline bankruptcy has become an everyday event in 2005. The first major US carrier, Braniff, failed back in 1982, only three years after the de jure deregulation of the US airline industry. It was followed shortly by the receivership of Continental the next year. Insolvency seems to have reached its peak this year with Delta and Northwest, both filing for court protection in October of 2005, and with American threatening to file at any time. In addition, UAL still operates under court protection (having filed almost 3 years ago) and US Airways has just exited from its second court filing. The situation is abysmal. To date over 148 air carriers have sought court protection and many have ceased to exist, including famous names, such as Braniff, Eastern, Pan Am and TWA. Several others, UAL and US Airways, are still not out of danger and could follow their predecessors into oblivion.

Obviously, methods that could predict insolvency, or at least gauge relative financial conditions, are important. Historically, financial analysts have measured financial strength by calculating ratios derived from various financial statements such as the balance sheet and income statement. It has only

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2 The views expressed here do not represent the official position of the US Dept. of Transportation and/or any division within DOT.

3 Thirteen major carriers now exist/or have existed since 1980. Those carriers include: Alaska, American, America West, Braniff, Continental, Delta, Eastern, Pan Am, Northwest, Southwest, TWA, United and US Air. Ten have filed for bankruptcy/reorganization, in some cases multiple times (Eastern, Continental, TWA and US Airways), and several have disappeared forever (Braniff, Eastern, Pan Am and TWA). That is a failure rate of almost 77%. That bankruptcy rate is appalling.
been since the mid-1960s, however, that attempts were made to sophisticate traditional financial ratio analysis by the use of newer statistical techniques. The purpose of this chapter is to chronicle the history and to outline and briefly discuss many of the different models, both generic and industry specific, that have been used to assess the financial health of air transportation, such a vital industry in the US economy. It should be stressed that models can be designed for international carriers as well, and have been, as will be explored below. A number of groups would be interested in such research. They include financial analysts, bond holders and other credits, stockholders, lessors, governmental agencies and others.

Financial Ratios as Predictors of Stress

Historically, analysts have computed different types of financial ratio to assess four separate aspects of financial well-being. These four types of ratio measure liquidity (the ability of a firm to pay its obligations as they come due), leverage (the extent to which a firm uses debt as a method of finance), activity or turnover (the efficiency of asset usage) and profitability. More recently, financial researchers have begun to combine these financial ratios into models that produce an overall score that can be used to both assess financial stress and to predict bankruptcy well in advance of the event. What follows is a summary of some of the models that the authors, and others, have used over time, and in some cases designed, for this purpose. The models are:

1. The Altman Model, often referred to as the Z Score (and its variant, the Z” Score)
2. The Altman ZETA® Model
3. The AIRSCORE Model
4. The Pilarski or P-SCORE Model
5. Neural Networks (NN)
6. Genetic Algorithms (GA)
7. The Gudmunsson Model
8. A “Fuzzy” Logic Model

The first two models are generic; i.e. they were specified using a wide sample of different firms in various industries. The latter six are industry specific; i.e. they were designed using airline data only.
Generic Models: (1) The Altman Z Score Model

Edward Altman of NYU is truly the ‘father of financial bankruptcy forecasting.’ His early research in 1968 resulting in the design of what is perhaps the most famous bankruptcy-forecasting model, the Z Score [Altman, 1968]. Designed using a database of 33 failed and 33 non-failed manufacturing companies, Altman used a stepwise multiple discriminant regression to specify the following model from a group of 23 financial ratios:

\[ Z = 0.012X_1 + 0.014X_2 + 0.033X_3 + 0.006X_4 + 0.999X_5 \]

Where \( X_1 \) – \( X_5 \) are ratios that measured each of the aspects of strength.

\[ X_1 = \text{net working capital to total assets (a liquidity ratio)} \]
\[ X_2 = \text{retained earnings to total assets (a profitability ratio)} \]
\[ X_3 = \text{operating profit to total assets (a profitability ratio)} \]
\[ X_4 = \text{market value of equity to book value of debt (a leverage ratio)} \]
\[ X_5 = \text{operating revenues to total assets (a turnover ratio)} \]

High ratios in each category increase the Z Score and thus lessen the danger of failure. Altman found that the critical values of \( Z \) were 1.81 and 2.99. Firms with scores of <1.81 fit a bankruptcy profile, whereas firms with \( Z \)s >2.99 fit the solvency profile. Scores between the two values lie in what Altman called the ‘grey zone’ where profiling is more difficult. Altman argued for a 2.67 cut-off, if one barrier was desired. The model’s success rate in forecasting insolvency was 76%. It should be noted that the model can also be used to assess overall relative financial strength.

Gritta (1982) used the basic Altman Model and forecasted the insolvencies of both Braniff and Continental several years before their actual filings. Subsequently, Gritta used the model to assess the industry in several other published studies (e.g., Gritta, Chow and Davalos 2002). The following chart summarizes Z Scores for different years over the past four decades. The carriers are grouped into two categories: those that failed over the period and those that have remained solvent for the entire study period. The figures for the year 2001 were computed for the January-August period, to exclude the effects of 9/11. Z Scores after that date fell significantly.

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4 Altman has produced models for many different US industries (railroads, over-the-counter broker/dealers, etc.) and many of his doctoral students have modeled bankruptcy in countries such as Austria, New Zealand, Britain and Israel). One of the authors of this chapter has also specified a model for the US motor carrier industry.
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<td>-0.04</td>
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Notes:

1. Alaska became a major carrier in the late 1980s; National was acquired by Pan Am in 1979; Southwest became a major in 1989 and Western was acquired by Delta in 1979.
3. United files in 2002 and now operates under Chapter 1; both Delta and Northwest file in October 2005.

Source: All scores calculated from data contained in the *Handbook of Airline Financial Statistics and Air Carrier Financial Statistics Quarterly* (various issues).
The chart clearly shows the usefulness of the **Z Scores** in both signaling an early warning and in assessing the relative financial strengths of the major carriers. It also shows the decline in the overall financial health of the US airline industry since the 1960s. The scores during that decade were all well above the barrier on solvent specified by Altman. It is worthy to note that scores declined sharply after the deregulation of the industry in 1978.

A variation of the model has been in use at the US Bureau of Transportation Statistics to track airline financial health. That model is referred to as the **Z” Score Model**. Some analysts feel that the $X_5$ ratio can distort the results because of the significant use of operating leases by air carriers. Such leases do not appear on the balance sheet of the carrier, but the revenues resulting from these leases appear on the carrier’s income statement (Gritta, Chou & Lippman 1995). The result is to inflate the ratio for one carrier using operating leases over the ratio of a comparable carrier that owns its aircraft. Altman suggested the use of a variant of the original **Z Score** to circumvent this problem (Altman 1983). Called the **Z” Score**, the model gets around this problem by deleting the turnover ratio. The resulting model is:

\[
Z = 6.56X_1 +3.26X_2 + 6.72X_3+ 1.05X_4
\]

This model utilizes four input variables; $X_1 –X_4$ as defined above.

A **Z-Score** of 1.1 or less indicates a high probability of bankruptcy in the near future. A **Z-Score** of 2.6 or above indicates a high probability that bankruptcy will not occur. A **Z-Score** between these two numbers indicates that there is insufficient statistical significance to make a prediction. As in the **Z Score** Model, Altman originally referred to scores in this range as the ‘zone of ignorance,’ now referred to as the ‘grey zone.’ This zone contains some firms that have failed and some that have remained solvent. The following table shows **Z” Scores** for the major carriers for the year end 2004.

<table>
<thead>
<tr>
<th>CARRIER</th>
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<td>American</td>
<td>-1.209711065</td>
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<td>1.030260765</td>
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<td>Continental</td>
<td>-0.680997649</td>
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<td>Delta</td>
<td>-2.436372612</td>
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<td>America West</td>
<td>-1.214482870</td>
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<td>United</td>
<td>-4.113404597</td>
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<td>-2.455284490</td>
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<tr>
<td>Southwest</td>
<td>2.597307223</td>
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The very poor scores for all the carriers except Southwest, and to some extent Alaska, confirm the very shaky position of the major carriers despite the economic recovery now in progress.

Generic Models: (2) The ZETA® Credit Score Model

Although the Z Score Model (and its variant, the Z”) was over 76% successful in predicting insolvency, Altman later added several variables to his original model, and respecified the model in an effort to increase its predictive powers. Called the ZETA® credit score model (Altman, Haldeman and Narayanan 1977), it takes the form:

$$ZETA^® = a_1X_1+a_2X_2+a_3X_3+a_4X_4+a_5X_5+a_6X_6+a_7X_7$$

Where $X_1$-$X_7$ are:

$X_1$ = return on assets (the same ratio as $X_3$ in the Z Score Model)
$X_2$ = earnings stability (the deviation around a 10-year trend line of ($X_1$))
$X_3$ = debt service
$X_4$ = cumulative profitability (the same as $X_2$ in Z Score)
$X_5$ = liquidity (measured by the current ratio)
$X_6$ = the ratio of equity to debt (using market values and a 5-year trend)
$X_7$ = firm size (measured by the log of the firm’s total assets).

The ZETA® credit score model is centered on 0. Scores less than 0 indicate stress. The model was applied to the airline industry in 1984 and was found to be reliable (Altman and Gritta 1984). The scores flashed advance warnings for several carriers that subsequently failed. These were US Airways (-0.06), TWA (-0.13), Eastern (-3.85), Pan Am (-4.17), Continental (-4.99) and Braniff (-15.42). Unfortunately, the model is proprietary and the intercept terms in the equation are not published. ZETA® credit scores are only available by subscription from ZETA® Services of Mountainside, New Jersey. This limits its availability, at least to academic researchers. The following are scores for the major airlines just before and after September 11, 2001. (The scores were provided courtesy of Bob Haldeman of ZETA® Services.)

Again, the poor scores for many of the airlines indicate the industry’s problems well in advance of the events of September 11, 2001. They also signaled the filings United (2002), and of Delta and Northwest in 2005.
Industry Specific Models: (3) The AIRSCORE Model:

It can be argued that a model derived from a sample of the same industry would be even more accurate than a generalized model such as the Altman Z Score or ZETA® credit scores. With that in mind, an industry specific model, AIRSCORE, was specified using a sample restricted to the airline industry (Chow, Gritta and Leung 1991). It included a significant sample of the large and smaller carriers (the latter referred to as regional airlines). Using an MDA approached similar to that utilized by Altman, the model derived was:

\[
\text{AIRSCORE} = -0.34140X_1 + 0.00003X_2 + 0.36134X_3
\]

The three ratios that were predictive of insolvency or stress were:

\[X_1 = \text{interest/total liabilities (the imputed interest rate on debt)}\]
\[X_2 = \text{operating revenues per air mile}\]
\[X_3 = \text{shareholders’ equity/total liabilities}\]

Because the distribution of the scores made the application of a single cut-off point difficult and inappropriate, several “gray zones” were defined and the model yielded results similar to the Altman Z Score and to ZETA® credit scores. It was able to achieve accuracy rates of between 76 and 83%, depending on the zone used. Although the model was somewhat accurate, it did seem to be a bit biased toward the larger carriers in the sample. The interested reader is referred to the article for different cut-offs and the results.
Industry Specific Models: (4) The Pilarski Score Model

Logistics regression analysis has also been used to forecast financial stress and has become widely accepted (Ohlson 1980). Logit models estimate the probability of bankruptcy and are useful in ranking firms in terms of financial strength. A logit model has been used to specify a model for airline financial stress (Pilarski and Dinh 1999). Called P-Score, the model takes the form:

\[ W = -1.98X_1 - 4.95X_2 - 1.96X_3 - 0.14X_4 - 2.38X_5 \]

Where:

\( X_1 = \text{operating revenues/total assets} \)
\( X_2 = \text{retained earnings/total assets} \)
\( X_3 = \text{equity/total debt obligations} \)
\( X_4 = \text{liquid assets/current maturities of total debt obligations} \)
\( X_5 = \text{earnings before interest and taxes/operating revenues} \)

The number \( P \) is determined by:

\[ P = \frac{1}{1+e^{-W}} \]

Notice that several of the input ratios (\( X_1, X_2 \) and \( X_3 \)) are borrowed from the Altman Z score model. Rather than producing a score that must be compared to a scale, as is the case with the previous models, this model produces the probability of bankruptcy. \( P \) is that probability. The higher the \( P \) value, the greater is the financial stress and the more likely is the chance of failure. The P-Score is used by the US Department of Transportation to track financial strength. The authors used the P-Score to assess the financial condition of the major carriers and found the model to be correlated to the Altman Z” (Goodfriend, Gritta, Adrangi and Davalos 2005). The following charts from that article present P-Scores for two groups of carriers: the high risk and the intermediate risk carriers. The scores for the other majors are not shown because they are so low (i.e. probabilities of default are near zero).
The following chart presents more recent results, namely the **P-Scores** for the 4th quarter of 2004.

<table>
<thead>
<tr>
<th>CARRIER</th>
<th>P_Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>American</td>
<td>0.152570469</td>
</tr>
<tr>
<td>Alaska</td>
<td>0.003763529</td>
</tr>
<tr>
<td>Continental</td>
<td>0.095027839</td>
</tr>
<tr>
<td>Delta</td>
<td>0.390392591</td>
</tr>
<tr>
<td>America West</td>
<td>0.048881060</td>
</tr>
<tr>
<td>Northwest</td>
<td>0.085842447</td>
</tr>
<tr>
<td>United</td>
<td>0.686357381</td>
</tr>
<tr>
<td>US Airways</td>
<td>0.257064338</td>
</tr>
<tr>
<td>Southwest</td>
<td>0.000616504</td>
</tr>
</tbody>
</table>

The score for Alaska indicates, e.g., that the carrier’s likelihood of insolvency is only 0.3% while that of Delta is 39.0%. Overall, they do show the continued weaken condition of the major airlines after the events of 9/11. The **P Scores** are flashing a warning for American, Delta and Northwest. The latter two carriers did file in October 2005, and American is still threatening to file.

**Industry Specific Models: (5) Neural Networks**

In the continuing search for even more accurate methods of gauging financial strength, some researchers have pursued a newer approach-- the use of artificial **NNs**. The use of artificial intelligence has gained widespread support for a variety of uses in finance, forecasting solvency being one major area of application. **NNs** mirror the architecture of the brain and are derived from research on the neural architecture of the brain (Caudill, 1989). **NNs** are composed of inter-connected neurons linked together through a network of layers. Inputs of data are provided to the network along with desired outputs. The network then trains itself to classify new information based on the abilities it derives to separate the groups input into the model. The standard back-propagation network has several elements. They are an input layer, an output layer and at least one hidden layer. Each layer is fully connected to each succeeding layer and each layer can contain any number of neurons.

**269** **NNs** have several advantages over the MDA technique (Udo 1993). They can be run on smaller samples than MDA models, they can tolerate “noise” or missing data, they can self-organize and learn by changing the network connections and they can find and establish complex relationships among input variables.
neurons or interconnections. The figure below depicts the feed forward of node values and the back propagation of error information.

Typical Back Propagation Network

An error function (it can be any error function) is used to evaluate the difference between the NN output node values to the expected output. This error is back-propagated to adjust the weights associated with each node. Because each node contributes to the global error, the adjustment made to its weights is directly proportional to the magnitude of the weight. Thus, the larger node weights get the most adjustment. The amount of the error of each node is based on the partial derivative of the error with respect to the node’s output. This will have the effect of adjusting the weights between the individual nodes locally based on the global error E of the system. The change (delta) in the weight is further adjusted by the use of a factor called the learning coefficient. The learning coefficient affects the rate at which the BP method converges on the configuration of network weights that is the optimum for minimizing the global error. In summary, the gradient descent method is based on making adjustments in each dimension (determined by the number of input variables) in a direction (partial derivative) that will minimize the global error. The size of the adjustment is based on the learning coefficient.
In three dimensions, it is analogous to being on a terrain and moving in the x, y and z directions that moves to the global minimum point. The learning coefficient is the size of the steps taken. Note that if the size of the steps is too large, the global minimum may be overstepped. The actual construction of NN is, as the case with the MDA technique, quite complex. The interested reader should consult references provided at the end of the chapter for the mathematical model itself.

Several of the authors trained a NN using only airline data. Two separate studies were conducted on the air carriers using the NN. Inputting 21 pieces of financial information from carrier balance sheets and income statements, a NN was specified for the major US airlines (Davalos, Gritta and Chow 1999). In a second study, a NN was trained to identify bankrupt/stressed smaller carriers, known as large and medium regional airlines (Gritta, Davalos, Chow and Huang 2002). The first study successfully classified all the major carriers that filed for receivership. The second study achieved an overall success rate of 88% in predicting stress for the smaller airlines. The network classified 77% of the total sample accurately. Two types of error are present: Type I and Type II. A Type I error occurs when a bankrupt carrier is incorrectly classified as solvent. A Type II error results when a non-bankrupt carrier is classified as failed. Of the total 15 errors, 7 were Type I and 8 were Type II. Thus, the successful classification rate for each group of carriers was:

| Number Correct | 50 | 77%  |
| Number of Type I Errors | 7 | 11% |
| Number of Type II Errors | 8 | 12% |
| Total in Sample | 65 | 100% |

As indicated, the overall success rate of the model was 77% (50/65). More importantly, the success rate of predicting bankruptcy or distress was 89% (or 100% – 11%, the failure rate) and that of solvency 88%. The use of NNs thus provides an interesting supplement to the analyst in appraising financial health.

Industry Specific Models: (6) Genetic Algorithms

Whereas NNs have been used successfully to classify organizations in terms of solvency, they are limited in degree of generalization either by requiring linearly separable variables, lack of knowledge of how a conclusion is reached, or lack of a consistent approach for dealing with local optimal solution whether maximum or minimum. Because of this, the authors decided to try an even newer approach to the problem-- a genetic algorithm (GA). A
GA has the ability of the NN method to deal with linearly inseparable variables and incomplete, noisy data; but at the same time, it resolves the problem of falling into a local optimum in searching the problem space.

The concept behind the GA is not new. It is based on the survival of the fittest and evolution. Starting with members of a candidate population of solutions, this population is evolved to the best set of solutions in an evolutionary manner. GAs are stochastic, global search techniques that can search large, complicated spaces (Goldberg 1989). It was thus decided to apply a GA to airline data, focusing on ratios that assess liquidity, leverage, activity and profitability (Davalos, Gritta, Goodfriend and Adrangi 2005). The steps in the design of the genetic algorithm are as follows:

1. A population of candidate solutions is randomly generated.
2. Members of this population are then evaluated for fitness based on a fitness function. The fitness function is used to determine how well the solution performs. The fitness function cannot be derived automatically but must be developed based on the judgment of the developer.
3. Once all members of the current population have been evaluated, the next step is to remove members from the population and introduce new members. The weakest performing members are removed. The number removed depends on how many are in the population, but this number removed must be consistent.
4. New members of the population are generated based on reproduction and mutation. Through reproduction, a potentially better performing offspring is produced. Through mutation, new members are introduced that have the potential of introducing a solution that would not have been derived through the reproduction method because mutations are random.
5. The new population then goes through steps 2-4 until a predetermined level of fitness is reached or enough iterations have been conducted without any improvement.

The fitness function evaluates the quality of each rule (individual). The fitness function is based on the following four types of result that can occur for a prediction:

- true positive (tp) - the rule predicts that the firm is financially insolvent and it is.
- false positive (fp) – the rule predicts that the firm is financially insolvent and it is not.
- true negative (tn) - the rule predicts that the firm is financially solvent and it is;
- false negative (fn) - the rule predicts that that the firm is financially solvent and it is not.
The fitness function utilized combines two indicators commonly used in statistical analysis, namely the sensitivity ($Se$) and the specificity ($Sp$), defined as follows:

\[
Se = \frac{tp}{tp + fn} \quad (1)
\]

\[
Sp = \frac{tn}{tn + fp} \quad (2)
\]

Finally, the fitness function used by our system is defined as the product of these two indicators, i.e.:

\[
fitness = Se \times Sp \quad (3)
\]

The goal is to maximize both the $Se$ and the $Sp$ at the same time, and the product shown in equation (3) provides a good gradient for the function.

Twenty-one financial variables from the carrier income statements and balance sheets were first collected for the data set. Seven ratios were used based on the three types of financial ratio that measure liquidity, profitability, operating efficiency and financial leverage. The seven were: A liquidity measure- current liabilities to total assets (CLIAB/TA); a profitability measure- retained earnings to total assets (REARN/TA); an efficiency ratio- operating expenses to revenue (OE/REV); another profitability ratio- profit to operating expenses (PROFIT/OE); a financial leverage measure-total liabilities to total assets (TLIAB/TA); another liquidity measure- current assets to total assets (CA/TA); and lastly, another liquidity measure-current assets to operating revenue (CA/REV). These ratios where then calculated for each data point. A string of the following form was used:

\[
\text{String(Var1, Var2, ... VarN, Op1, Op2, ..., OpN, X1, X2, ..., XN}).
\]

This string represented a rule that compared each of the selected variables given by Var1 using the relational operator Op against the variable value, X. The particular variable used could be randomly selected. Rules were limited to only four of the seven ratios. Rules could take on the following form:

\[
\text{If Var1 > X1, And Var2 < X2, ... And VarN > XN}
\]

then the prediction would be Solvency.(specific operators were used to better illustrate the format).

A training set was used to train the GA and then a test set was used to evaluate the outcome. Several iterations were conducted to examine variations in performance. The average prediction accuracy was 91%. The result of the most successful GA is a rule that can then be applied to the ratios to determine a firm’s solvency. The table below depicts the results of a run.
with 94% accuracy. All seven ratios were used in this run: CLIAB/TA, REARN/TA, OE/REV, PROFIT/OE, TLIAB/TASSET, CA/TA, CA/REV. The data row references the ratio used. The operators are either 1 or 2 with a 1 for “<” and a 2 for “>”.

In the example below there are five rules.

Rule 1 is as follows: If CA/TA < 0.22 THEN TRUE; IF NOT THEN FALSE
Rule 2 is If CA/TA < 0.189 THEN TRUE ELSE FALSE.
Rule 3 is If CA/REV < 0.239 THEN TRUE ELSE FALSE
Rule 4 is If EXP/SALES < 0.996 THEN TRUE ELSE FALSE
Rule 5 is If TLIAB/TA < 0.603 THEN TRUE ELSE FALSE

<table>
<thead>
<tr>
<th>CLIAB/TA</th>
<th>REARN/TA</th>
<th>OE/REV</th>
<th>PROFIT/OE</th>
<th>TLIAB/TASSET</th>
<th>CA/TA</th>
<th>CA/REV</th>
<th>Rule #</th>
<th>Value Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>data</td>
<td>6</td>
<td>6</td>
<td>7</td>
<td>3</td>
<td>5</td>
<td></td>
<td></td>
<td>1 - 7 [INT]</td>
</tr>
<tr>
<td>operator</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td></td>
<td></td>
<td>1 - 2 [INT]</td>
</tr>
<tr>
<td>Cut-off</td>
<td>0.322</td>
<td>0.189</td>
<td>0.239</td>
<td>0.996</td>
<td>0.603</td>
<td></td>
<td>0 - 1</td>
<td></td>
</tr>
</tbody>
</table>

For a company to be predicted as financially solvent, all five rules have to be true.

Industry Specific Models: (7) The Gudmundsson Model
(An International Model)

Although financial variables are obviously important to the prediction process, Gudmundsson argued that other non-financial variables might also play a role, especially when forecasting multi-country failure (Gudmundsson 2002). Like Pilarski, he also felt that logistic regression analysis (LRA) provides a better forecast than MDA. Gudmundsson specified the following model:

\[ Z = B_0 + B_1X_1 + B_2X_2 + B_3X_3 + B_4X_4 + \ldots \ldots B_nX_n \]

and:

\[ P = 1/[1+e^{-Z}] \]
As in the case of the Pilarski Model, $P$ is the probability of bankruptcy. The independent variables in the regression are as follows:

$X_1 =$ load factor (i.e. the percent of the aircraft filled)  
$X_2 =$ number of passengers per departure  
$X_3 =$ number of hours flown per pilot  
$X_4 =$ number of departures per aircraft  
$X_5 =$ number of pilots per aircraft  
$X_6 =$ number of employees per aircraft  
$X_7 =$ average age of aircraft fleet  
$X_8 =$ annual inflation rate in the carrier’s home economy  
$X_9 =$ number of different brands of aircraft operated  
$X_{10} =$ political influence (a dummy variable: yes=1; no=0)

The dataset used by Gudmundsson consisted of ratios, as well as continuous and nominal variables collected over a 3-year period (1996-1998) for 41 commercial airlines worldwide. (Data were collected from the Air Transport World’s Airline Report, IATA World Airline Statistics and ICAO Annual Digest of Statistics.). Although not all the variables that entered the model were statistically significant, the overall accuracy rate of his model was 90.2%.

Industry Specific Models: (8) Fuzzy Logic Model (An International Model)

Several researchers have utilized yet another approach to forecasting air carrier insolvency. Silva, Santo and Portugal (2005) employed a multivariate technique called Hybrid Financial Statement Analysis (HFSAT) to test several American and Brazilian carriers’ financial conditions and to profile the risk of bankruptcy. HFSAT is the result of a discriminant analysis multiple-variable model and the application of Fuzzy Logic to a firm’s financial data.270

Discriminate analysis, as noted above, is a statistical tool used to classify a certain element in a determining group over the existent groups ($G_1, G_2... G_n$). This requires that the element to be classified really belongs to one of

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270 Silva, Santo and Portugal (2005) argue that the HFSAT application has the following advantages: It can classify a firm’s financial condition using a consistent theoretical base; it frees the analyst from the slow process of investigating a company’s financial structure by means of a large set of indexes; it is a functional and easily implemented algorithm; its quantitative and qualitative measures are intuitive to the analyst; and it can be used to compare companies in different markets, because the source data includes all the same classification criteria.
the groups and that the characteristics of the elements of the two groups are known, so that comparisons among the characteristics of the elements of the several groups can be made. Those characteristics are specified starting from a group of aleatory variables \( n (X_1, \ldots, X_n) \) (Silva 1983). According to Hair et al. (1995), the discriminant method is particularly useful in those situations where the total sample can be divided into groups based on the dependent variable, characterizing well-known classes. Those classes can be represented by dicotomic or multicotomics variables (e.g., male-female, high-medium-low, etc.). The discriminant model can then be combined with Fuzzy Logic as a base. Fuzzy Logic consists of modeling the human thought structure for the problems resolution and decision making by means of mathematical instruments. Those instruments derive from the set theory, algebra, and so on, and they can be represented by discrete models or even by means of integrals (integral-fuzzy). Zadeh (1975) argues that one of the great advantages of Fuzzy Logic is to obtain, by means of the fuzzy set properties, the translation of linguistic terms used in the daily communications (natural language) in mathematical expressions. According to Ross (1995),

in classical, or crisp, sets the transition for an element in the universe between membership and non-membership in a given set is abrupt and well-defined (said to be ‘crisp’).

For an element in a universe that contains fuzzy sets, this transition can be gradual. Its transition among various degrees of membership can be thought of conforming to the fact that the boundaries of the fuzzy sets are vague and ambiguous. Hence, membership of an element from the universe in this set is measured by a function that attempts to describe vagueness and ambiguity. The fuzzy set representation can be given by means of discrete or continuous expressions as in the figure below.

Expression of Fuzzy Sets

Discrete expression (when the universe is finite): Let the universe \( X \) be

\[
X = \{x_1, x_2, \ldots, x_n\}
\]

Then, a fuzzy set \( A \) on \( X \) can be represented as follows:

\[
A = \frac{\mu_A(x_1)}{x_1} + \frac{\mu_A(x_2)}{x_2} + \ldots + \frac{\mu_A(x_n)}{x_n}
= \sum \frac{\mu_A(x_i)}{x_i}
\]

Continuous expression (when the universe is infinite): When the universe \( X \) is not infinite set, a fuzzy set \( A \) on \( X \) can be represented as follows:

\[
A = \int \frac{\mu_A(x_i)}{x_i}
\]

Source: An Introduction to Fuzzy Logic for Practical Applications (Tanaka 1997).
The steps required to specify the model include database structuring together with the calculation of an economic and financial index and the use of Fuzzy Logic. Silva, Santo and Portugal (2005) structured the database dividing the air carriers into three categories (healthy, high risk and insolvent). Twenty-nine ratios (measuring profitability, liquidity, etc.) were then selected and a ‘stepwise regression’ with a ‘forward and backward’ method was used to specify the discriminant function.\textsuperscript{271} The inputs were from the financial statements of airlines on file with the Brazilian Department of Civil Aviation and from carrier websites. The output of the multiple regression was Equation 1.

\[ Z = 2.637 - 0.879X_1 + 0.466X_2 - 0.268X_3 - 0.28X_4 \quad (1) \]

Where:

\begin{itemize}
\item $X_1 =$ Shareholder Funds by Total Assets ($\text{Equity} \div \text{Total Asset}$)
\item $X_2 =$ Liquidity ($\text{Current Liabilities} + \text{Long Term Liabilities} \div \text{Total Asset}$)
\item $X_3 =$ Net Operating Revenue by Total Assets ($\text{Net Op Revenue} \div \text{Total Asset}$)
\item $X_4 =$ Fixed Assets by Total Assets ($\text{Fixed Assets} \div \text{Total Asset}$)
\end{itemize}

Using the regression results, Silva, Santo and Portugal (2005) argued that there were five groups evident (based on $Z$ values). Firms were grouped follows: healthy, low risk, moderate risk, high risk and insolvent.\textsuperscript{272} Employing Tanaka’s approach (1997), the authors then applied a fuzzy logic model using the following equations.

\begin{table}[h]
\centering
\begin{tabular}{|c|c|}
\hline
\textbf{Classification} & \textbf{Limit of Z} \\
\hline
Healthy & $Z \leq 1.862$ \\
Low Risk & $1.862 \leq Z \leq 2.2$ \\
Moderate Risk & $2.2 \leq Z \leq 2.515$ \\
High Risk & $2.515 \leq Z \leq 2.73$ \\
Insolvent & $Z \geq 2.73$ \\
\hline
\end{tabular}
\end{table}

\textsuperscript{271} This method removes and adds variables to the regression model in order to identify the best set of predictor variables.

\textsuperscript{272} The categories were determined by the $Z$ values.
The output of these equations indicates the percentage identification with each category. If $\mu(G_1) = 1.0$ or 100%, then that carrier is clearly in the healthy range. A $\mu(G_2)$ in the midrange indicates moderate to high risk and a $\mu(G_3)$ at 1.0 or 100% indicates an insolvency profile. As a case study, Silva et al. applied the above approach to eight carriers: American, United, Southwest, LanChile, Varig, Vasp, TAM and Gol. The study encompassed three years of data, i.e. 2002-2004. The following chart shows most of the results for these carriers.

<table>
<thead>
<tr>
<th>Carrier</th>
<th>Year</th>
<th>Z</th>
<th>$\mu(G_1)$</th>
<th>$\mu(G_2)$</th>
<th>$\mu(G_3)$</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>American</td>
<td>2004</td>
<td>2.60</td>
<td>2%</td>
<td>91%</td>
<td>42%</td>
<td>High Risk</td>
</tr>
<tr>
<td></td>
<td>2003</td>
<td>2.62</td>
<td>2%</td>
<td>89%</td>
<td>43%</td>
<td>High Risk</td>
</tr>
<tr>
<td>Southwest</td>
<td>2004</td>
<td>1.84</td>
<td>100%</td>
<td>1%</td>
<td>0%</td>
<td>Healthy</td>
</tr>
<tr>
<td></td>
<td>2003</td>
<td>1.81</td>
<td>100%</td>
<td>0%</td>
<td>0%</td>
<td>Healthy</td>
</tr>
<tr>
<td>United</td>
<td>2004</td>
<td>3.08</td>
<td>0%</td>
<td>2%</td>
<td>99%</td>
<td>Insolvent</td>
</tr>
<tr>
<td></td>
<td>2003</td>
<td>2.93</td>
<td>0%</td>
<td>13%</td>
<td>89%</td>
<td>Insolvent</td>
</tr>
<tr>
<td>LanChile</td>
<td>2004</td>
<td>2.34</td>
<td>20%</td>
<td>69%</td>
<td>13%</td>
<td>Moderate Risk</td>
</tr>
<tr>
<td></td>
<td>2003</td>
<td>2.39</td>
<td>13%</td>
<td>84%</td>
<td>18%</td>
<td>Moderate Risk</td>
</tr>
<tr>
<td>GOL</td>
<td>2003</td>
<td>1.83</td>
<td>100%</td>
<td>0%</td>
<td>0%</td>
<td>Healthy</td>
</tr>
<tr>
<td>Varig</td>
<td>2003</td>
<td>5.80</td>
<td>0%</td>
<td>0%</td>
<td>100%</td>
<td>Insolvent</td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td>4.93</td>
<td>0%</td>
<td>0%</td>
<td>100%</td>
<td>Insolvent</td>
</tr>
<tr>
<td>Vasp</td>
<td>2003</td>
<td>2.69</td>
<td>1%</td>
<td>75%</td>
<td>55%</td>
<td>High Risk</td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td>2.69</td>
<td>1%</td>
<td>76%</td>
<td>55%</td>
<td>High Risk</td>
</tr>
<tr>
<td>TAM</td>
<td>2003</td>
<td>2.58</td>
<td>2%</td>
<td>98%</td>
<td>38%</td>
<td>High Risk</td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td>2.58</td>
<td>2%</td>
<td>97%</td>
<td>39%</td>
<td>High Risk</td>
</tr>
</tbody>
</table>

The authors’ results of the preliminary test were interesting and show promise for future research. The intent of several authors of this chapter is to collaborate on a study involving a much larger sample and an extended time horizon.

Conclusion

The purpose of this chapter was to detail the history of bankruptcy forecasting in the airline industry and to outline various models that can be of use to different interested groups, ranging from creditors, to stockholders, to governmental regulators, etc. With that goal in mind, the chapter has examined a range of different statistical techniques useful in forecasting airline bankruptcy and/or financial stress. Two of the models are generic or non-industry specific. The others are all industry specific, having been designed using only airline data. In addition, two of the models involved international carriers. Finally, it bears mentioning that the non-generic models can be used for many different industries, and researchers in different countries can design models using many or all of the above techniques to better understand the factors behind financial stress and the forecasting of the event in different country environments.

References


A Network Perspective on Bankruptcies, Mergers and Acquisitions

Jeanette Fors

Modern market economies are dynamic. Organizations are constantly changing and developing from internal as well as external forces. In business, we make strategic decisions, technological improvements, modifications in production capacity, mergers and acquisitions. Consequently, organizational change is an important research area.

However, the effects of these changes on other companies in the same organizational network are less readily recognized. According to business-to-business marketing research, actors are not isolated, but connected through technologies, knowledge, social relationships, administrative routines and other interdependencies. Every firm is directly and indirectly connected in relationships with others in such a way that it can be affected by changes within other organizations.

Some of the most important changes in organizations are bankruptcies, mergers and acquisitions, which are studied within multiple disciplines and from varying perspectives. For many years, researchers have been investigating different aspects of bankruptcies: reasons for bankruptcies, bankruptcy-related costs, reconstruction of firms, efficiency of the bankruptcy process, economic historical perspectives and managerial issues (for an overview, see Gratzer and Sjögren 1999, Bruhner 2004). Mergers and acquisitions, on the other hand, have been studied from the perspective of the merging companies: their organizational fit, company cultures, mergers and acquisitions as strategic change, the merger or acquisition process and arising synergies between companies (for an overview, see Anderson et al. 2003).

The aim of this chapter is to explore change one step beyond the company in question, placing bankruptcies, mergers and acquisitions in a wider context of business relationships and interconnected firms. In the first section, I will introduce relevant theories and definitions in the network perspective and explain business relationships, how relationships are connected in networks and how changes in one part of the network may spread and affect other parts. In the second section, I will give an illustrative example that describes the development of one company’s network context during the years of the Swedish dotcom crash. I think the dotcom crash is a good empirical
setting because the concentration of events such as bankruptcies, mergers and acquisitions is so high during this period.

Relationships, networks and spread of change

Business relationships and business networks

Business relationships have always existed, but it was not until the mid-1970s that relationships were deemed to warrant their own research studies. This shift of attention from single firms to relationships (dyads) as the smallest research entity originated to a large extent from The Industrial Marketing and Purchasing Group (the IMP Group), formed in 1976. The group’s interaction approach places business actors in a dynamic model of buyer-seller relationships, and emphasizes that buying and selling activities should be seen as episodes in complex and often long-term stable relationships between companies (Håkansson 1982).

According to the interaction approach, any relationship between two entities starts with one or a few single exchange activities. For example, a big provider of telecom equipment, Company A, might choose a new contractor of office supplies, Company B. They make an order of pens and paper for one of their offices. After several exchanges, the parties may begin to discover possibilities for deeper collaboration and therefore begin to think in a perspective of long-term devotion. Step by step, they begin to adapt to one another. Company B wants to use custom made order forms to reduce their handling time and Company A agrees to this for a future discount of 5%. Contact patterns and routines are created. Each firm forms expectations about its own and the other party’s role and responsibilities. From all these acting rules – the common arena where the concerned parties know where they stand in relation to each other – earlier fragmented interactions come together to form a relationship

A business relationship is created when acting rules based on mutual expectations emerge from several exchange activities.

Håkansson and Snehota (1995) summarize business relationships as being made up of interdependencies or a substance composed of three layers: (1) activity links, which include transactions and processes such as communication, adaptation and coordination; (2) resource ties, which attach knowledge, technology, material and other resource elements between the counterparts; and (3) actor bonds, which consist of personal relationships between indi-

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1 A dyad is any two-part constellation. The term is also applied to pairs of colors, persons, musical notes, and so on.
individuals from respective firms. Individuals develop a relational infrastructure of norms, trust, commitment and inter-firm knowledge.

Gradually, these interdependencies become *institutionalized*, which means that actors will have difficulty questioning them. This also makes it hard for a single firm to terminate a business relationship and establish a new one with another party. Rather, problems and obstacles are solved through step-by-step adaptation from each side of the dyad. Researchers have emphasized that business relationships change gradually and continuously in content, strength and nature through ongoing interaction between the involved parties. Actors adapt to each other through incremental and controllable steps, which makes the overall pattern of business-to-business markets rather stable (Anderson et al. 1994, Håkansson and Snehota 1995).

Because both parties engaged in the dyad are also involved in relationships with other than the focal\(^2\), every relationship is in fact a small part of a *structure* of relationships. Even the smallest company has a minimum web of direct relationships – for instance, with customers, suppliers, authorities, banks, landlords, accountants, and so on – and indirect relationships with the customer’s customer, the supplier’s supplier and other related parties without whom it would go out of business. In other words, every relationship is a component of a wider business network. An activity link is only a small part of a bigger aggregated activity pattern, a resource tie only a part of a wider cumulative resource constellation and an actor bond a piece of a whole web of actors. To describe this concept and as an extension of the interaction approach, the IMP Group developed the *network approach* (Håkansson and Snehota 1995).

A business network is a structure of inter-linked business relationships. According to this view, a network is in theory boundless – all relationships are directly or indirectly connected to each other. But this is hardly relevant in any practical sense. In the understanding of networks, we have to set limits. From an individual company’s point of view, the part of the network perceived as most relevant, and to which it is directly or indirectly connected forms the *context* for its business operations. The boundary of the network can be broadened by defining the *network horizon*, which refers to how extended an actor’s view of the network is (Figure 1). The network context and the network horizon must be seen as variable depending on the actor or relationship in focus (Anderson et al. 1994).

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\(^2\) The term focal is used to refer to the business relationship or company in focus of the study.
Radical change and network effects

There are situations where incremental changes and adaptations between firms are not enough, situations where the parties might consider ending or must end their relationships. There are also situations where actors must establish new relationships, either with actors already existing in the network or with actors entering the network.

Dissolution of business relationships and creation of new ones have been characterized as radical changes in the network structure (Halinen et al. 1999, p 785). When the relationship between Company A and Company B is terminated, the earlier network structure is deprived of one connection. Conversely, when Company A decides to be part of a new relationship, one connection is added to the earlier network structure. In both cases, the network is exposed to restructuring as opposed to incremental adaptation.

A radical change is a dissolution or a creation of a business relationship

During the 1980s and 1990s, radical change was mainly studied as creation of new relationships. In their 2002 review, however, Tähtinen and Halinen observed an increasing interest among researchers for studying dissolution of business relationships. The first article on such dissolution was published in 1980, but it was not until the mid-1990s that this theme achieved acclaim as
being a further aspect for understanding business relationships and business networks.

Because of the connectedness of relationships, one dissolution can lead to single actors being disconnected from others with whom they were indirectly connected. In many cases, this will create the need for adjustments in old relationships, formation of new relationships or dissolution of additional relationships. These various needs and actions can also come from one relationship being established in the network. Consequently, a change that occurs in one relationship can spread and affect other relationships as well (Håkansson and Snehota 1995). Changes that do not stay within the dyad have been labeled with different terms: connected change\(^3\) (Halinen et al. 1999), the network function (Håkansson and Snehota 1995), domino effects (Hertz 1993) and network effects (Dahlin, Fors, Havila and Thilén 2005).

A network effect is the effect that one radical change has on the surrounding business network.

Changes that appear in a dyad can create anxiety and speculations in the network. Actors begin to assess the way the changes will affect them and the future of their relationships. Whether a network effect starts or not is very much dependent on the network members’ interpretations and reactions to change. It is actors’ perceptions of a radical change that activate different needs and measures taken in other relationships. Despite this, and although the past decade has seen increased attention on radical change and researchers have pointed out the existence of network effects, we still don’t know exactly how radical changes affect other business relationships in the surrounding network.

Bankruptcies, mergers and acquisitions as critical events

To understand radical changes and network effects, Havila and Salmi (2000) find it important to look into the specific events that cause these changes. They argue that some events are critical, “…meaning that they lead to either disruption or establishment of relationships…” (Havila and Salmi, 2000, p 110). Thus, radical changes and consequently network effects are set in motion by a critical event, which releases tension among connected actors (Halinen et al. 1999, p 786).\(^4\)

Bankruptcies, mergers and acquisitions have been identified as potential critical events for a business relationship and the connected business network (Halinen et al. 1999, Havila and Salmi 2000, Havila and Salmi 2002). In the

\(^3\) As opposed to confined change, which stays within the dyad (Halinen et al. 1999).
\(^4\) The idea of critical events has been used in other contexts as well. For a review, see Havila and Salmi 2000, p 109.
case of a bankruptcy, one actor disappears from the network, always dissolving relationships to other firms. A bankruptcy is an alarming occurrence, especially when appearing in clusters in the same industry. Actors faced with a bankrupt partner will in many cases find a substitute and create a new relationship, but may also terminate the affected parts of its own business activities, leaving yet more relationships to dissolve. Even if a merger or an acquisition does not always encompass a radical change, similar patterns can often be observed.

A critical event is the happening that triggers radical change.\(^5\)

Three types of critical event can be distinguished depending on where they occur.\(^6\) (1) First, those events that appear within a company; critical events that involve, e.g., changes in a company’s organizational or marketing strategies, modifications in an organization’s internal structure, an organization’s sales of subsidiaries, a firm’s investments in a new business market or in the case of a bankruptcy as illustrated in Figure 2, which could well be the best example. When Company A, a big provider of telecom equipment, goes into bankruptcy, all connections to suppliers, customers and other parties disappear. For instance, both Company B, an office supplier, and Company C, a software supplier, are suddenly left with terminated customer contracts.

\[\text{Figure 2. A critical event (the exclamation mark) within a company. The event, in this case the bankruptcy of Company A, leaves the relationships with Company B and Company C (marked with crosses) broken.}\]

(2) Second, there are events that take place in the interaction between two companies, i.e. circumstances that result from mutual decisions or in any other way between two actors. Being an integral part of a business relation-

\(^5\) In a series of radical changes (e.g., a dissolution leading to another dissolution), only the first triggering event would be the critical one. However, there is always a difficulty in determining what really caused a radical change and how far back to look. See more on this below.

\(^6\) According to Halinen et al. (1999), there are two types of critical events: those arising from a company’s business environment and those arising from interaction between two companies. However, I think it is important to also bring out the events taking place within an individual company.
ship must involve making many choices together, even if only one of the parties initiates the topic under discussion. A common decision between two companies, such as a joint venture, may turn out to be unsuccessful and be detrimental to the future of the firms involved and their relationships. Mergers and acquisitions can be critical events in two cases: (a) when they lead to one party’s relationship being dissolved (as in Figure 3) (e.g., to remove redundant connections or cut costs); and (b) when they lead to new relationships being created (for instance, to satisfy arising needs). Example: Two providers of telecom equipment, Company A and Company B, which both have similar office suppliers, Company C and Company D, decide to merge. In the merger process, the parties can wish to reduce superfluous connections and therefore terminate one of their existing office supplier relationships.

![Figure 3](image)

Figure 3. A critical event (the exclamation mark) taking place between two companies. The event, in this case the merger between Company A and Company B, results in the dissolution of the relationship between Company B and Company D.

(3) Third, there are also events that occur in a company’s business environment or business network. Business actors repeatedly face external events, such as technological improvements, political and social developments, current economic issues or major changes in their business network, all of which are often beyond their control. Each individual company must develop and implement a policy to manage those external influences. An example of a critical event that takes place in the environment (as in Figure 4) is when a technological innovation makes a traditional product line obsolete. Company A, a manufacturer of switchboards, has one product line for small businesses, like company B. Technological innovations make it possible for telecom operators to offer the same functionality as a service, which makes the need of hardware equipment obsolete.
Establishing the cause of a radical change is not an easy task. Within any undoing of a business relationship or establishment of a new one, there are potentially thousands of factors that may or may not be a direct cause. How, then, can we decipher exactly which moment was the critical event? For instance, Company A may deal in importing livestock from Asia. It is discovered that imports of this nature are involved in many shipping accidents. A change in government results in banning such imports, dissolving Company A’s relationships with foreign farmers, local producers, slaughterhouses, feed suppliers, and so on. In this situation, then, is the critical event the change in legislation? Is it the shipping accidents? Is it Company A’s decision to expand to live imports? This sort of difficulty exists in a great number of relationship dissolutions and would of course apply to the establishment of new relationships.

Netquakes – earthquakes in business networks

A critical event should then be seen as the impulse that sets radical change in motion (Halinen et al. 1999, p 786). As already mentioned, we still know very little about how to exactly demonstrate the way these changes affect the connected business network. Earlier research has called attention to spread of change throughout the network, but it is only now that we have been able to develop tools to describe these changes. Dahlin, Fors, Havila and Thilenius (2005) use an earthquake as a metaphor for understanding the process that comes into force after the ending of a business relationship. The effects of a dissolution spread throughout (directly and indirectly) connected relationships in the same way as the released energy stretches from the epicenter to adjoining areas in an earthquake. The term netquake has been coined to describe this concept.

To understand the idea of netquakes, let us first take a quick look at earthquakes. Simplified, the earth is divided into different layers, of which
the topmost is the lithosphere. The lithosphere is divided into a number of plates, which are constantly moving in relation to each other, not unlike companies operating within any given industry. An earthquake occurs when the plates press towards each other, dive under one another or pull away from each other. While the plates move, they exert force both on themselves and on each other. “When the force is large enough, the crust is forced to break. When the break occurs, the stress is released as energy which moves through the earth in the form of waves, which we feel and call an earthquake.” (http://scign.jpl.nasa.gov/learn/eq1.htm, 2004-07-27) The point on the earth’s surface vertically above the spot of the origin of an earthquake is the epicenter (http://scign.jpl.nasa.gov/learn/glossary.htm, 2004-07-28).

The sequence of a netquake is similar to that of an earthquake. When there is too much stress involved between two parties in a business relationship, it must be released, similar to two plates exerting force on themselves and each other in an earthquake. In some cases this stress results in the termination of the relationship, which creates waves of uncertainty throughout the business network as actors begin to speculate on how they will be affected. The spreading effects that this generates can be described as a netquake, with the initial broken business relationship as the epicenter.7

A netquake is the wave of effects that starts if external parties react to a dissolved business relationship

The effects in a netquake can be measured with the Richter Scale and/or the Modified Mercalli Intensity Scale (both are used to measure earthquakes). Dahlin, Fors, Havila and Thilenius (2005) use the Netquake Intensity Scale, which is divided into four levels of observable effects: trembling, swaying, shaking and breaking effect. The higher the effects are in the network the stronger the netquake. The lower levels (1-2) depict the way the netquake is experienced by business actors and the higher levels (3-4) express effects on the network structure. Table 1 describes each level of observable effects in the Netquake Intensity Scale8.

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7 One of the effects in a netquake could be another dissolved relationship. In this case, only the first dissolution would be the epicenter of the netquake.

8 The levels on the Netquake Intensity Scale should not be seen at the dyadic level — a relationship itself cannot tremble, sway or shake (though it can break).
Levels | Effects on the business network | Observable effects
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1. Trembling | The ending of a business relationship in the network does not lead to any change, but is observed by others who are alerted by the dissolution. | - Increased flow of information
2. Swaying | The ending of a business relationship in the network leads to some changes, mostly in the form of adaptations in the ongoing business relationships. | - All connected relationships can adapt to the new situation within the existing network structure.
- No connected relationships are broken and no new relationships are created.
3. Shaking | The ending of a business relationship in the network leads to changes, both through adaptations in the ongoing business relationships and through changes in the network structure. | - Most connected relationships are affected.
- Some of the connected relationships adapt to the new situation within the existing network structure.
- Some of the connected relationships are broken and/or some new relationships are created.
4. Breaking | The ending of a business relationship in the network leads to changes, mostly through changes in the network structure. | - All connected relationships are affected.
- Few of the connected relationships adapt to the new situation within the existing network structure.
- Many of the connected relationships are broken and/or many new relationships are created.

Table 1. The Netquake Intensity Scale (adapted from Dahlin, Fors, Havila and Thilenius 2005, p 6).

Although the sequence of a netquake is similar to that of an earthquake, the effects in a netquake are quite different. Unlike an earthquake, netquakes can bring about positive or negative changes. A dissolution can, for instance, lead to the establishment of new relationships and positive adaptations in already existing relationships. For some actors, additional dissolutions in the surrounding network might even be encouraged, especially for fast-moving and innovative newcomers to competitive industries. This being the case, firms involved in a netquake at the same intensity level may experience this differently as either positive or negative.

The limits for each level in the Netquake Intensity Scale probably cannot be exactly determined. But more case studies will clarify a little more, e.g., how to draw the line between shaking and breaking network effects – proportionately how many relationships need to dissolve to become part of a breaking network effect? However, the concept can be seen and begin to be
used as an analytical tool for understanding spread of change in business networks. Figures 5a-5d illustrate the four network effects: trembling, swaying, shaking and breaking effect. In each case the black circle represents a company that has gone bankrupt, leaving two relationships in dissolution and creating two netquake epicenters (because these appear simultaneously they could be considered to be the same epicenter). In the figures, it is clear that the higher in the Netquake Intensity Scale, from trembling to breaking, the more relationships are affected and the greater the changes are in the network structure.

**Trembling effect**

*Figure 5a.* A trembling network effect with increased flow of information but without changes in the network structure.

**Swaying effect**

*Figure 5b.* A swaying network effect with increased flow of information and adapting relationships but without changes in the network structure.

**Shaking effect**

*Figure 5c.* A shaking network effect with some changes in the network structure, in the form of new relationships being formed and more relationships being dissolved.

**Breaking effect**

*Figure 5d.* A breaking network effect where all business relationships are affected and most changes are in the network structure.
The severity of the effects may be greater far away from the epicenter than close to it. The effects that strike the network depend, among other things, on how tightly connected the relationships are (Håkansson and Snehota 1995) and on the characteristics of the relationships regarding commitment, trust, norms and the nature of the exchanges taking place (Håkansson 1982). The effects of an earthquake can vary a great deal depending on the geological configuration of the earth’s outermost layer as well as the quality and construction of buildings. In the same way, the connected network can feel different degrees of the effects depending on the network’s structural ground and constructions of relationships (Dahlin, Fors, Havila and Thilenius 2005).

**Empirical setting**

**Background**

Therefore, it is apparent that there is a great domino or butterfly effect in all business networks. When changes occur in one part of the network, most business relationships are affected on some level. The purpose of this section is to illustrate, with real world examples, the complexities and dynamics of business networks and exemplify the network perspective: how we can understand and illustrate networks. This provides a basic approach in business network studies and shows how network change can be studied over time. The following example points to the fact that there are critical events leading to radical changes in the form of dissolved or established business relationships. However, the example does not demonstrate network effects, which can be included in the prolongation.

I will give a short historical introduction to the Swedish dotcom crash, as it is a good empirical setting because of its high concentration of bankruptcies, mergers and acquisitions. I will then move on to the specific case of Nocom AB, where I will demonstrate the inner circle of the network context closest to the focal company. As already mentioned, a network is in theory boundless – this text shows only the very closest relationships to the company under study.

The main source of information used to grasp events connected to Nocom is the company’s annual reports and press releases. An interview with the firm’s managing director (Skarin, 2005-10-20) and Nocom’s website (www.nocom.se, 2005-11-17) are used as complementary sources. Please keep in mind that the figures presented below are not to be seen as complete or precise, but as a well-founded approximation of Nocom’s relationships and events.
The Swedish dotcom crash

During the late twentieth century, many information technology (IT) companies were established on the Swedish market. Business actors, politicians and consumers had high expectations of IT and what it could accomplish, both in business and in everyday life. IT companies soon became important providers of a diverse range of products and services to a wide target group, establishing new relationships with customers and taking positions in already existing business networks. For many IT companies, growth was established through strategic mergers and acquisitions. Nevertheless, this period has been described in terms of an IT bubble with unsubstantial business concepts, untested business models, overrated companies and unsafe IT shares.

In 2000, the number of new IT companies had boomed, increasing from 2,670 start-ups in 1999 to 3,363, an increase of 26% (Sundell, 2005-06-17). At the same time, the anticipation of many analysts was realized: the IT-bubble burst. Positive expectations were interrupted by decline and disappointment. This “dotcom” crash can be linked to many bankruptcies, sales of subsidiaries, eliminations of unprofitable business sectors and additional mergers and acquisitions in the Swedish IT industry. Because of the nature of interconnected firms, this also implies that many business relationships with customers, suppliers and other counterparts dissolved, leaving existing networks in reformation.

Following the Swedish Standard Industrial Classification 2002, the Swedish IT industry is described as being composed of companies operating with ‘computer and related activities’ (Statistics Sweden 2004). This definition includes, e.g., hardware and software consultants as well as data processing and database companies. However, it does not include manufacturers and retailers, which could also be argued to have important roles within the industry. Given this classification, the number of bankruptcies increased from 141 in the year 1999 to 205 in the year 2000 (an increase of 45%). The effects from the downturn in the whole industry continued to be evident in 2001, when the number of bankruptcies rose to 337 (an increase of 64% since 2000 and 139% since 1999) (Sundell, 2005-06-17). Unfortunately, corresponding statistics for mergers, acquisitions and sales of subsidiaries are not available because of the complexity of registration of such events (Andersson, 2005-07-01). But there is no reason to believe that the number of mergers, acquisitions and sales of subsidiaries have not also increased following the same patterns as bankruptcies.

It is clear, then, that the Swedish IT industry suffered from the dotcom crash at the turn of the century. It is true that many IT companies were established and that many new relationships were generated, but at the same time many companies were involved in events such as bankruptcies, which means that many relationships also came to an end. The Swedish dotcom crash is an ideal example of critical events appearing in clusters or waves within a very
short period. The sheer magnitude of critical events and potential critical events concentrated to the same industry and period allowed for speculations and uncertainty among industry members, which created anxiety and may have set domino effects in motion. The complexity of the industry and the number of firms that were both established and wound up make the Swedish IT industry and the Swedish dotcom crash a particularly good empirical setting for studying spread of change in business networks. There is reason to regard this specific period – from the late 1990s to the early part of this century – as a critical phase for many relationships and surrounding business networks.

Illustrative example of the empirical setting – Nocom AB

Nocom was established in 1985 with a focus on value-added software distribution. In the early years, the company’s strength lay in identifying innovative software and concepts and introducing them to the Nordic market. All distribution activities were gathered within the affiliated company Nocom Software, which was oriented only towards resellers and partners. Nocom had no business directly with end customers in software but did, through the affiliated service company Nocom Professional Services, provide customers with support, training and updates (Figure 6).

In 1999, a new phase began at Nocom. The company’s B-shares were noted on the Stockholm Stock Exchange’s O-list at the same time as the IT market was growing at an explosive rate with, to all appearances, endless business opportunities. Growth became the new motto for the whole industry. As a result of this market development, Nocom made the decision to broaden existing offers as well as to alter the existing business strategy by intensifying its relationships with end customers and to a much greater extent start selling directly to them. To bring about these changes, a new expansion strategy was built based on recruiting customers primarily through strategic acquisitions.

Figure 6 shows the first acquisition of the operating service company Bizit AB in 1999 with customers such as Interjet, ASG, Sifo, Telia, Infomedia and Volkswagen, which were all added to Nocom’s customer database. Through this event Nocom also gained two very important partners: Europolitan (presently Vodafone) and Ericsson. In addition, Nocom planned to acquire the IT consulting firm Interactive-TM AB and the industrial marketing communication company Hera AB along with its subsidiary ECMM.
In 1999, Nocom acquired Bizit AB to broaden existing offers and to increase the customer database. Nocom also planned to acquire Interactive-TM AB and Hera AB along with its subsidiary company ECMM.

In the Swedish dotcom crash, Nocom experienced a downturn because of inflated valuations that caused a sharp fall in share value (from ~100 SEK in March 2000 to ~8 SEK in December 2000). In the meantime, Nocom continued to grow, both organically and through strategic acquisitions. By the end of 2000, the number of employees had increased from 146 in 1999 to 241. Nocom had representations in nine countries, and as Figure 7 shows, 12 separate businesses. Through seven additional acquisitions, Nocom’s market offer had been broadened to include not only software but also customer support and IT consulting (Cyberink, Interactive-TM and Bizit Integration), operating services (Nocom.net, former Bizit), industrial marketing communication (Hera and ECMM), e-logistics (Tradevision) and mobile services.
(Mobile Relations and MCS). Nocom committed itself to further activities and achieved new expertise, partners and, above all, customer projects.

Thus, during this period, there were several critical events leading to the establishment of new business relationships. All these radical changes can probably be linked to additional effects in the network, especially because they appeared so closely in time. By pursuing this case study further, we could measure these network effects on the Netquake Intensity Scale.

Figure 7. In 2000, Nocom acquired Tradevision, Interactive-TM AB, Bizit Integration, Cyberink, 70% of MCS AB and Hera AB along with its subsidiary company ECMM. Nocom also planned to acquire the remaining 30% of MCS AB as well as Aero Hosting AB. As a joint venture with Europolitan, Nocom founded Mobile Relations.
Soon, a decision was taken to wind up most of the recently acquired companies and a new wave of radical changes began, but this time in the shape of dissolution of business relationships. The effects of the downturn that had occurred earlier in 2000 became evident. Nocom recorded a loss of approximately MSEK 65 in 2000 as the entire IT market started to collapse. Some contracts with customers were terminated in advance and overall Nocom had MSEK 9 in customer losses. This negative trend continued in 2001 when the major investments in expansion through acquisitions during 1999, 2000 and the beginning of 2001 resulted in increased difficulties in integrating new operations with Nocom’s core business. Many segments of the organization lost contact with the company’s core activities, despite the fact that this is where most of Nocom’s original resellers and customers can be found. Like many other IT companies, Nocom’s direction and offers became unclear, not only for employees, but for resellers, customers, suppliers and other counterparts. The situation was so serious that Nocom was now only weeks from bankruptcy.

Given this situation, it was necessary to act. Management was changed and an action program created with the aim of reversing the company’s negative profit trend, strengthen liquidity and optimize efficiency throughout the organization. A lot of effort was put into streamlining the company’s activities and strengthening the core operations to return the company to profitability. Restructuring measures were taken. All sales to resellers and partners were moved to an independent company, Nocom Partner Network (formerly Nocom Software AB) to emphasize the importance of all relationships to resellers and partners. Cost-saving measures were taken by reducing the number of staff in consultant operations in Gothenburg and Norway and closing segments of operations within Nocom Travelutions (a company that had been established by the acquisition of Aero Hosting and the remaining 30% of MCS the same year). The total number of employees decreased from 241 to 155, and by the end of 2001 some non-core operations had been either sold or put in liquidation. Hera, ECMM and Tradevision, which were contributory factors to Nocom’s growth, were sold (Figure 8).
Figure 8. In 2001, Nocom acquired Aero Hosting AB and the remaining 30% of MCS AB. Later the same year Nocom sold Hera AB, ECMM and Tradevision.

All of these changes were necessary for Nocom to recover. Nevertheless, they cost the company a great deal. During 2001, Nocom recorded a heavy loss of approximately MSEK 190, a record loss. Additional measures were required to rebuild profitability into the organization. Thus, Nocom launched a new action program in 2002, which meant winding up the entire IT consulting business, including all ongoing customer relationships.

The history of Nocom is a history of critical events and radical changes. First, the company decided to grow and establish new customer relationships through strategic acquisitions. Then, the situation was so intolerable that Nocom had to close down all new subsidiaries and terminate the relationships.
involved. Only then, after returning Nocom to its original core business – value-added software distribution only via resellers and partners – could the company achieve its highest sales in five years. This positive development is still progressing. And although strategic acquisitions and growth are still on the agenda, the organization has learnt from its earlier mistakes.

When Nocom had stabilized its profitability, it ended 2004 by announcing its bid to acquire TurnIT and IAR Systems (the latter owned to 75% by TurnIT). At the time of the bid (Figure 9), TurnIT was in the process of selling two subsidiaries, CityData and IAR Systems Jonkoping. The remaining activities were divided into two business areas: (1) a distribution area consisting of two firms, SweDeltaco and Network Innovation, both of which sell only through resellers and partners; and (2) a consulting and software area organized into four firms (the Arete Group) providing a variety of IT services directly to customers, and one firm (IAR Systems) distributing licensed and proprietary software.
In 2004, Nocom acquired Tempest A/S and announced its bid to acquire TurnIT and IAR Systems (which were owned to 75% by TurnIT). During the same period, TurnIT sold CityData and IAR Systems Jonkoping.
TurnIT and IAR Systems were acquired in March 2005. But there was one problem: the Arete Group of four firms. As I mentioned above, these firms were specialized in IT consulting services and had relationships directly with end customers. Owing to earlier backfall in connection with Nocom’s growth and alteration in existing business strategy, Nocom had learnt not to make that mistake again. Therefore, just 2 months after the acquisition of TurnIT and IAR Systems, Nocom wound up the Arete Group with all connected customers. Once again, we can witness a critical event leading to the dissolution of several customer relationships.

Concluding remarks
I hope that I have made the network perspective a little more vivid by this case. I have only shown the very closest relationships to the focal company, but the events in the network history of Nocom are diverse and very intense, making it an ideal company for deeper analysis, not only with regard to the dynamics within business networks but also in the extension on the effects on business networks from specific critical events. By illustrating and capturing network structures over time in the way presented in this section, we will in the future reach a more profound understanding of how changes in the network spread depending on actors’ perceptions and reactions. It is evident that business relationships between organizations are complex and interconnected and that the network perspective must be considered when faced with major changes. Changes to organizational structure and position within the market place should be considered to affect not only the company in question but also most associated companies.

Discussion
Business networks exist within all sectors of all industries. Already in the first phase of its existence, every company establishes interconnections with suppliers, resellers, customers, and so on – interconnections that continue to rise and fall throughout all changes that the company undergoes, not the least in the case of bankruptcies, mergers and acquisitions. The work already done by researchers, such as Gratzer and Sjögren (1999) and those mentioned in the review by Anderson et al. (2003) have shown great interest in several aspects of bankruptcies, mergers and acquisitions.

However, to comprehend properly the ways in which single organizations suffer, benefit or react in these situations, the network perspective must be considered. Bankruptcies, mergers and acquisitions should be seen as critical events or potential critical events that can lead to major changes in the surrounding network. Understanding this perspective could realistically save
companies and their connected partners’ time, money and other valuable resources.

To maximize the potential for growth and minimize the risk of collapse, it is vital to understand and anticipate disruptions to and changes within evolving, developing industries. Because all companies are connected and can be affected by changes in the surrounding network, there is a need for every individual firm to take precautions, develop plans and consciously make choices about how to manage a nearby critical event. Spread of change can be prevented or promoted by directly affected firms as well as by connected firms. The actions taken to deal with changes in the surrounding network are a central part of a company’s business strategy. In fact, as an extension to this reasoning, “strategy” could even be defined as a firm’s conscious effort to direct its resources and relationships to the environment. Therefore, the reaction of each organization forms part of what should be a stringently monitored change management undertaking, ensuring that the outcome of the interconnected change can be encouraged to envelope positive restructure. The reaction of a firm to particular external occurrences can have a great impact, positively or negatively, on the future of the firm.

It is clear that without a proper understanding of the way the changes are being managed and planned for, companies are unable to use them to their strategic benefit and thus set themselves up for potential negative change. Organizations should invest a portion of their resources in effective bankruptcy, merger and acquisition management, whether or not they are directly or indirectly affected by it. Firms should have strategies in place and improve their understanding of the way business relationships are structured in order to manage these situations as well as possible.

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Part III
A comparative legal perspective
Economic Policies and Bankruptcy Institutions: Brazil in a Period of Transition from Colony to an Independent Nation

*M. Teresa Ribeiro de Oliveira*¹

Changes in Brazilian bankruptcy law introduced in 2004 that provide better conditions for the recovery of indebted firms have been seen as a major step towards modernization of Brazilian legislation. The new law reflects greater concern in economic policy with growth and employment as opposed to the safeguarding of the rights of creditor. This kind of trend is not new in Brazilian history. It could be seen in the colonial period as part of a package of incentives offered by Portugal in order to promote economic activities in its colonies in accordance with the aims embodied in the mercantilism policies of that time.

On the basis of the definition of institutions provided by Douglass (1990, p 3) - “the rules of the game in a society, or more formally….the humanly designed constraints that shape human interaction” - the relevance of institutions in shaping Brazilian economic development in the nineteenth century has not been denied or ignored by economic historians. However, studies of the impacts of institutions have not followed the principles or methodologies suggested in more recent literature. The effects of institutions on economic growth have been mostly assumed and not duly investigated. Consequently, some spurious causal relationships have been established and become widely accepted. This has been the case, for instance, with one type of institution, the rules embodied in legal texts. On the one hand, such institutions are often used to explain developments that took place in the economy without sufficient investigation of their ability to account for the phenomena observed. On the other hand, the possibility that institutions of this kind may be the explanation for the course of certain events is frequently not considered at all. Even though there may be some exceptions, this reveals a certain lack of interest in the actual role played by legislation in shaping the developments observed. Laws have not been properly studied, leading economic historians either to ignore significant institutional changes or to misinterpret them.

¹ Papers published by the author before 1992 were signed M. Teresa R. O. Versiani
The study of the origins of Brazilian industrialization in the nineteenth century is a good example of this. Although the literature has emphasized the role of protective policies as responsible for attracting investments in industrial production, most of these studies are restricted to fiscal privileges: concession of financial subsidies, exemption or reduction of import tariffs on machinery and inputs, prohibitive import tariffs on similar products, etc. Such privileges, involving either the reduction of the costs of production for domestic firms or the enlargement of the demand for their products, would have given rise to more favorable forecasts regarding the profitability of the sector. Protection given to industry by means of other institutions, such as bankruptcy legislation, has been overlooked. Notwithstanding, prevailing bankruptcy regimes may have significant effects on economic performance, and changes in such regimes have been used from colonial times up to the present as one of the protective devices intended to direct investments towards specific sectors.

Any person or firm unable to pay their debts is insolvent. If their state of insolvency is legally recognized, they become bankrupt. Once acknowledged as bankrupt, the payment of their debts must be made according to bankruptcy laws and, when this is the case, they may become subject to legal penalties. According to legislation in force, losses from individual bankruptcies may be extended to firms as long as they are partially or entirely owned by bankrupt individuals. Thus, the bankruptcy of a firm may result from bad administration - fraudulent or not - from unfavorable business conditions or from individual bankruptcies of their owners.

The consequences of bankruptcies of firms are not restricted to the expulsion of inefficient firms from the market. Depending on the nature of the firm, its size and the characteristics of its production process, such consequences may spread at different rates of speed and to varying degrees of intensity to other firms and sectors. Considering that bankruptcy laws establish the legal limits of property rights of creditors and debtors, modifications of those laws and changes in those limits may have significant consequences for the performance of the economy as a whole.

Changes in bankruptcy laws have different effects not only among different firms but also among different agents involved directly or indirectly in the productive process of a firm. Legal measures protecting the property rights of the owners in relation to the assets of the firm certainly reduce their individual risks. Such a reduction in risks, all else being equal, will favor investments in these firms and, as far as labor is concerned, will provide a safeguard against unemployment in the case a firm becomes insolvent. However, another consideration is that, given such increased protection, the firm may face credit restrictions as creditors may see their property rights adversely affected. Therefore, the concession of privileged bankruptcy legislation for specific firms or sectors may serve as an efficient device for protec-
tion only if the adverse effects on credit restrictions do not counteract their protective effects.

The purpose of this chapter is to investigate the use of bankruptcy legislation as one of the instruments of economic policy used by the Government of D. João VI (1808-1821) by means of a thorough examination of the legal texts promulgated during this period. The assumption is that the bankruptcy legislation of D. João VI was part of a package of measures of economic policy taken with the primary purpose of increasing revenues collected by the government in order to deal with the increased costs of the Portuguese administration. This policy, stimulating investments in the production of commodities, such as gold and sugar, had long term effects on the development of the Brazilian economy in the nineteenth century, delaying the emergence of industry. It is not the purpose of this chapter to test such a correlation, as the data available would not be able to provide reliable results.

The period to be examined is particularly interesting in Brazilian economic history since it is a period of transition from a colonial government to an independent one. In fact, as far as Latin American countries are concerned, the transfer of the Portuguese Court to Brazil in 1808 and the stay of D. João VI Brazil until 1821 created conditions for a unique experience of transition from colonial to independent status. Not only was the transition relatively peaceful, but at the same time it did not entail a drastic rupture of institutions. On the contrary, as pointed out by some authors, the government of D. João VI restricted itself to transplanting Portuguese institutions to Brazil. In fact, in relation to the administrative apparatus required by the Government in order to be able to exercise its functions from its new seat, this was copied from Lisbon without taking into consideration the peculiarities of the new place where the court was being established.

However, the impact of a great and highly diverse set of external factors demanded changes in the institutions. Such changes were introduced in the form of legislation suitable for the new role to be played by the colony under the new circumstances. New institutions were created and old ones modified in order to build an institutional structure compatible with a new economic and political situation. The new institutional arrangements, which were the result of exogenous factors, became the heritage of the independent government of D. Pedro I in 1822.

The study of the legislation on bankruptcy enforced by the government of D. João VI does not only allows the incorporation of a new variable into the study of economic development during this period but also reveals some of the purposes of the economic policy pursued. The aim of this chapter is not only to present the body of legislation on bankruptcy created or modified during the period but also to shed some light on the reasons behind such innovations. By doing so, it hopes to contribute to a general review of the nature and characteristics of D. João VI’s protectionist economic policy.
In terms of insolvency, D. João VI legislation followed the same pattern as of Portugal towards its colony. No general law on bankruptcy was promulgated until 1850, but protection to insolvent firms was provided to firms operating in specified sectors in order to stimulate investments in areas more likely to produce higher revenues for the government.

The examination of the legislation on bankruptcy enforced by the government of D. João VI does not only allow for the incorporation of a new variable into the study of economic development during this period but also reveals some of the purposes of the economic policy pursued. Thus, the aim of this chapter is not only to present the body of legislation on bankruptcy created or modified during this period but also to shed some light on the reasons behind such innovations. By doing so, it hopes to contribute to a general review of the nature and characteristics of D. João VI’s protectionist economic policy in Brazil.

The first section describes changes introduced into the Portuguese legislation on bankruptcy law before the arrival of D. João VI in Brazil with the purpose of stimulating investments in activities most capable of producing revenues for the metropolis, namely gold mining and sugar production. The increase in such protection of gold and sugar activities in the government of D. João VI is examined in the second section. The third section investigates the incentives provided for the formation of capital partnerships and presents the bankruptcy legislation for gold mining societies. The fourth section shows how bankruptcy laws were adjusted to deal with the joint stock companies authorized to be founded during this period. The conclusions are presented in the last section.

Bankruptcy laws in Colonial Brazil prior to the transfer of the Portuguese Court to Brazil: privileges for miners and sugar producers

In the colonial period, Portuguese laws were enforced in Brazil: the Ordenações Manuelinas, from 1521 to 1603, and the Ordenações Filipinas, thereafter. As for bankruptcy, this legislation did not establish a clear distinction between insolvent individuals and insolvent firms and did not show any special concern in setting conditions for their rehabilitation.

The Alvará of November 13, 1756, enacted by the Marquis of Pombal a year after the Lisbon Earthquake, has been considered by some jurists to be a landmark in the history of Brazilian legislation on bankruptcy by introducing “very original and authentic proceedings in commercial courts restricted to merchants, traders or business men”, as mentioned by Ferreira (1955, p 20).2

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2 *Alvará* was a royal decision that, at least in principle, was temporary in nature.
This Alvará had the purpose of rehabilitating credit in the Lisbon market, which had been chaotic since the earthquake of November 1 that resulted in a great number of bankruptcies and encouraged fraudulent actions on the part of debtors.3

As a first step, the bankrupt was to present himself at the Commercial Court. On the same day or, latest, on the following day, he was supposed to pay his debts according to the contracts. He also had to declare all of his assets, present his books with all entries chronologically registered, declare under oath the causes of his insolvency and hand over the keys to his enterprise. After that, an inventory was to be made of all of his assets that would be deposited in Court and entrusted to a businessman officially nominated as depositary. Then, news of the bankruptcy was to be duly published so that all those interested could appear. Once this first stage was concluded, a lawsuit was to be filed. If the bankrupt was considered guilty, he would be put in jail and subsequently subjected to trial. Finally, all of the bankrupt’s assets were to be publicly auctioned. Of the liquid proceeds from such an auction, 10% was to be put aside for maintenance expenses for the bankrupt and his family, in the event that the bankruptcy process was not deemed fraudulent. The remaining liquid proceeds were to be distributed among the creditors.

Despite the general bankruptcy legislation in force, new legal texts were issued from time to time granting special privileges to some specific sectors that the government wished to protect and stimulate. In fact, as early as 1618, all of the mining enterprises in the capitanias of São Paulo and S. Vicente were exempted from impoundment and execution, regardless of their size (Alvará of August 8, 1618,§3). Such a privilege was part of a set of incentives for promoting the discovery of new gold deposits in the region. In the 1750s when, after reaching its peak, gold production started to decrease, this privilege was extended to all miners with more than 30 slaves (Decree of February 19, 1752 and Resolution of June 22, 1758).

A significant reduction in the revenues collected by the Portuguese government, resulting from the decrease in gold production in the second half of the eighteenth century as well as from increasing tax evasion, led the Portuguese government to intensify its protection to gold miners. As the decline in gold production was seen as a result of the exhaustion of deposits that could be explored at low cost, the government began stimulating the organization of capital partnerships. Such partnerships were expected to be able to attract the amount of resources necessary for gold mining under the new circumstances.

The Alvará of May 13, 1803 introduced a new regulation for the organization and administration of diamond and gold mines in Brazil, with the purpose of increasing their production and eliminating tax evasion. This Alvará

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3 The main objectives of this Alvará are stated in its introduction. This Alvará provides a new version to be enforced from that point up to Title LXVI of the Ordenações Book V.
granted privileges to companies and capital partnerships but did not include any references to the bankruptcy regimes to be followed. According to the first paragraph of Article VI, preference should be given to companies and partnerships in the distribution of mineral lands that required more labor and diligence. And the following article prescribed that in the case of swollen rivers, work should be given to companies because “…for their work, much more larger expenses are necessary, superior to the faculties of only one individual…”

These capital partnerships and companies were to be incorporated on the initiative of the General Mining Intendant and supported by the Administrative Council of Mines and the Governor of the capitania. The shares of those companies and partnerships would be divided among the partners or shareholders according to the number of slaves they had provided. The expenses would be divided among all shareholders according to the number of shares they owned.⁴ Even though this Alvará did not involve any innovations in the bankruptcy legislation, it brought about strong incentives for the formation of companies and capital partnerships in gold mining. Once partnerships in the form of joint stock companies started to be founded, they required specific regulations on bankruptcy. Such regulations were provided through their statutes.

Special bankruptcy legislation in the colonial period was not restricted to gold mining. It was also extended to sugar producers. Through the Resolution of September 22, 1758 and the Provision of April 26, 1760, ownership of sugar mills and sugar farms in Rio de Janeiro was exempted from impoundment and execution for payment of debts, execution being restricted to the profits. In 1807, those benefits were extended to all Portuguese ultramarine dominions (Alvará of July 6, 1807).

In the case of the gold mining sector, it is reasonable to assume that this special legislation on bankruptcy encouraged investments, even though the available data does not allow for a quantitative measurement of such effects. The high degree of uncertainty associated with gold mining activities in this period was reduced by the legal guarantee that the assets of an enterprise would not be lost in the case of bad luck and consequent bankruptcy of the owners. As the capital value of the enterprise was restricted almost completely to the value of the slaves for whom there were alternative uses, it seems clear that potential investors welcomed such exemptions from pledges and execution. Since slaves, working or not, have to be clothed and fed, the costs of keeping an operative mine were quite negligible. Thus, as variable costs were relatively low, it is reasonable to believe that a miner at this time did not have to have recourse to loans for working capital. Therefore, it is

⁴ Alvará of May 13, 1803, Article VII, Paragraph 3. Of the 128 shares that would form the capital of the company, 2 shares were to go to the government and were not subject to the payment of expenses.
possible to conclude that any adverse effects on the credit side, if any, were minor ones.

The transfer of the Portuguese court to Brazil and the maintenance of protection for gold and sugar activities by means of special legislation on bankruptcy

Protection for gold and sugar production by means of special legislation on bankruptcy was maintained in the government of D. João VI (1808-1821). References in the literature to the economic policy pursued by the government of D. João VI (1808-1821) have emphasized incentives provided to industry. This emphasis is understandable, given that one of the first measures adopted by D. João VI after his arrival in Rio was to abrogate the prohibition related to the production of cloth in Brazil. Freedom given to industry and the opening of Brazilian ports to international trade on January 28, 1808 may have suggested a departure from previous mercantilist policies (Carta Régia January 28, 1808).

However, an analysis of the legislation makes it clear that the purposes of the economic policy were still predominantly mercantilist. Brazil, either as a colony or as part of the reign of Portugal, was expected to continue to produce primary commodities and to provide increased revenues for the royal treasury. The study of legislation during this period reveals those objectives and indicates the sectors that received more incentives: iron and gold mining, transport, colonization and banking. This section will examine such incentives in order to detect privileges related to special bankruptcy regimes in the case of gold mining and sugar production.

Reliable data on Brazilian exports during the colonial period are not yet available. However, even if estimates from contemporary sources diverge significantly in absolute values, they tend to coincide in terms of relative values. There is no doubt that gold and sugar were responsible for most of Brazilian exports during colonial times. However, by the first decade of the nineteenth century, mining production was in evident decline and sugar exports, even though in recovery, were far from the levels attained in the seventeenth century. Considering that the main source of revenues for the government were taxes on gold production and taxes levied on imports and exports, it is not surprising that, despite the growth of the domestic market and

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5 The Alvará of D. Maria I on January 5, 1785 prohibited the production of cloth in Brazil, except cloth for "use and dressing of slaves, for sacking and wrapping cloth and other similar uses." By the Alvará of April 28, 1809, everyone in Brasil and in other Portuguese domains became free to establish any kind of manufacturing in the country.

6 According to Simonsen (1937), these products would have been responsible for 88% of the exports in the colonial period.
all of the measures taken to tax it, mining and international trade were the main focus of government attention. Therefore, it is easy to understand why the government of D. João VI would try to reverse the process of decay in mining production and to provide incentives for sugar exports. This was done by providing direct privileges and incentives not only to these activities but also to activities connected with the construction of the infrastructure necessary for the transport of exportable goods.

Although protection given to all of these sectors took different forms, this chapter will restrict itself to the examination one of them: special bankruptcy regimes.

Special bankruptcy regimes for miners.

In 1813, miners who employed fewer than 30 slaves requested that privileges related to exemptions from impoundment and execution given to large-scale miners in the 1750s be extended to them. They claimed that without such benefits their businesses could hardly be sustained. The Alvará of November 17, 1813, in addition to complying with this request, established other dispositions to be followed in case of bankruptcies in gold mining businesses. In fact, this was the first piece of legislation to deal exclusively with the regulation of specific privileges granted to bankrupt gold miners and to show an explicit concern for the rights of their creditors. Among the justifications for the new legislation, it is not only the needs of the royal treasury that are once more invoked but also the need to reconcile privileges granted to gold miners with those of their creditors.

This Alvará contained four articles. The first one granted to all miners engaged in gold production and employing any number of slaves the privilege of not being subject to impoundment or execution “...either their mines, or their slaves, tools, instruments and other of their belongings”. Such privileges covered all kinds of debts, including not only those incurred before the ownership and exploration of mines but even debts for which buildings, slaves and tools were offered as guarantees. The following article makes it clear that such privileges would also include fiscal debts. The last two articles were concerned with the rights of creditors and show that the purpose of the legislation was not to protect individuals but to keep gold mines operating.

In fact, the third article stipulated that, in order to be reimbursed, creditors should look for other assets of the debtor that could be pledged and executed. Those assets should include one-third of the profits to the business. And the fourth article introduced the possibility for gold mining enterprises to be impounded and executed. Such enterprises would be liable to execution if their

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7 A reference to this appeal from small miners is in the introductory part of the Alvará of November 17, 1813.
value was equal to or lower than the debts of their owners. In this case, plots of land, slaves, tools and remaining belongings could be executed under the condition that the enterprise was neither destroyed nor bought by a single individual. If there were no bids at the auction, ownership of the enterprise would be transferred to the creditor, who could not dismantle it or divide it.

The requirements for impoundment and execution of a mining enterprise in this Alvará make it clear that the spirit of the legislation did not involve the protection of creditors in case of insolvency of miners but the establishment of certain rules to avoid a reduction in gold production. Any reduction in gold production would cause a significant decrease in the revenues collected. As mentioned in the introduction of the Alvará, one reason for its publication was the Regent Prince’s wish “to promote the increase of this important branch of the mining sector, which is the source of the prosperity of my States and of revenues for my Royal Crown”.

Questions about the real meaning of the expression “remaining belongings” used in the Alvará of 1813 led to another Alvará, namely the Alvará of July 8, 1819 that specified how exactly this term should be understood: houses of miners built on the lands of the mines they explored, repair shops, windmills, store houses for preparing and keeping food for slaves as well as the food kept in them, animals and anything else necessary for the mining work. Given that many gold miners were evading the payment of taxes on gold, the privileges of the 1813 Alvará were restricted in 1820 to those bankrupt miners who could prove with documents duly authenticated by the competent office that they had taken their production to places authorized to melt the gold and to extract the part due as taxes. In addition, creditors would be allowed to show that miners had failed to do so in order to be exempted from such privileges and forced to pay them.8

The fixed capital of a gold mining firm in the early nineteenth century was restricted to slaves that could have alternative employments. Therefore, the exemption of slaves from the rigors of general laws on bankruptcy, either because the undertaking turned out to be a failure or because the owners were in debt due to involvement in previous businesses, was certainly prone to function as an incentive for investment.

Special bankruptcy regimes for sugar cane producers.

Special bankruptcy privileges for sugar producers were also maintained and strengthened in the government of D. João VI. The Alvará enacted on January 21, 1809 responded to a demand from small sugar producers that privileges conceded to sugar producers of the Capitania of Rio de Janeiro in the 1750s should be extended to all producers. The Alvará of 1809 makes it clear that the main aim of the government was to create a legal apparatus that

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8 Alvará of September 28, 1820
would allow producers facing financial difficulties to remain in operation. In fact, the advantages for the economy, for the government and for future creditors of keeping those enterprises in operation are emphasized in the text:

in the present circumstances of great weakness in Commerce, it would be convenient to my service that the use of the mentioned privilege were more largely extended to the farmers able to keep their establishments at work for the general utility of the inhabitants of this State and in favor of the culture what conciliated with the interests of their creditors

In fact, this Alvará reaffirms the privileges of exemption from impoundment and execution for ownership of sugar mills and farms operating regularly and the limitations on possible execution to one-third of the yield of the enterprise. It also allows for the possibility of execution when the debt is equal to or greater than the value of the sugar cane farm or the sugar mill and establishes that the evaluation of the mills should take into consideration slaves, cattle, lands and tools. In this case, execution should follow rules prescribed by the law of June 20, 1774. However, this Alvará introduces an extra protection for the creditor. Referring to Paragraph 3 of the Alvará of 1807, it stipulates that in order to prove that debts have reached the value required for execution, the creditor may add other debts incurred by the debtor. However, in order to do so, certain procedures had to be followed by the creditor. The Alvará of January 21, 1814 made it clear that fiscal debts were included in the privileges granted to sugar cane and sugar producers.

The D. João VI incentives for the formation of capital partnerships and his bankruptcy legislation for gold mining societies

As discussed above, the Portuguese government had started to encourage the formation of capital partnerships for gold exploration even before the transfer of the Portuguese Court to Brazil. D. João VI pursued this same policy. In a Carta Régia to the governor of the Capitania of Minas Gerais on August 12, 1817, D. João VI stated that “the state of decadence of the works in the gold mines, each day more expensive, not only because most of the lands easy to be worked on have already been worked on, but mainly because miners do not have the necessary practical mining knowledge”. To allow for the introduction of new technology, he ordered that stock capital partnerships should be founded in Minas Gerais. The formation of those partnerships was to be the initiative of the Mining General Inspector or its representative and should take place under the authority of the General Governor of the capitania. The statutes to be adopted by those partnerships, signed by the Minister
and Secretary of States for the Reign Affairs, were attached to the Carta Ré-
gia.⁹

Even though the format for those partnerships, as suggested by the statues, were similar in many ways to the common format for joint stock companies, there is no explicit mention of the limitation on the liability of shareholders to the value of their shares, one of the main characteristics of joint stock companies. In addition, Article 2 stated that shareholders would not have any right to interfere with the partnership management. An interesting peculiarity of those societies was that the value of the shares was expressed in money and in number of slaves. According to Article II, each share would correspond to 400$ or to “three young and healthy slaves aged from 16 to 26 years.” Article V reaffirmed privileges granted by the Alvará of 1803 to those partnerships (their preferences in the distribution of any mineral lands to be discovered). According to Article IX, they would be able to use the services of mining masters who had been brought from Germany by the government. Government expenses for the partnership would be reimbursed from the profits corresponding to one or two shares, according to the size of the firm. A major indicator of the government’s keen interest in encouraging investments in gold mining is provided in Article XV, which grants a tax reduction on gold production from 20% to 10% 2 years after a firm begins operations and as long as it is proved that the right technology had been used. This Alvará may be seen as one of the first attempts from the Brazilian government to launch public and private partnerships.

According to Article XV of the statute, shares could be transferred by sale, inheritance impoundment, but the new owner would not be allowed to withdraw the money or the slaves. In the case of insolvency of one of the shareholders, slaves corresponding to his shares could not be sold for the payment of his debts. However, the ownership of those shares could go to his creditors, who would receive all corresponding dividends. Thus, the right of creditors to receive payment from their credits was differed to the future, and the value to be received became uncertain. It is also worth noting that inasmuch as they were established as joint stock companies, the specifics of such partnerships have to be taken into consideration. In a joint stock company, the liability of a shareholder is restricted to the value of his shares. Therefore, in principle, if the assets of a bankrupt shareholder were to be pledged and executed, this would involve a portion of the assets of the company corresponding to the value of his shares. In the case of gold mining and sugar farms and mills, such executions were already prohibited by the legislation in force. In other ventures that did not have such protection, the shares of bankrupt shareholders could be entrusted to a depositary and afterwards sold at public auction, reverting the proceeds from such a sale to the credi-

⁹ Estatutos para as sociedades das lavras das minas de ouro, que se hão de estabelecer na Capitania de Minas Geraes enclosed to the Carta Régia of August 12, 1817.
Considering the non-existence of a capital market, this could hardly be a solution.

Even though the liability of a shareholder was limited to the value of his shares, his property rights were not limited to his shares but included dividends distributed to shareholders. Could the property rights on those future dividends be credited to shareholders? No general legal solution was provided for this problem, leading companies to create their own rules regarding the matter. Those rules were included in their statutes and were, therefore, subject to the approval of the government. In fact, by then, any joint company in Brazil, in order to exist legally, had to be authorized to operate and have its statutes approved by the government. Thus, each company created its own bankruptcy regime.

The transfer of a share corresponds to a change in the ownership of part of the physical assets of a firm. If the shares could be pledged and executed, the continuation of the operations of a firm could be jeopardized. Therefore, to assure protection, joint stock companies introduced dispositions in their statutes giving their shareholders the privilege of exemption from execution of their shares.

Joint stock companies authorized by D. João VI

Joint stock companies certainly facilitate the aggregation of financial resources from the private sector, and they have been used by different governments from different countries in order to attract savings for investments that are considered to be a priority. To induce the private sector to invest in such undertakings and to make government projects feasible, different benefits and privileges are offered to investors. This has been the case in Brazil as well. The role played by joint stock companies in the enforcement of economic policies is not new. Trade companies created to operate in Brazil in the early colonial period certainly helped the Portuguese government achieve its mercantilist purposes.

In Brazil, authorization from the government was a necessary condition for incorporating any joint stock company until 1882, even though the need for such authorization was only regulated in 1849. The requirement for such approval created the basis for the establishment of public and private partnerships. On the one hand, the format of joint stock companies was in itself an attraction to individual savers, as it enhanced their possibilities for investments. On the other hand, the need for authorization provided the government with a means of attracting such savings for projects of its own interest. In fact, the acquiescence of the private sector to entering into these partnerships was often obtained thanks to different benefits granted to shareholders and to companies.
This section lists (Table 1) all of the joint stock companies authorized to be founded in the period and investigates the bankruptcy regimes adopted by them. At this point, it should be noted that despite the requirement of legal authorization, some companies were organized and started operating without such permission. Therefore, the list presented does not comprise all joint companies in operation.

As shown in Table 1, only seven joint stock companies were approved in legal documents in the period 1801-1821: three marine insurance companies, two gold mining companies, one bank and one fluvial transport company. How those companies protected themselves against the unfavorable effects of the legislation in the case of a future bankruptcy is investigated in the following sub-sections.

Table 1. Joint stock companies authorized by D. João VI (1808-1821)

<table>
<thead>
<tr>
<th>Years</th>
<th>Legal Document</th>
<th>Company name</th>
<th>Object of the company</th>
<th>Company’s headquarters</th>
</tr>
</thead>
<tbody>
<tr>
<td>1808</td>
<td>Decreto 24/02/1808</td>
<td>Cia de Seguros Boa Fé</td>
<td>Maritime insurance</td>
<td>City of Bahia</td>
</tr>
<tr>
<td>1808</td>
<td>Alvará 12/10/1808</td>
<td>Banco do Brazil</td>
<td>Deposit discount and issue</td>
<td>City of Rio de Janeiro</td>
</tr>
<tr>
<td>1808</td>
<td>Carta Régia 24/10/1808</td>
<td>Cia de Seguros Conceito Público</td>
<td>Maritime insurance</td>
<td>City of Bahia</td>
</tr>
<tr>
<td>1810</td>
<td>Decisão N.5 05/02/1810</td>
<td>Cia de Seguros Marítimos Inemnidade</td>
<td>Maritime insurance</td>
<td>City of Rio de Janeiro</td>
</tr>
<tr>
<td>1817</td>
<td>Carta Régia 16/01/1817</td>
<td>Cia de Mineração do Cuyabá</td>
<td>Gold Mining</td>
<td>Na</td>
</tr>
<tr>
<td>1819</td>
<td>Decisão N.55 15/12/1819</td>
<td>Sociedade de Agricultura Commercio e Navegação do Rio Doce</td>
<td>Fluvial transportation</td>
<td>Na</td>
</tr>
<tr>
<td>1821</td>
<td>Carta Régia 21/02/1821</td>
<td>Cia de Mineração dos Anicuns</td>
<td>Gold Mining</td>
<td>Na</td>
</tr>
</tbody>
</table>

Sources: legislation and companies’ statutes mentioned in the text

The maritime insurance companies

As shown in Table 1, only three joint stock maritime insurance companies were authorized to be founded in this period. The literature mentions seven insurance companies that were founded in the city of Rio de Janeiro during the government of D. João VI\(^\text{10}\). Either some of the extra four companies were not founded as joint stock companies or they were informally formed as such but did not receive government approval.

The provision of maritime insurance services, in high demand in an economy specialized in the production of commodities for export and based on

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African slave labor, could hardly be financed by one individual. Therefore, it is to be expected that those services were offered by firms founded as capital partnerships. In addition, given that such services were a response to pressing needs from export and import merchants, they did not require special privileges from the government to be founded.

As soon as D. João VI arrived in Bahia, he signed a decree (Decree of February 24, 1808) authorizing the formation of a maritime insurance company, the Companhia de Seguros Boa Fé. According to the text of the decree, the merchants of the city of Bahia had required such authorization. Article 4 of the statutes of this company, attached to the decree, characterizes this company as a joint stock company: “the shareholders’ liability does not go beyond the value of their shares.”

Insurance companies displayed, then, peculiar characteristics. They required very little investment in terms of physical assets, and their operational costs were relatively low. Therefore, the capital of the companies largely corresponded to the amount of financial resources available eventually needed for the payment of insurance premiums. As a consequence, shareholders joining the company were not required to pay for the entire value of their shares. This meant that a significant portion of the capital remained with the shareholders and out of the control of the management of the company.

Assuming that an insurance company was well managed and no liability beyond its ability to pay was assumed, temporary problems of liquidity were expected to be solved by the payment of unpaid shares. If some shareholders refused to do so and the firm went bankrupt, there were no firm assets to be executed, as the capital of a firm did not correspond to its physical assets. If the capital of a company was less than its debts, there was no way shareholders assets could be impounded and executed because, in a joint company, the liability of shareholders did not go beyond the value of their shares. In addition, impoundment and execution of shares belonging to an individual bankrupt shareholder would involve a complicated process whenever those shares had not been paid for. Thus, the basis of such companies was trust among shareholders. Consequently, it would be reasonable to expect that insurance capital partnerships, joint stock or not, were founded by a small group of individuals linked to each other by family, friendship or business ties, those ties being more important than the format of the association among them. In fact, this seems to have been the case.

Florentino (1997) calls attention to the great demand for insurance services resulting from the slave trade between Africa and Brazil. According to him, the insurance business in the city of Rio de Janeiro was mainly financed by slave traders.
partnerships were founded in the cities of Bahia and Rio de Janeiro to deal with insurance business. In the case of Companhia de Seguros Boa Fé, protection against bankruptcy granted to investors - in addition to the limitation on the liability of the shareholders to the amount of their shares given to investors in any joint stock company – involved severe penalties to be imposed on shareholders who refused to pay for their shares whenever they were asked. Its capital was fixed at 400 contos, and the statutes did not establish any deadlines for the payment of the shares to the company. This payment would only become mandatory when the amount of financial resources maintained by the company were not enough to cover the losses of those insured. In such a case, shareholders were to pay the amount required to cover the company’s debts (proportional to their holdings) within eight days. In case a shareholder refused to comply with his obligation, he would immediately be expelled from the company without any rights.

Another insurance company authorized by the Carta Régia of October 24, 1808 to be established in the city of Bahia was the Companhia de Seguros Conceito Público, also an enterprise of local traders.

The first joint stock maritime insurance company authorized to be founded in the city of Rio de Janeiro was the Companhia de Seguros. Such authorization was given in 1810. According to their statutes, each shareholder was immediately to pay an amount corresponding to 10% of his shares, the remaining amount to be paid whenever required by circumstances. The process of official approval of the statutes of this company reveals the government’s concern with the rights of creditors. According to a statement from the Junta do Commercio Agricultura, Fabricas e Navegação that supported D. JoãoVI’s decision, the statutes originally presented had to be modified in order to make all shareholders liable for the capital of the company in case some of them went bankrupt. The Junta emphasized that mutual trust among shareholders that allowed them to keep 90% of the value of the shares to be used for their own benefit should not be detrimental to those insured. Similarly, problems caused by insurance being taken out over and above the capital of the company should not be harmful to those insured. Accordingly, in the statutes approved, the liability of shareholders was “in

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14 Condições da Companhia de Seguros da cidade da Bahia, Article 2. These statutes were attached to the Decree of February 24, 1808.
15 Condições da Companhia, art. 11.
16 The statutes of this company have not yet been located.
17 N. 5 BRAZIL Resolução de consulta da Real Junta do Commercio, Agricultura, Fabricas e Navegação de 5 de fevereiro de 1810.
18 Although this capital partnership carried the name of the company, usually given to partnerships constituted as joint stocks, the liability of the shareholders was not limited to the value of the shares.
solidum’, not only in relation to the capital of their shares but also in relation to everything exposed to risks. 19 “The shareholder who did not accomplish with his obligations related to the payment of their shares would lose his right to past profits, would share the responsibility for losses brought to the company from adverse conditions and would be subject to the payment of interests” 20.

The Bank of Brazil

The transfer of the Portuguese court to Brazil made radical institutional monetary and fiscal reforms an imperative. The scarcity of currency in circulation increased with the intensification of international trade after the opening of Brazilian ports on January 28, 1808. A monetary reform was required in order to introduce liquidity to the economy so as to support the expansion of commercial activities. Increased administrative expenses in Brazil, as well as the financial difficulties faced by a metropolis at war, also required new sources for government financial resources. An examination of the legislation enacted during the period shows that an increase in the financial resources at the disposal of the Royal Treasury was in fact the main aim of D. João VI’s economic policy. Not only were a great variety of new taxes levied, but activities (e.g., mining) that were most able to generate public revenues were also stimulated. In this context, the establishment of a public bank in Brazil to provide financial resources for the Royal Treasury and to increase the circulation of money was seen as a measure of top priority to be taken by D. João VI’s government as soon as the Portuguese Court was installed in Rio de Janeiro. The Alvará of October 12, 1808 ordered the establishment of a public bank in the city of Rio de Janeiro.

Unable to finance such an undertaking, the Government was forced to turn to private investors, and this first public bank may be seen as the first example of a private and public partnership. 21 According to the statutes attached to the Alvará and signed by the Minister of Finance on October 8, 1808, the bank, named Banco do Brazil, would be founded as a joint stock

19 Condições da Companhia de Seguros – Indemnidade confirmadas por sua Alteza Real o Príncipe Regente Nosso Senhor, pela immediata Resolução de 5 de fevereiro de 1810, estabelecida nesta praça do Rio de Janeiro pelos negociantes abaixo declarados, attached to N. 5 BRAZIL Resolução de consulta da Real Junta do Commercio, Art.2
20 Condições da Companhia de Seguros– Indemnidade , Article 3
21 The creation of the Bank of Brazil, as a response not only to the demands of the government but also of those dealing with commerce, entailed a very significant institutional change that was to have critical direct and indirect effects in short and long term on future institutional arrangements as well as on development.
company. In fact, its capital would be divided into shares, where the liability of the shareholder would be limited to the value of each one’s shares. Although this joint company was to be established on the basis of private savings, the bank to be created was a public undertaking. Government interference in the creation of the bank was not limited to initiating its establishment and formulating its statutes. The statutes of the company created conditions for governmental interference in the administration and management of the bank, as well as limiting the rights of the shareholders.  

As far as bankruptcy is concerned, this company introduced a significant innovation. According to its statutes, “any impoundment or execution, either fiscal or civil on the bank’s shares was null and prohibited” No other clauses in the statutes mentioned any rights of creditors of bankrupt shareholders, in relation either to future dividends or to past profits. Notwithstanding this, the government had many difficulties in attracting private savings to constitute the capital of the bank. The legislation in this period, as well as some contemporary stories, reveals different kinds of pressure that were used to force people to subscribe to shares. Historians dealing with the creation of the first Banco do Brazil have described the most bizarre concessions and privileges offered to subscribers, but none of them mentions those related to a special bankruptcy regime. In fact, protection offered by the statutes was not enough to encourage private investors in the first years to be willing to allocate their savings to this government undertaking.

The gold mining companies: Companhia de Mineração do Cuyabá and Companhia de Mineração dos Anicuns.

Given that very few capital partnerships were legally established in the sector of gold mining, the bankruptcy legislation promulgated up until 1817 dealt exclusively with the properties of mining enterprises and did not mention what would happen with the shares of bankrupt shareholders. The founding of those companies generally adhered to the legislation on gold mining then in force that allowed for a great degree of government interference in its management in order to assure the collection of taxes from increased gold production.

The Companhia de Mineração do Cuyabá was the first joint stock gold mining company to have its statutes officially approved by the government. These statutes, sent by the Governor of the capitação of Matto Grosso for

22 Alvará of October 12, 1808.
23 Estatutos para o Banco Público estabelecido em virtude do Alvará de 12 de Outubro de 1808 attached to the Alvará of October 18, 1808, Articles IX to XIII. The first directors and members of the of the Bank Board were nominated by the Decree of January 24 1809.
24 Estatutos para o Banco Público estabelecido em virtude do Alvará de 12 de Outubro de 1808, Art. VI. Those statutes were signed by D. Fernando José de Portugal, appointed Minister of Finance by the decree of March 26, 1808.
royal approval on 31 May 31, 1814, were approved by the Carta Régia of January 16, 1817, 8 months before the new legislation regulating the establishment of capital partnerships to explore gold in Minas Gerais was enacted. The approval of such a document reveals not only the persistent interest of the government in the establishment of capital partnerships to explore gold mines but also in extending such explorations to areas outside the capitania of Minas Gerais. The reason for this interest was once more made explicit in the text: the possibility that those undertakings would increase revenues collected through taxation. In fact, in this document D. João VI refers to the “the advantages that such establishment may bring to my Royal Treasure”.

According to the statutes, the capital of the company was to be constituted on the basis of shares, each share corresponding to 100$ in currency to be paid at the time of subscription and two slaves dressed and equipped with tools to be handed over to the company as soon as mining operations had begun. The payments in currency would be used to finance preliminary operations necessary to prepare the mines for exploration.25

Since mining activities up to then were not established – at least officially – as capital partnerships, the legislation related to the consequences of bankruptcy in force was restricted to the properties and profits of the mining business. According to the legislation in force as provided by the Alvará of November 17, 1813 and July 8, 1819, mining enterprises could only be executed under very special circumstances, and the execution of profits was limited to one-third of the total.

The adoption of a joint company as a format for new capital partnerships in the sector introduced the possibility of increasing the protection provided to creditors of bankrupt miners. This protection was not provided by any general law but by the statutes of the company seeking government approval. That there was a significant interest in safeguarding the rights of creditors in the companies to be founded is easy to understand. Those companies were created to explore gold deposits to which access was more difficult and, thus, were expected to involve greater expenses. Not only would equipment would have to be imported, but the assistance of foreign technicians would also be needed. Such new operations would require a greater dependence on credit. Thus, the statutes of companies should not only provide incentives for a large number of individuals to invest in the new undertaking. They also had to safeguard the rights of the creditors.

In the case of the Companhia de Mineração do Cuyabá, its statutes increased protection of debtors and creditors. The statues of the Carta Régia of August 12, 1817 regulating the establishment of companies for the exploration of gold mines to be established in Minas Gerais included in Article XIV

25 Estatutos para o Governo da Companhia de Mineração do Cuyabá, attached to the Carta Régia of January 16, 1817
the possibility of impounding shares of the companies. In the case of the Companhia de Mineração do Cuyabá, this possibility was explicitly rejected: “The shares of this company are exempted of any fiscal or civil impoundment or from the Judge of Orphans, Deceased and Absents.” Despite the legislation in force that limited the possibility for execution of the gold mining profits to one-third, the statutes of the Companhia de Mineração do Cuyabá did not establish such a limit. However, as the company was to keep one-sixth of the profits owed to each subscriber on reserve, the appropriation limit per creditor was significantly decreased from one-third to one-sixth. In fact, according to Article X of the statutes, the shares of a debtor would not be transferred to creditors, but rather his debts would be paid by future dividends on his shares: “The creditors’ rights will be restricted to the profits coming from these shares, requiring them only when they are distributed to all shareholders”.

The Carta Régia of February 21, 1821 approved the statues of another gold mining joint stock company, the Companhia de Mineração dos Anicuns. This company came to replace a previously unsuccessful partnership that had been established with the purpose of exploring gold in this province but that went into bankruptcy. In his letter to the governor of the capitania giving his approval to the establishment of a new company, D. João VI complained about “the meager profits My Royal Finances have taken from the rich discovery of the Anicuns under the management of the previous partnership”.

The value of shares in the new company were to correspond to 12$ and one slave of an age between 16 to 35 years and without any disease, dressed and equipped with tools.

Even though legislation on privileges granted to gold miners in 1813 and 1819 did not take into account the specifics of societies established as capital partnerships, the statutes of these new companies extended to their shares the privileges of not being pledged and executed. In fact, according to Article 48 of the statutes, the shareholders, as far as their shares and respective profits were concerned, would have the privileges granted by the Alvarás of November 17, 1813 and July 8, 1819.

\[26\] Estatutos para as Sociedades das lavras das minas de ouro, que se hão de estabelecer na Capitania de Minas Geraes, attached to the Carta Régia, August 12,1817

\[27\] Estatutos para o Governo da Companhia de Mineração do Cuyabá, attached to the Carta Régia of January 16,1817, Article X.

\[28\] Alvará de 17 de Novembro de 1813, artigo 3

\[29\] Carta Regia of February 21, 1821

\[30\] Estatutos para a companhia de Mineração dos Anicuns na Província de Goyaz, attached to the Carta Régia of February 21, 1821
Sociedade de Agricultura Commercio and Navegação do Rio Doce

The government’s concern for promoting activities capable of producing higher public revenues, one of the outstanding characteristics of D. João VI’s economic policy, entailed not only granting privileges and concessions to sugar and gold producers. Taxes on imports were another significant source of income. In this context, the development of a transport system that created conditions for an intensification of import and export trade was certainly seen as an important goal to achieve. It is in this context that the great interest of the government in colonizing the northeastern regions of Minas Gerais and in opening roads from Minas to the ports of the capitania of Espírito Santo should be understood. On the one hand, those lands and rivers were expected to contain rich deposits of gold. On the other hand, the establishment of fluvial navigation on the river Rio Doce would allow access to the old gold regions of the central areas of Minas Gerais and to the potential gold areas of the northeastern areas to the seaports of the Espírito Santo capitania. Such possibilities may explain the government’s persistence in fighting the indigenous people who lived in the region and in promoting the colonization of the region. The policies implemented by the government were not successful. It was only in 1819 that a company - Sociedade Agricultura Commercio e Navegação do Rio Doce - was established with the purpose of promoting navigation in this river by offering transport and trade services.

In the process of obtaining governmental approval for the statutes, some modifications had to be made to the company’s proposal. One of these modifications was related to the article dealing with the vulnerability of the company’s shares to pledge and execution. According to the legal text that approved the company’s statutes, the payments of the shareholders to the company were not at all exempted from pledge and execution. On the contrary, legal procedures made it possible for the resources of the shareholders up to the value of their debts and in accordance with judicial decisions to be taken by creditors. Those resources could not be withdrawn from the company, but the subrogated creditors would have the right to receive the dividends whenever distributed and under the same conditions as other shareholders. The same procedure would apply to fiscal creditors.

Final Remarks and Conclusions

The study of legislation passed by D. João VI suggests that the development of a manufacturing sector in Brazil was not one of the major concerns of the Portuguese administration, as is often emphasized in the literature. Nor

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31 Carta Régia of May 13, 1808
should the opening of Brazilian ports to international trade be viewed as an abandonment of mercantilist policies. Freedom to trade and freedom to establish domestic manufacturers were more the result of difficulties faced by a metropolis occupied by Napoleonic troops than of a sudden adherence to the liberal ideas of Adam Smith. In fact, legislation during the period reveals constant interference by the government in the economy.

The investigation of legislation on bankruptcy enacted during the period confirms this point of view. This legislation was used as one device, among many others, to induce investment in activities capable of producing in a shorter period of time greater resources for the Royal Treasury. Activities of this kind were seen as those oriented to the supply of commodities (gold and sugar) in high demand in European markets. The acceptance of Smith’s theory of comparative advantages did not entail adherence to the classical principle of non-intervention by the state in the economy.

In this context, legislation on bankruptcy of sugar and gold mining establishments was intended to stimulate new investments. As long as such activities were not highly dependent on credit, legislation tended to provide greater protection to bankrupt producers in order to keep their enterprises in operation. In the case of mine producers, some regard to the rights of creditor was shown once the degree of insolvency of an enterprise became too high, indicating the possibility of a reduction in production. The legislation of 1813 granting such protection to creditors was introduced in a period when the production of gold began to require more sophisticated technology and became more dependent on credit.

Once capital partnerships began to be formed as joint stock companies and single individuals did not own the physical assets of an enterprise, changes had to be made to the rules applied in case the company, or some of their shareholders, became insolvent. Such changes were not made through special legislation for joint stock companies but through the statutes of these companies. Since the formation of companies was subject to official approval of their statutes, a channel for government interference was open.

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Sociedades de mineração, *Estatutos para as sociedades das lavras das minas de ouro, que se hão de estabelecer na Capitania de Minas Geraes* enclosed to Carta Régia of 12 August 1817.
During the course of the nineteenth and twentieth centuries, economic transformations, cultural change, and general institutional modifications had a massive impact on the structure and working of bankruptcy laws, procedures and enforcement mechanisms. Western countries witnessed the rise of industrialization, the separation between company ownership and control and attitude changes towards debts. In this changing environment, old bankruptcy laws, conceived to deal with pre-industrial economies and relatively undeveloped credit markets, appeared inadequate. Since the mid-nineteenth century, and earlier in Britain, bankruptcy legislation therefore passed through a process of rethinking and change. Despite similarities in the causes leading to the transformation of bankruptcy laws in various Western countries, at the end of the process England, France, Germany, Italy and the US had developed very dissimilar bankruptcy regimes. Two key dimensions of the legislation such as the balance of power between debtors and creditors and the attitude towards firm liquidation or survival, took very different forms.

At first glance, different legal traditions – common law or civil law – could be believed to be the most direct explanation of such diversity. In fact, this was not the case, as the English bankruptcy regime looked only marginally similar to the American one. The timing and depth of economic transformation is another ‘usual suspect’. Not surprisingly, bankruptcy law in Britain changed significantly in the eighteenth and early nineteenth century, while it was only in the mid-late nineteenth century that Italian (or Piedmontese), French, Belgian and American laws started to witness massive transformations. Having started earlier than any other country, the English legis-

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* Paolo Di Martino, University of Manchester (UK). I wish to thank the participants of the workshop at the Södertörns Högskola (Stockholm, August 2005) for comments and sugges-
lator was able to produce in 1883 a complete and satisfactory law whose structure benefited from the results of previous experiments and transformations. In the same period, laws were passed in other countries, but in these cases, they represented more the starting point than the final result, which was reached only in the mid-late 1930s. However, it cannot be denied that even at the end of the process of institutional change huge differences still existed, and the English law was just superficially copied by the Americans and represented an even less appealing model for Italian legislators.

If the timing of economic transformation and belonging to different legal traditions only superficially explain the process of institutional change, how can we account for it? The aim of this chapter is to give an answer to this question. I argue that three causes deeply influenced the structure of bankruptcy law in various countries: the distance between the popular attitude towards debt and bankruptcy and legislators’ view on the same issues; the degree of interference of legal bodies (parliament, government and courts) with spontaneous non-judicial contractually based solutions to bankruptcy disputes; and the impact of economic and financial crises. I also maintain that the various laws were not just apparently different but they can also be ranked in terms of efficiency and that historical evolution helps to explain this result.

The analysis focuses on Italy, the US and England in the nineteenth and twentieth centuries and it is structured as follows: section one describes the historical evolution of bankruptcy law in the three examples. Section two analyses the difference in terms of debtors/creditors’ orientation and continuation/liquidation bias. Section three focuses on the causes of transformation, considering the three elements specified above. In section four, the relation between historical evolution of various bankruptcy laws and relative degree of efficiency is considered. Section five provides some concluding remarks.

Historical development of bankruptcy law and procedure in England, the US and Italy

The historical evolution of bankruptcy laws and procedures in various Western countries has been investigated in detail in a number of studies; therefore, I limit my analysis to a sketched reconstruction, highlighting the most significant issues for the argument of this chapter.

1 Bonsignori (1986, p 27).
England

Modern English bankruptcy legislation has its roots in strict and creditors-supportive medieval laws but began to lose its punitive nature in the beginning of the eighteenth century. Economic turbulence caused by fast development of trade and economic activity in general made clear that the equation bankruptcy equals fraud had little empirical support. In response to this changing attitude, the revolutionary instrument of debt discharge was introduced in the early eighteenth century and, in the course of the nineteenth century, reformative effort took momentum. Free from the constraining influence of the Napoleonic code, the English legislators moved in the direction of making bankruptcy easier and softer for debtors; the introduction of deeds of arrangement, separate treatment for small debts, abolition of the strict insolvency law for non-traders and of the imprisonment for debts are all examples of this evolution. Creditors progressively lost power vis-à-vis debtors and public bodies up to the point when, in the 1880s, management of bankruptcy laws and procedures was firmly put in the hands of the board of trade.

Changes did not necessarily come from formal transformation of rules but were also driven by judicial interpretation. For example, courts recognition of the ‘floating charge’ (a contractual devise on the basis of which the most senior creditor in practice monopolized the procedure at his advantage) is a fundamental component of corporate insolvency introduced in 1890.

The last important changes in bankruptcy law took place in 1914, but after that date the legislation only saw marginal transformations, even during the depression of the 1930s.

US

The first bankruptcy law was enacted in 1800 and was simply a copy of the English one. During the whole nineteenth century, various attempts at passing a national law took place, but none of them proved successful. The 1800 law was repealed in 1803; a subsequent act, passed in 1841, did not last longer than 2 years while a further law enacted in 1867 was repetitively amended and finally repealed in 1878. In the meantime, the US faced the urgent problem of finding a solution to the railways crisis. Somehow, this endemic problem became particularly acute in 1884 with the failure of the Wabash Railway. Given the absence of a national law and the incongruities of state laws, the problem was tackled by the judicial system. Given the im-

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3 Duffy (1985).
4 For details, see Lester (1995).
5 Johnson (2000).
7 Largely concerning the conditions for debt discharge.
importance of the industry as the core of the American economic development, with all possible consequences in terms of lobbying and political pressure, judges accepted the principle of the necessity of keeping railways as ongoing concerns rather then looking at ways of liquidating them. Receivers appointed to manage the case operated with the explicit aim of reaching such a result. This *ad hoc* solution created a precedent that was perfected over time and transformed into a specific institution ("equity receivership") to be used to deal with the problem of corporate insolvency. Parallel to the judicial solution to railway crisis, the first national bankruptcy law was introduced in 1898.

The 1898 bankruptcy law and equity receivership continued to operate until the 1930s when the consequences of the great depression pushed for another institutional change. The law changed in 1934 and 1938, ratifying the operating procedures created in the 1880s.

**Italy**

After the experiment of the application of the Piedmontese law during the 1860s and 1870s, Italy saw the appearance of a first unified bankruptcy law following the approval of the 1882 code. At the time, Italy still had a strong tradition of using punitive commercial laws, the legacy of medieval legislation reinforced by the spirit of the Napoleonic code.\(^8\) In the 1880s, the legislator aimed at promoting a less strict set of instruments in an attempt of conciliating the defense of creditors with the necessity of promoting risk-taking and entrepreneurship. The compromise, however, was only on paper and bankruptcy law retained its pro-creditors and relatively strict nature. For example, debt discharge and friendly compromises alternative to liquidation (similar to the English deeds of arrangement) were not included in the new law. On the other hand, bankruptcy procedures, which were managed by creditors’ representatives, remained inefficient, slow and open to corruption.\(^9\)

The absence of ‘friendly’ devices and the general inefficiency of procedures created problems in the management of everyday insolvency but, more importantly, limited the possibility of using official bankruptcy procedures to deal with systemic economic and financial crises such as the one in the 1890s.\(^10\) The conflict between rigidity and inefficiency of legislation on the one hand, and instability of the macroeconomic environment on the other, paved the way for deep reforms of formal bankruptcy law, legal procedures and enforcement mechanisms. Unfortunately, these reforms took a very inconsistent and confused path. During the first two decades of the twentieth century, various instruments such as moratorium or *concordato* (equivalent

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\(^8\) Bonsignori (1986).

\(^9\) Pipia (1932).

to the English deeds) were first introduced, then repealed, then introduced again but, until the late 1930s, Italian legislation proved unable to deal with crises, nor did the quality of procedures increase.

In the mid-late 1930s after the destructive impact of the great depression, Italian bankruptcy law was extensively revised; new, more flexible and comprehensive instruments alternative to liquidation were introduced and management of procedure became the task of public institutional bodies. Almost 60 years after England, Italy seemed finally to have an adequate bankruptcy law. Differences, however, remained as debt-discharge, a pillar of Anglo-Saxon legislation, was not contemplated even in the legislative reforms of the 1930s.

**Structural differences among bankruptcy regimes**

Based on the above analysis, I am able to summarize the historical evolution of bankruptcy law in various countries. In England, the process culminated with the provision of the 1883 law; in the US, the 1898 law dominated the scene until the extended reforms of the 1930s; and in Italy, an almost uninterrupted series of changes ended up with the legal reforms of the mid-1930s. Between the 1880s and the late 1930s, the three countries operated on the basis of very diverse systems of bankruptcy laws and procedures and even at the end of the 1930s large differences still existed.

To capture the distance that separated the three examples, I consider two fundamental features of bankruptcy legislation: the balance between the defense of creditors and debtors’ rights and the pro-liquidation or pro-continuation attitude.

In the process of bankruptcy debtors and creditors are, by definition, motivated by opposite aims and goals. *Ex-ante*, creditors want a tough rule in order to enforce debtors’ behavior, whereas debtors aim at minimizing the expected cost associated with the irreducible level of business risk. *Ex-post*, creditors want fast and cheap procedures to recover as much as possible and as soon as possible, whereas debtors aim at slow and accurate processes in order for each agent’s situation to be carefully analyzed and to reach the best deal possible in case of friendly agreement, debt discharge, or any other instrument alternative to liquidation. According to a widespread but incorrect commonplace, creditors are believed to benefit from the use of tough last-resort instruments, such as physical punishment, imprisonment of debtors, and so on. In fact, such instruments are usually useless in terms of asset recovery and thus do not give creditors any advantage. It is true, however, that in every country creditors tried both to impose strict criteria in order for friendly agreements to be reached or debts discharge to be allowed, a well as to retain the power of managing procedures.
In general, debtors and creditors have opposite motivations and goals and bankruptcy law must compromise between these two. The balance of such a compromise is a fundamental feature of each law.

It is often believed that debtors-friendly laws have a continuation bias (i.e. they aim at keeping firms as ongoing concerns), whereas creditor-oriented legislation tends to lead to company liquidation. However, this is not entirely true in that liquidation is not necessarily the best way for creditors to recover their assets, especially when a firm is only illiquid or victim of exogenous short-term market downturns, but fundamentally sound. Therefore, even if there is a hypothetical link between creditor/debtor orientation and companies’ liquidation/continuation, the two features must be analyzed separately.

Debtors vs. creditors

The inclination towards the defense of debtors’ rights or of creditors’ interests is a fundamental feature of bankruptcy laws. The pro-creditors or pro-debtors nature of a bankruptcy regulation cannot only be seen in the formal aspects of legislation (i.e. in the kind of instruments provided) but also in the nature of procedures and in the way various devices were used. When all these aspects are considered, it appears that historically Italy was the most creditors-oriented system, the US the most debtors-supportive, with England somewhere in between.

As far as the formal structure of legislation is concerned, debts discharge can be seen as the major difference between Italy and the US, on the one hand, and England, on the other. Since the early eighteenth century, the principle of debt-discharge became a pillar of English law, as well as the clearest evidence of the legislators’ changing attitude towards debts and failures from being the sign of a crime (or of mismanagement at least), to be the manifestation of adversity and misfortune.11 This remarkably debtor-friendly idea crossed the ocean as soon as English bankruptcy law was exported in America. However, Italian scholars and legislators simply rejected the idea of allowing debtors who failed to meet their full burden of responsibility to be discharged. This position was clearly ideological and was retained even against the evidence of a positive impact of debt-discharge on economic performance.12

Management of procedures is another perspective to look at in order to assess the rather pro-creditor orientation of various bankruptcy regimes. Originally, in all systems creditors had a huge role in the practical conduct of bankruptcy procedures, including managing the collection of information about debtors, giving a seal of approval to sentences (especially in the case of friendly agreements) and in organizing and monitoring the liquidation of

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12 Del Marmol (1936).
assets. The degree at which creditors managed to retain their relative power over procedures is then a good measure of a system’s pro-creditors orientation. In English personal bankruptcy, ‘officialism’ was first experimented with during the 1860s and became the rule in the early 1880s; this meant that the Board of Trade employees, rather than representatives of creditors, managed the phase of the collection of information, and often the liquidation of assets as well.\textsuperscript{13} In practice since the 1880s in some cases, creditors had virtually no role in the organization and management of procedures. In the US corporate bankruptcy, receivers were appointed by the court and were accountable to the judicial system only. On the contrary, creditors’ power lasted for a relatively long time in Italy; only in the early 1920s did official bodies start to ‘erode’ the monopoly of creditors and, in the case of the liquidation of the 1921 giant bankruptcy of the \textit{Banca Italiana di Sconto}, creditors were over-compensated in terms of guaranteed returns. Only in the 1930s, five decades after the introduction of ‘officialism’ in England, did the administration of bankruptcy in Italy show a similar level of independence from creditors.\textsuperscript{14}

These examples already show how Italy had and maintained a peculiar pro-creditors orientation as compared with the US and England. The attitude towards friendly agreements confirms this result; in general, friendly agreements between creditors and debtors can be seen as advantageous for both categories, but debtors particularly welcome this device as it enables them to avoid bankruptcy, and both the social stigma and the economic consequences associated with it. This means that the easier conditions for reaching friendly agreements, the relatively more pro-debtor the legislation. In England, the “deeds of arrangements” have been part of the procedure since the 1830s. During the evolution of bankruptcy law, creditors’ power to impose conditions to reach friendly agreements declined (although not consistently) to be replaced by court supervision. In turn, court approval was largely inspired by the aim of easing the process as much as possible, as long as equal treatment for all creditors was guaranteed. This meant that courts progressively lost interest in imposing preliminary conditions, such as the guarantee of a given amount of money to be paid in advance in order for the agreement to be approved. In the US, even if creditors retained a relatively stronger power in accepting friendly agreements, court approval did not depend on any preliminary payment either.

In Italy, two features of the way in which friendly agreements were organized reveal the strong creditor orientation of the system. First, friendly

\textsuperscript{13} Under the 1883 bankruptcy act, the court nominated an official receiver (an employee of the Board of Trade) to collect information and manage the preliminary phases of the procedure. After that, creditors had the right to appoint a representative to be in charge of assets liquidation. However, the court could veto an unwanted representative and, if so, the same official receiver remained in power.

\textsuperscript{14} Di Martino (2004).
agreements were introduced only as late as 1903. Second, until 1920, the Italian law imposed guaranteed payment of 40% of unsecured debts as a requirement for approving the deal. This was a peculiarity of the Italian regime and was strongly supported by Italian scholars who considered this requirement an efficient disincentive against a too generous usage of friendly agreements.\footnote{Di Martino (2005b).}

Features such as the absence of debt discharge, the management of procedures and conditions to reach friendly agreements all indicate that Italy was clearly the most creditor-oriented case as compared with England and the US. This result, however, does not mean it is possible to divide the three cases in terms of Italy on one side and England and the US on the other. In fact, deep differences existed between the two Anglo-Saxon countries. For instance in terms of corporate failure (similar considerations apply to personal bankruptcy), where – following the solution invented to deal with the railways crisis - the interest of debtors had the priority over creditors’ rights. The American law of 1898, e.g., substantially limited the use of involuntary liquidation,\footnote{Brown (1900).} something different from the English law and that has been interpreted as a strong pro-debtors feature.\footnote{See Skeel (2001, pp 41-42).} The debt discharge procedure is another field in which the pro-debtors attitude of the American system can be noted. Whereas the English procedure was based on an accurate inquiry conducted by the receiver, the debtors-prone legislation did not contemplate such an intrusion into the bankrupt’s sphere, giving the applicant wider room for making a case for deserving discharge without having to deal with ‘intrusive’ controls and checks. Consequently, discharge was much easier in the US than in England, which represents a clear debtors-oriented nature of legislation.\footnote{Radin (1931) and Del Marmol (1936).}

Continuation vs. interruption

In analyzing the issue of continuation vs. interruption bias, it is again easy to be tempted to separate Italy from the two Anglo-Saxon countries. In this case, however, first impressions based on superficial similarities between England the US prove misleading. The peculiar absence of debt discharge in Italy is already enough to prove the ‘interruption’ bias of the legislation, as debt discharge is a fundamental device to allow bankrupt entrepreneurs to restart. Without discharge, agents remain in the unpleasant condition of being ‘bankrupt’ and cannot embark on any new business until all past debts are cleared. Further, discharge prevents any future income from being claimed to settle old unpaid debts. Thus, economic agents can benefit from a 'fresh
start‘without any fear of seeing the results of their efforts being eroded by the legacy of old failures.

Another ’anti-restart‘ feature of the Italian legislation can be inferred by looking at the link between friendly agreements and the impossibility of transferring to debtors all the company’s assets. Friendly agreements are very important instruments to keep firms as ongoing concerns because they allow debtors and creditors to agree on scheduled repayment of debts over a certain period, thus avoiding immediate liquidation. However, various laws established a minimum quota of unsecured debts to be paid immediately in order for the agreement to have the court’s approval. Depending on the level of unsecured debts to be paid before reaching the agreement, debtors had to sell assets on the market to raise enough cash to meet short-term requirements, an operation that in many cases simply makes the continuation of business impossible. This problem could be solved by allowing debtors to transfer into the hands of creditors all the assets: this would satisfy creditors while at the same time keep the business intact. This possibility, however, was legally impossible in many countries, making the continuation of business via friendly agreement more difficult. From this point of view, Italy and England apparently were in the same position, but a deeper investigation reveals how the anti-continuation bias was stronger in the former case. In fact, both the English and the Italian law established a lowest minimum payment in order to reach a pre-bankruptcy agreement, but such a quota was much lower in England than in Italy (25 as compared to 40%). Furthermore, the clause establishing the impossibility to transfer the whole lot of assets to creditors was abolished in England in 1911.19

As compared with Italy, England was a much more continuation-oriented country. However, scholars also insist on the fact that English legislation was much more interruption-oriented that the American one. Again, rather than the absence or the presence of specific instruments, it was their use and implementation that made the US government relatively more continuation-inclined. Corporate insolvency is a good case in point. The way in which in practice equity receivership operated in the railway cases shows how strongly it favored the continuation the procedure was. In particular, receivers were allowed to issue ’super senior’ securities called ’receiver’s certificates’, guaranteed against the ’whole estate‘. Owners of such securities were guaranteed the highest level of seniority and had the incentive of putting money into railway companies without the fear of seeing senior creditors to reap-off the fruit of their efforts. On the other hand, courts strongly reduced the bargaining power of junior creditors via the specific use of what was known as ’upset price‘. The upset price was a sort of liquidation for creditors who did not want to join the reorganization project. Courts fixed very low prices for junior creditors in order to decrease their appeal for a ’wait-and

see‘ option: in other words, waiting to be conveniently bought-out by senior creditors.\textsuperscript{20}

A pro-continuation bias in the administration of procedures can also be noticed in the case of debt discharge. We already saw how discharge was much easier in the US, witnessing a more credit-oriented character of the American law; discharge in England, however, was also more articulated, reflecting a less marked willingness to allow entrepreneurs to re-start whatever their ability, commitment or honesty. The American procedure only contemplated two possible outcomes: discharge allowed or refused and very often it was the first case to prevail, as screening devices were rather loose.\textsuperscript{21} In contrast, in England courts could decide among four possible general sentences (discharge allowed, refused, allowed but suspended for a varying number of years and allowed but conditional to the payment of part of debts) and based their decisions on a wide and clear-cut set of criteria. This meant that in England it was possible to restart companies, but courts had wide latitude in deciding under which conditions. In other words, whereas in the US discharge was conceived as a pure re-starting device (with a minimal selective function), in England it played the role of screening and selecting economic agents.\textsuperscript{22}

The determinants of institutional change

In the previous section, we saw how in terms of both creditors/debtors balance and continuation/interruption bias it is tempting to separate between creditor-oriented and interruption-biased Italy and the debtors-supportive and pro-continuation Anglo-Saxon world. In fact, many differences emerge also between England and the US, suggesting that it is more appropriate to establish a different ranking, where England appeared very much to be a compromise between the other two examples. This result naturally raises a question: How did the necessity of dealing with similar economic issues lead to the provision of such a diverse spectrum of legal instruments?

To answer this question, one must focus on what I believe are the three most important elements affecting the development of bankruptcy and insolvency laws and procedures in England, the US and Italy. First, what one can define as ‘the cultural model’; in other words, the way in which both society in general and legislators in particular conceived of the issue of debt, indebtedness and failure to repay debts, as well as how such conceptions evolved. Second, the extent to which laws and procedures simply codified spontane-

\textsuperscript{20} See Tufano (1997).
\textsuperscript{21} As already noticed, no preliminary and independent inquiry into debtors’ behavior and the causes of failures was allowed under the American law.
\textsuperscript{22} Di Martino (2005b).
ous ‘market-oriented’ contractual solutions to the problem. Third, the impact of economic and financial crises.

Cultural models
During the whole nineteenth and well into the twentieth century, the cultural perception of bankruptcy changed, but remained negative. Public opinion found it increasingly difficult to accept the idea that someone could be imprisoned for debts, and this change in mentality led to major reforms of the institution if not to its abolition. Despite this development, bankrupts were still viewed with suspicion and the assumption that in most cases criminal behavior could have been the reason behind the failure to re-pay debts remained a very popular idea.

For a long period, very strict laws operating in the US, Italy and England indicated that the views of lawmakers matched popular attitudes. However, while popular views on bankruptcy were and remained relatively strict in all countries, the way in which judges, parliaments and governments viewed the same issue varied and changed very much. A gap emerged between the cultural wisdom of insolvency and the legislators’ approach to the problem in countries in which the ‘legal’ view on bankruptcy became more tolerant. This gap helps explain why various countries implemented different legal remedies in relation to bankruptcy despite similar pressures coming from the developments in the economic sphere. In the case of Italy, it is possible to show how the legislator, even while trying to implement a more lenient legal instrument, still retained a negative moral bias towards bankrupts. According to a widely shared interpretation, the impact of the Napoleonic code was fundamental in reinforcing this attitude. Anglo-Saxon countries were not affected by the French code and, perhaps not surprisingly, in parliamentary discussions no moral issues were raised in discussing changes in the bankruptcy law. In England and the US, the debate was animated and shaped by the working of creditors’ and debtors’ lobbies, but both parties avoided battling on the moral ground. Once again, it would seem natural to distinguish between Italy and the Anglo-Saxon countries; but, once again, this would be a mistake. In fact, if we broaden the perspective from the law itself to encompass its application and enforcement, we discover that differences existed between England and the US. According to Johnson (at least during the entire nineteenth century), judges took moral considerations into account when applying the law to different categories of debtors. In particular, whereas middle-class debtors could rely on a fair application of bankruptcy

23 For England, see Finn (2003) and for the US, see Coleman (1974). In Italy, imprisonment for debt was abolished in 1876.
law and debt discharge, working class people found the theoretically lenient small-debt law enforced in a very strict, if not clearly punitive and vindictive, way. It was as if the cultural disregard for insolvent debtors, still dominant in the man-in-the-street view, was still reflected in the law, but only when applied to poorer people. In other words, bankrupts of the middle class were not criminal by definition any more, but working-class debtors were. The historiography found no traces of such an attitude in the way American judges operated.

Codification of contracts vs. superimposed legislations and procedures.

In theory, there is no need for the state to provide bankruptcy laws or to manage procedures; instead, private contracts can operate perfectly and creditors can efficiently enforce their implementation. Private contracts, however, are not necessarily the best way to reach aggregate results, such as equal treatment of all debtors, support of risk-taking or smooth working of credit intermediation. These considerations were (explicitly or implicitly) behind every government’s willingness to engage with bankruptcy regulation. However, the degree of interference with market-shaped contractual solutions and their enforcement and management is one of the most important differences among various legislations: in this respect, it is particularly illuminating when to compare England and the US. According to Franks and Sussman, the English and American corporate bankruptcy systems were very different in terms of upholding contractual agreements. In the US, corporate legislation had been heavily influenced by the decisions of the courts about railways and the political desire to avoid their liquidation. As a result, judges distorted the original contractual agreements to reach specific aims and the law later simply codified this distortion. On the contrary, in England corporate insolvency embedded the spirit of contracts that reflected the willingness of the parts.

Economic shocks

Economic shocks may have a very strong influence in shaping bankruptcy law; during crises, the number of distresses rockets and the relation between debtors and creditors worsens. Under these circumstances, governments may feel the urgency to implement emergency devices and such temporary measures sometimes become permanent.

Banking, financial and economic crises had a very deep impact on both the American and Italian law. Scholars suggested that American bankruptcy

26 Johnson (2000).
law had an ‘anti-cyclical’ nature, meaning that often the law was changed after major turmoil to make it more debtors friendly.\textsuperscript{28} Berglof and Rosenthal go as far as saying that not only did economic shocks shape the characteristics of various legislations but that, even more fundamentally, economic downturns were one of the two necessary conditions for the adoption of a national bankruptcy law.\textsuperscript{29}

In Italy, subsequent waves of crises motivated lawmakers to provide, abolish and/or change legal instruments without any long-term view. Bankruptcy law was thus changed after the 1890s, the 1920s and the 1930s crises.\textsuperscript{30}

This was not the case in England for two reasons. First, as compared with Italy and the US, England was relatively immune to major shocks, at least during the nineteenth century and the 1920s. Second, even when crises occurred, they left little mark on bankruptcy law. The 1878 banking crisis, probably the most severe downturn in the nineteenth century British economy, led to changes in accountancy techniques and banking practices, but not in bankruptcy law. Even during the great depression of the 1930s, no real change took place. Again one would be tempted to associate the ‘maturity’ of English law, which had two centuries to evolve and learn how to cope with crises, with the lack of changes during the 1930s. However, it must be recalled that in the early 1930s both the Italian and American law had passed through at least 50 years of changes and experimentation but despite this, they had to be extensively revised in conjunction with the great depression.

The efficiency issue

Changes in the cultural approach to insolvency, the way in which governments, parliaments and courts interfered with contracts, as well as the impact of economic shocks produced three very different sets of legal instruments in Italy, England and the US. A closely linked question is whether these legislations were simply formally different or whether they were also characterized by substantially different levels of efficiency.

The answer to this question immediately clashes with respect to the problem of defining what efficiency of bankruptcy law is, given the number of

\textsuperscript{28} See, in particular, Warren (1935), Domowitz and Tamer (1997) and, to a lesser extent, Skeel (2001) who also emphasizes the lobbying power of the bar association as the one of the major forces in shaping the character of American law. However, Hansen (1998) completely dismisses the point that the 1889 bankruptcy law was the response to the 1893 economic crisis.

\textsuperscript{29} “We find that two conditions were necessary for bankruptcy legislation to be adopted during the nineteenth century: a ‘panic’, that is a deep downturn in the economy and the unified control of the executive and legislative branches of government by conservative parties” Berglof and Rosenthal (1998, p 3).

\textsuperscript{30} See Di Martino (2004).
conflicting issues and problems legislation has to encompass. Elsewhere I had provided a broad definition of efficiency taking into account various aims laws had to deal with and instruments that are provided. I have argued that the larger the number of issues a law was able to cope with, the higher the relative efficiency. 31 This definition is necessarily very broad and useless as a measure of absolute efficiency; however, it can be used to rank different legislations, none of which would likely be theoretically the ‘efficient’ one. The most important issues bankruptcy legislation has to deal with can be summarized as follows:

a. Ex-ante, bankruptcy law must back-up risk-taking in order to be entrepreneur supportive, but also to constrain debtors’ behavior in order to avoid frauds and speculation, therefore enforcing credit contract and protecting financial and banking intermediation. Instruments to reach these aims are efficient screening devices, perceived tough punishment for misbehaving debtors and soft remedies for competent but unlucky entrepreneurs.

b. Ex-post, creditors must recover as much as possible as soon as possible, while it should be possible for good debtors to restart their activity to avoid that valuable business might be liquidated and not be given a chance to restart. Instruments to reach those goals include fast and cheap liquidation procedures to maximize returns to creditors and encourage careful investigations of debtors’ conduct in order to select the ones who deserve a second chance.

In my study, I have shown how the English law was superior to the Italian one from all possible points of view. English public procedures were accurate and less prone to corruption and thus provided good screening devices, something that the creditors-managed Italian ones did not. Complex but fair debt discharge procedures benefited competent and incorrupt debtors, representing both a useful ex-post re-starting device and an ex-ante constraining and ‘educational’ mechanism. Wide usage of friendly agreements allowed a cheap, yet efficiently scrutinized way to address insolvency, taking into account both creditors’ needs to recover as much as possible and debtors’ desire to be given a second chance.

Based on the same criteria, it is possible to show that English bankruptcy law was superior to the American one, too. According to both European and American contemporary observers, discharge procedures were the real advantage of the English law. 32 As noticed above, in England, decisions about discharge were based on an accurate collection of information obtained during the official receiver’s investigation, something that did not happen in the

31 Di Martino (2005a).
32 Radin (1931) and Del Marmol (1936).
US. Reliable information (it must be noticed that debtors’ behavior during the procedure was checked ex-post in a meeting with creditors) was used by the courts. In turn, English courts had a wide range of sentences that could be used, whereas the US courts only had the possibility of allowing or denying discharge. In England, judges could also suspend it for a variable amount of time as well as giving an immediate discharge conditional on the payment of a variable amount of money. Well-informed, accurate and multi-result English discharge procedures ensured, ex-ante, both incentives to entrepreneurship and guarantees to creditors, whereas ex-post contributing to an efficient selection among entrepreneurs and companies, something that did not fully happen in the US.33

Little is known about the comparative efficiency of assets liquidation in England and the US; data are available for England34 but, to my knowledge, no study has yet covered this issue in relation to the US. In general, English procedures were considered more expensive than the American equivalent; therefore, comparative higher costs might have impacted upon the degree of creditors’ re-payment. However, even assuming that American creditors benefited from comparably cheaper and faster procedures than in England, still these (alleged) advantages were counterbalanced by a general anti-creditor structure of the law. In conclusion, it seems that the English legislation had many advantages over the American legislation, even if we do not know very much about one important dimension of the problem.

Conclusions: Evolution and efficiency

The basic conclusion of this study can be summarized as follows: during the nineteenth and twentieth centuries, complex historical processes forged different bankruptcy legislations in Italy, England and the US. These legislations proved to have dissimilar degrees of efficiency in dealing with what in theory were rather similar problems and issues, such as the stability of the macroeconomic environment, the defense of creditors’ rights and the necessity of fostering entrepreneurship and risk-taking. This diversity represents a puzzle because, in theory, institutions are offered in a ‘free market’. Thus, each country could have simply imitated the most efficient legislation. One basic explanation is that macroeconomic conditions, financial structures and business organizations were rather diverse in the three examples and hence institutions had to deal with only apparently similar problems.

33 In the US, “a discharge is granted without regard to the dividends or the lack of them, and without the assent of any part of the creditors”, Harvard Law Review, xii, p 272, quoted by Brown (1900, p 264).
Having said that, however, it is also interesting to investigate whether or not the nature of the evolutionary pattern of institutional change can be provided as an alternative or complementary explanation for the different degrees of efficiency of the three sets of rules. In other words, we can test the hypothesis that historical evolution once started produces rigidities and idiosyncrasies that do not allow choosing the theoretically most efficient solution. In this regard, something can be inferred by looking at the two less efficient examples: Italy and the US. In the Italian case, the inability of bankruptcy legislations to deal successfully with the problem of insolvency can be captured by looking at the way in which banking crises were addressed; continuous recourse to state-engineered bailing-out operations is an excellent sign of the failure of ordinary laws. In this case, rigidities in patterns of evolution are revealing: Italian legislators never abandoned the punitive view of the issue, the legacy of medieval legislation reinforced by the nature of the Napoleonic code, and were never able to credibly reform bankruptcy formatives. However, insolvency and banking distress were endless threats to the Italian economy. Consequently, they had to be addressed somehow. The combination of a structurally rigid approach and continuous emergences produces a series of ad hoc solutions unable to deal with the more general problem. In the US, the process was similar regarding some aspects of the evolution and opposite concerning others. The American law, inspired by English law, never had the problem of being excessively punitive. However, like in Italy, a number of financial and economic downturns affected the US. In this case, the combination of “tolerance” and crises led to the emergence of an extra-lenient, debtor-friendly and continuation-oriented legislation. Such an institution was not only suitable to deal with the issue of supporting entrepreneurship and aiding recovery from shocks, but also fostered speculation, ultra-risk behavior and frauds.

References


35 This is a phenomenon known as 'path dependency'.


Insolvency and Privatization: The European Transition Economies in the 1990s

Dieter Stiefel

Insolvency policies played a different role in transition countries than in established market economies. This was, first, the result of the pre-existing planned economy, subsequently succeeded by the radically different market economy. There were, however, remarkable differences. The fact that the Eastern Bloc was perceived as a unity was in essence a result of successful political propaganda during the cold war. In fact, centrally planned models and their exhibited characteristics were as different in the various countries as their preconditions had been. Only in two cases, those of East Germany and Czechoslovakia, could one speak of industrial states at the moment of the communists’ introduction of a centrally planned economy. All other communist countries were initially agrarian states, showing only the first signs of industrialization. Until 1918, some of them had been part of the Austro-Hungarian Empire, which had advanced insolvency legislation. Some successor states, such as Yugoslavia and Hungary, permitted private initiatives, primarily family enterprises, alongside state-owned enterprises, especially in the sectors of public service and tourism; others, such as Czechoslovakia, were prevented from developing a ‘human form of communism’ by the troops of the Warsaw Pact, and others such as the DDR saw themselves as model acolytes of the planned-economy system. The Soviet Union, with its communist past of 80 years, had almost no experience of a market economy at all, whereas Central European countries could refer to their experience and in particular to their insolvency laws that had been enacted 40 years before. The era of the centrally planned economy also had very different priorities. Hungary and Czechoslovakia never neglected agriculture. In this field, they had no shortage of supply and reached high quality and considerable export opportunities. Unlike these, Poland focused on heavy industry, which entered a crisis not only within the centrally planned economies but also globally from the 1980s onwards. Differences in the number of state-owned enterprises, their industrial focus and the possibility of private initiatives during the era of the centrally planned economy characterized the transition of these countries to a market economy.
The transit from a centrally planned economy to a market economy presupposed a complete reorientation in the management of enterprises. Today, enterprises are regarded as ‘learning units’, because not only individuals, but also groups and organizations, can learn. That is the only way in which the ‘physics of market economy’, as one might call it, can work, i.e. phenomena of expansion and reduction of enterprises, of their adaptation or resistance. The entirety of experience was suddenly no longer valid. Literature on this subject thus speaks correctly of a ‘shock’ in the economic sphere. In communism, there is no separation between politics and economy. Economic activity thus becomes political activity. Accordingly, the leading positions are occupied by people with a clear political orientation, who may well be good managers, but do not have to be. The reluctance to embrace innovation is thus explicable, first, by the fact that the managers’ economic aim is restricted to high employment quotas and the achievement of their production targets. The lack of interest in innovation is either also due to the firms being monopoly enterprises or to their being in a sellers’ market, and to the consideration that every change in production entails dangers. Unlike their market economy counterparts, the personal success of managers in a centrally planned economy, i.e. social advancement and material reward, cannot be reached through the enterprise itself, but primarily through the party. A manager’s main interest, therefore, had to be focused on political activity. Further, the centrally planned economy thinks in quantities, not in prices. Its typical representative is the engineer, whereas in a market economy it is the Chief Financial Officer (CFO), the controller. In a centrally planned economy, enterprises had to produce certain quantities, the unit costs were in most cases not known and even if they were, this was not of vital importance. The transition from one economic system to the other meant a change in the way of thinking, from production-oriented to cost-oriented, and was thus a ‘cultural shock’. The legislation on insolvency was part of this shock. The essence of the transition is a radical change of the type of management, of its incentives and risks policies.

The problems of a state-owned economy are not completely unknown to market economy countries. Economic history shows the different functions of the private sector of the economy and the state during the past five centuries. They are the two partners in the advancement of capitalism (or, as one might say, of market economics), where the enterprise qua ‘homo oeconomicus’ must pursue its own interests while the state gives the general rules. They need each other, like two card players, to play the game: one takes care of the economic production and the other of the social compatibility of this dynamic process. The risk of nationalization is that public functions are transferred to the private sector of the economy, i.e. a card player ends up playing with himself and the game thus loses its dynamics. As a result, regional social interests, which may sometimes be an obstacle to economic efficiency, become part of the decision-making process (Brada 1992,
Because in centrally planned economies the capital city was often far away, it was, as a rule, the regional party that had the largest influence on the appointment of a business’s management. The party’s interest focused on employment and production in its own region. Even in those cases where the government emphasized the importance of efficiency, decision-making processes were influenced by considerations regarding the regional repercussions of the reorganization or closure of firms.

The Czech Republic

Bankruptcy legislation in the Czech Republic derives from the Austrian bankruptcy law of 1915, which also applied to Bohemia and Moravia. In 1931, in the newly formed Czechoslovakia, this law was changed but it lost its importance completely during the communist era. In 1950, these regulations were lifted and replaced by civil proceedings. The concept of bankruptcy was replaced by that of liquidation, which could be imposed by court decision. The creditors’ autonomy was thus removed and courts deliberated exclusively on the distribution of the revenues from liquidation. In a nationalized economy, insolvency proceedings were no longer important because both creditor and debtor enterprises were state-owned. For political reasons, mainly related to reciprocity with foreign countries, a few insolvency regulations remained. The regulation of insolvency cases concerning real estate was transferred to the notary chamber, which had been created in 1950 (Tichy 1993, p 96). The opening up of Eastern Europe led to new legislation on bankruptcy in 1991 – with amendments in 1993 and 1996 – which now did not refer only to its Austrian predecessor but also to the German example. The transition program of the Czech government of January 1991 provided for a rapid transition to a “market economy without adjectives”, as the then Prime Minister Václav Klaus phrased it, i.e. a market economy and nothing else, without adding ‘social’ or other adjectives. This meant the introduction of price elasticity, the liberalization of foreign trade, the discontinuation of subsidies and the introduction of real, market-oriented interest rates. These regulations, together with the extensive loss of the Eastern market, especially the former Soviet Union, and the confrontation with a highly competitive market economy in the West, came as a shock to almost all enterprises. The strict credit policy in Czechoslovakia and high interest rates led to enterprises having difficulties in obtaining foreign capital. Enterprises solved this transition problem by increasing their indebtedness with each other, delaying payments for increasingly long periods. This made possible the survival of insolvent enterprises.

The economic structure inherited from a centrally planned economy had a disproportionately large heavy-industry sector and an underdeveloped service sector, and thus required a rapid restructuring of economic resources,
with the risk, however, of widespread bankruptcy. The government implemented a number of regulations in order to avoid this: their aim was to reduce the burden of the past, to promote the privatization of heavily indebted enterprises and to increase the liquidity of banks that had a considerable amount of doubtful receivables. Most important among such regulations were a limited debt cancellation in 1991 (to the value of 50 billion crowns), the foundation of the Konsolidaceni Banka in 1991, which took over short-term corporate loans from other banks (110 billion crowns), the suspension of the new bankruptcy law until April 1993, the clearing of all debts enterprises had incurred with each other in May and September 1993 (980 million crowns) and the implicit credit cancellation of some enterprises that were in the process of being privatized (Hoshi et al 1998, pp 129-130). These regulations absorbed the shock of the transition to a market economy and facilitated the privatization or closure of state-owned enterprises by means of workouts, restructuring changes and downsizing. From 1993 onwards, however, insolvency proceedings were to become the usual solution for unprofitable enterprises.

In the Czech Republic, insolvency means that either an enterprise cannot discharge its payment obligations or that it is heavily indebted. A petition for insolvency can be submitted both by debtors and by creditors (Tichy 1993, p 84). Until 1996, in concord with the Austrian model, proceedings were initiated only if the assets could cover legal expenses. As of then, the payment of one lump sum is requested at the moment of the submission of the petition (10,000 crowns). In the case of state-owned enterprises, a petition for insolvency needs the approval of the relevant ministry; enterprises that are the object of a voucher privatization were excluded from bankruptcy proceedings until the change of ownership was completed. A petition of insolvency, just like in Austria, grants the debtor 3 months to solve his financial problems. During this period, called ‘automatic stay’, his creditors cannot prosecute him, the only exception being the employees’ claims and the taxes for the continuation of his business activity. The automatic stay is mainly for newly privatized enterprises in order to give them an opportunity to negotiate with their creditors before insolvency proceedings become unavoidable.

After this period of transition, courts appoint a trustee and all asset-based transactions that have taken place 6 months before the petition for insolvency are invalidated. The trustee has heavy responsibilities, he is personally liable for the correct treatment of the proceedings and he can prosecute the current management for irregularities dating back up to one year. Payment is determined according to a fixed tariff, which is rather low. The trustee makes a list of all assets and liabilities and creditors form a committee in charge of the supervision of his activity. Proceedings can end in simple restructuring, bankruptcy or enforced restructuring.

Within the 3-month automatic stay, the creditor can apply for simple restructuring, which must contain a rehabilitation plan and the cancellation of
at least 45% of unsecured debts within 2 years. If this plan meets with the creditors’ approval, courts can authorize restructuring. If this does not happen, courts order the liquidation, i.e. bankruptcy of the enterprise. Courts often fix the price at which the enterprise’s assets are to be sold in order to prevent malpractice. However, this has repeatedly led to delays, as the prices that have been fixed have often been hard to meet. If creditors have securities on individual assets of the enterprise, they can realize them for their own profit. Otherwise, Czech insolvency law provides for three classes of creditors: the first class includes the employees’ claims from the previous 3 years; the second class includes taxes, expenses and receivables of social security from the same period; and the third and last class contains all the remaining claims. Each class receives payments only after the class above it has been completely satisfied.

During insolvency proceedings, the debtor can also apply for enforced restructuring. This must lay out a plan for the payment of preferred debts and at least a third of the creditors’ doubtful receivables. This plan must meet the approval of the majority of creditors (three thirds of their receivables) and of the courts. The courts must check the debtor’s ‘honest intention’, above all that the application for enforced restructuring does not aim only to delay bankruptcy proceedings. If courts authorize enforced restructuring, a debtor is fully in charge of his enterprise again.

Between 1992 and 1996, the ever-accumulating petitions for insolvency reached 8,647 in the Czech Republic. In 1996, 53% of these had not yet been settled, 29% had been rejected for lack of assets or lacking formal preconditions and in 18% the verdict was bankruptcy. During this period, there were only 11 cases of restructuring (Hoshi et al 1998, p 135). The number of petitions for insolvency was surprisingly small, especially if one considers the problematic situation of a transition country. In the past, debtors with financial difficulties were not immediately forced to go to court. Above all, the large number of pending cases shows the overburdening of the courts. Ultimately, the strictness of this type of restructuring kept its number extremely small. Insolvencies affected in most cases small- and medium-sized enterprises. Unlike its Hungarian counterpart, Czech economic policy kept the number of insolvent large, state-owned enterprises quite small; for those that had been privatized, this was possible only with the conclusion of the voucherization from 1995 onwards.

This procedure, however, displays a whole series of problems (Hoshi et al 1998, p 137). Because of the still underdeveloped financial market and accounting standards, it was hard to gain insight into the financial situation of an enterprise. The bankruptcy law did not really change these circumstances. Before the 1996 amendment, management was not obliged to describe the state of the firm when they filed a petition for insolvency. The current management had little motivation to file such a petition, as it was more profitable for them to privatize the enterprise and thus keep their position. Bankruptcy
was to put an end to all this. On the other hand, the conditions for restructuring (45 or 33%) were extremely strict and could be met only rarely. Many Czech enterprises were financially burdened as a result of their past in a centrally planned economy and were now able to reach this restructuring rate only in rare cases. Therefore, firms that under more generous insolvency conditions would certainly have survived were closed. Czech bankruptcy legislation adopted this hostility towards the rehabilitation of enterprises from its German model, although here, too, an amendment in 1999 was to facilitate the reorganization of enterprises in insolvency proceedings, which follows the general trend. Initiating rehabilitation is also difficult because only debtors, not creditors, may submit a plan for it. As a result, it becomes harder for foreign capital to flow into the enterprise and for the trustee to act only as an umpire. Additionally, losses incurred during insolvency proceedings are not tax-deductible.

Generally speaking, insolvency proceedings burden the courts excessively. The Czech procedure is thus the opposite of the American one. The extensive involvement of courts is especially problematic in the case of a transition country, where more is lacking than the requisite number of judges with good knowledge of economics. Therefore, courts cannot cope with the situation and this results inter alia in the length of the proceedings. An opposite policy could be observed in Hungary, where courts dealt with approximately 90% of insolvency proceedings quickly and effortlessly.

The payment of a trustee was a further problem, which theory identifies as the classical problem of the principal-agent. Until 1996, a trustee was paid according to a fixed scheme, which was not very generous. Accordingly, he was not particularly motivated to achieve the highest possible realization value of the insolvent enterprise. Few counselors applied for this position and those who did, did not devote themselves exclusively to this task. At the end of the 18th century, the father of classical economics, Adam Smith, stressed that a market economy is based on the motivation of the individual and thus on his own interest, i.e. his selfishness. This principle must be accepted in order to adopt a market-economy system. The unsatisfactory payment of trustees may explain why some did not hesitate to line their own pockets during insolvency proceedings. This can only be avoided when the interests of the agent coincide with those of his principal, i.e. quick proceedings and high insolvency revenues are in the latter’s interest too. In 1996, therefore, a more generous amendment reworked the remuneration of trustees: they now receive a fixed salary and a results bonus that varies according to the revenues from the insolvency proceedings.

A special problem of the transition economy in all countries was the ‘creditors’ passivity’ (Hoshi et al 1998; Mitchell 1993). In a market economy, the creditors force an enterprise to resort to foreign capital: they request repayment with interest rates and know their last resort well – insolvency proceedings. In a transition economy, however, and especially at its
beginning, creditors were state-owned firms or state-owned banks that were not expected to justify the course of action of their management. They were linked to their clients by long business relations dating back to the planned-economy era, and a coherent application of insolvency policies would have revealed the plight in which banks found themselves. Also, they could still hope, as in 1991 and 1993, to be able to write off part of their problematic loans through governmental subsidies. The uncertainty as to how the transition phase would affect the whole economy of a country and its individual enterprises was a further reason not to be too strict with defaulting clients, all the more so as insolvency proceedings were highly bureaucratic and time-consuming. However, this was to change as a result of the increasing interests of foreign banks – mainly German and Austrian ones – in the Czech Republic.

Hungary

The introduction of insolvency law in planned-economy countries produced the most extraordinary results in Hungary. The problem of insolvency arose in Hungary as early as in the 1970s with the introduction of the new economic mechanism, through which profit was made the essential yardstick for the success of enterprises, including state-owned firms. However, as bankruptcy law would have addressed the question of property rights, development in this direction came to a halt. Instead, the relevant ministry/office or political institution dealt with problems individually. Small enterprises were usually merged with larger ones in case of difficulties. A first governmental decree dealt with insolvency proceedings in 1978, providing for both liquidation and rehabilitation. However, the proceedings were not very transparent and were left in the hands of the minister of finance or a specific minister. Only taxes, social security contributions and bank loans were taken into consideration. In the 1980s, only 13 state-owned firms were liquidated, which is negligible when compared with the growing number of state-owned firms in trouble. Nonetheless, this was a first step, and the insolvency decree of 1978 contributed inter alia to a growing privatization in which insolvent state-owned firms and parts of enterprises or assets were sold to private individuals. In 1990, a third of all enterprises incurred losses. As a result, the government requests ministries to initiate liquidation in case of a protracted reluctance to pay, or to double interest rates in case of delays in payment. In the 1990s, the last communist government enacted a law forcing all the enterprises that could not meet their financial commitments into liquidation. This law caused panic in state-owned enterprises, as the financial policy that had hitherto been customary had led to indebtedness which for hundreds of state-owned firms would now imply immediate liquidation. The new parliament softened these regulations and left space for individual treatment.
However, a clear message had been sent to the Hungarian economy (Mizsei 1993, p 24).

As the first transition country par excellence on January 1, 1992, Hungary enacted a strict insolvency law with a trigger mechanism for petitions for insolvency. All enterprises that had delayed payments to their creditor for over 90 days had to file a petition for insolvency within a week. Management was obliged to implement this measure under a threat of punishment. The law granted a grace period of 90 days before its introduction, after which 3,500 petitions were filed. Overall, in 1992-1993 there were 22,000 petitions for insolvency, which was far beyond all expectations (Gray et al 1998, p 175). In 1992, 83% of the petitions for insolvency had been filed as a result of this trigger mechanism and 85% of the petitions for liquidation were filed by creditors. In 1991, the enterprises for which petitions of insolvency were filed in 1992 had produced 14% of the GBP, 25.5% of exports and employed 17% of the workforce. Eleven per cent of these enterprises were state-owned firms and 26% were cooperatives that, at the same time, also represented large firms. Only 10% of state-owned firms were closed, whereas the percentage of cooperatives (50%) was very high (Hegedus 1994, pp 104-105). The new Hungarian insolvency law was modeled on the American one in many respects, with the exception of the compulsory, automatic petition mechanism. The debtor can file a petition for reorganization or liquidation, whereas the creditor can apply only for liquidation. When the debtor applied for rehabilitation, management remained in its role and had a 3-month ‘automatic stay’, that could be prolonged by a month. During this period, a debtor was expected to produce a rehabilitation plan that had to be unanimously accepted by creditors. Trustees and committees of creditors were not mandatory, but could be requested by the creditors themselves. New loans did not have a preferred status during rehabilitation proceedings. If an agreement with the creditors was reached, an automatic liquidation would ensue by law. In case of liquidation, a trustee was appointed who would deal with it and would distribute the revenues according to an order of preference: first, bankruptcy expenses; second, creditors with securities, taxes and social security contributions; third, those without securities and, last, the owners. The law regulated the payment of trustees and their professional qualification. Proceedings had to be completed within 2 years.

The aforementioned experiences with insolvency law led to some changes in September 1993. The creditors’ unanimous approval of the rehabilitation plan was regarded as too strict and was thus adapted to international standards, namely half of the creditors and three quarters of debts. The automatic stay was not only regarded as being too generous, but it also led to malpractice. For this reason, its ‘necessity’ was replaced by its ‘possibility’ if half of the creditors agreed. The automatic petition of insolvency and the automatic liquidation in cases of failed rehabilitation plans were lifted in order to staunch the flood of petitions for insolvency. Payment of liquidators was
here, too, increased, their obligation to submit a report became stricter and the creditors’ control over them was intensified. Foreign firms, too, could act as liquidators. The appointment of a trustee was now mandatory for all cases of rehabilitation.

After the 1993 amendments to the law, however, the number of cases of reorganization decreased dramatically. First, the carrot-and-stick mechanism, i.e. the ‘carrot’ of automatic stay and the ‘stick’ of automatic petition, disappeared. Also, the presence of a now mandatory trustee increased the costs of proceedings and granted outsiders an unwelcome insight into the enterprise. Moreover, at the end of 1993 an out-of-court proceeding for the consolidation of debtors was introduced, which was regarded as being more profitable in many cases. Finally, the economic situation improved considerably after 1994 (Grey et al 1998, p 179).

The enormous number of petitions for insolvency in 1992 was a consequence of the trigger mechanism: 17,000 petitions of a total of 22,000 were filed for liquidation and 5,000 for reorganization, a third of which, however, eventually also resulted in liquidation. It is hard to say how efficient these proceedings actually were and how much they separated the wheat from the chaff. In essence, there were three groups for liquidation: firms without assets, privately owned firms (mainly small ones) and state-owned firms. Gray emphasizes that in conversations with managers and trustees it became clear that the reorganization option was initially often chosen because the proceeding was still unknown. Also, one could gain time to sell off parts of the enterprise and assets to private firms, knowing full well that these transactions could not be controlled by anyone because of a lack of sources of information. Thus, a tacit privatization, so to speak, took place in which economic resources were redirected from troubled state-owned firms towards private firms and the related documents subsequently disappeared. Creditors, too, reached individual agreements and took their retrievable from the enterprise at the expense of other creditors, which in all bankruptcy laws is prosecuted. Since the ‘watch dogs’ of the market economy, i.e. accounting standards, lawyers, courts and credit rating agencies, were still underdeveloped in the transition countries and information was expensive and unreliable (Grey et al 1998, p 185/6).

The most astonishing element was the speed at which insolvency proceedings were dealt with in Hungary. In Budapest, there were only eight insolvency judges to deal with over 15,000 cases in 1992. Despite this, 60% of the cases of reorganization were concluded by 1992 and 95% of the cases in 1992-1993 by the end of 1993. On average, a debtor submitted a rehabilitation plan 8 weeks after the petition for insolvency and 8 months later all arrangements for both small and large enterprises had been concluded. The reason for this lay in the limited involvement of courts and trustees in insolvency proceedings. Once a case had been accepted by the courts – which
took about 3 months as a result of the work overload, proceedings were dealt with in a ‘decentralised’ manner by a debtor and his creditors.

Only in cases of liquidation were there difficulties because a court’s appointment of a liquidator alone lasted half a year and many cases had not been concluded within the mandatory 2 years. Also, a liquidator mostly used his strong position to keep the work places of the threatened firm as long as possible and tried to sell the enterprise as a whole to private individuals. The lack of co-determination among creditors in liquidation proceedings led to their incurring considerable losses, which also increased the cost of loans for the entire Hungarian economy. In the case of state-owned Hungarian banks, too, creditors’ passivity can be observed. After these banks had been recapitalized by the state between 1991 and 1995, there was little urge to deal with defaulting debtors with the strictness ordered by law. A considerable part of their receivables were therefore doubtful claims.

Nonetheless, insolvency proceedings in Hungary have not only produced professional trustees and liquidators who understand the financial demands of the market economy, they have also forced enterprises to think in the categories of the market economy, namely profit and loss.

Poland

In 1993, the Polish government issued a plan for the reorganization of enterprises and banks. Its aim was to rehabilitate (and prepare for privatization) seven of the nine commercial banks that had derived from the National Bank in 1989. At the same time, these banks were meant to direct and control the rehabilitation and privatization of state-owned banks that had financial troubles. There were 787 of these enterprises, with a volume of credit of $1.43 billion at that time. By April 1994, banks had first to implement regulations on loans that, at the end of 1991, had been regarded as doubtful or lost. Then, they had to differentiate between enterprises according to the following criteria (Gray/Holle 1998, pp 207-208):

- a debtor has redeemed his loans in the last three months. These enterprises were regarded as healthy and were the only group for which liquidation was not taken into consideration. They were usually large enterprises which temporarily had not been able to make a profit as a result of the dramatic transition to market-economy conditions in 1991/1992. A large number of these enterprises began repayments only as a result of new borrowings.
- court-managed or banking conciliation proceedings were carried out. These were for enterprises with the potential to survive and for which a rehabilitation made sense. Court-managed restructuring proceedings had
existed since the communist era (1934 Law) but had rarely been applied. The banking conciliation proceedings introduced by the plan for the reorganisation of enterprises and banks were flexible and for three years they were available for banks and enterprises in trouble.

- Bankruptcy proceedings according to the 1934 bankruptcy law provided for the court-managed closing of enterprises in trouble if debts exceeded the assets or if the liquidation value was higher than that of the enterprise as a productive unit. The revenues from the liquidation were then distributed among the creditors.

- Privatization or liquidation is in progress: this was the case of state-owned firms that were not insolvent.

- Debt instruments were sold on the secondary market. In this case, debt instruments were sold to enterprises that had better prospects of collecting such debts. This solution was rarely applied, as losses were not tax-deductible, unlike all other insolvency proceedings. Whenever debt instruments were sold, however, they were sold to clients of the enterprise who wanted to pay their deliveries with them or who might consider taking a stake in the company.

Court-managed restructuring proceedings were part of the 1934 bankruptcy law and were meant to offer an alternative to the closure of enterprises. Proceedings proved to be rather laborious, which is why banking conciliation proceedings were introduced in 1993. Court-managed restructuring does not affect creditors with securities and the public authorities (taxes and social security contribution), but only trade credits and unsecured loans. Proceedings refer only to financial reconstruction, not to other measures, such as headcount reduction. Every arrangement must be authorized by two thirds of the creditors’ claims, which was increased to four fifths if the write-offs amounted to more than 40%. However, only creditors who took part in the proceedings were entitled to vote. If courts approved the debtor’s application, a court commissioner and a reorganization trustee were appointed to control the management. Creditors with securities were excluded from losses but had to leave their securities within the enterprise, if this was unavoidable for the continuation of its activity. In 1990, this pre-war regulation was reactivated, leading to a rapid increase in the number of petitions. However, only 98 of the 688 petitions for restructuring in 1992 led to proceedings being initiated; 73 of these were rejected and the rest was either still pending or settled in out-of-court proceedings. Overall, court-managed restructuring proceedings achieved their aim only partly.

Polish bankruptcy proceedings were based on the 1934 law which was amended in 1990. Surprisingly, the bankruptcy law of the 1930s was never lifted: it was simply not applied in the era of centrally planned economy. Like the 1934 economic law, which had been instrumental in the transition to a market economy, the bankruptcy law of the 1930s could be applied im-
mediately, without much bureaucracy (Szlezak 1994, p 110). It resulted from the mentality of the years before the war and aimed at the liquidation of insolvent enterprises. Creditors, owners or management can file a petition for bankruptcy. As soon as insolvency becomes evident, management is obliged to file a petition within 2 weeks under personal liability. If an enterprise can cover their cost, proceedings are initiated. All debts are immediately due and creditors must declare their receivables in court. A trustee is appointed to be in charge of the continuation of the enterprise’s activity, if this can secure the preservation of its assets. A bankruptcy judge fixes the trustee’s payment. The trustee lists assets and debts, interest rates no longer increase, with the exception of secured loans. If 20% of creditors demand it, a committee of creditors can be created. These proceedings aim to pay the public authorities first and are therefore uninteresting for unsecured creditors. If the cost of proceedings, taxes and social security contributions do not exhaust the assets available, the rest almost certainly goes to the claims of employees. Also, creditors are obliged to pay the court between 5 and 13% of their receivables in advance to cover the cost of the proceedings, which is a further loss of money. Finally, a trustee’s potential malpractice is hard to prevent in Poland, too. Fraudulent transactions must have been widespread and must have reduced faith in the reliability of court-managed proceedings (Gray/Holle 1998, p 223).

The number of bankruptcy petitions increased to over 5,000 from 1990 to 1993 but decreased again thereafter. However, courts rejected more than half of them for lack of assets. Proceedings are impaired not only by bad conditions for simple creditors but also by institutional weaknesses. Courts are understaffed, have only a small budget and limited knowledge of economic matters. Moreover, there is a clear lack of auxiliary professionals, such as lawyers, trustees and accountants that take care of the necessary information flow in developed free-market economies. A study of 80 bankruptcy proceedings for the year 1993 showed that only 15 had been completed. The others were rejected for lack of formal requirements or because the assets were not sufficient to meet the cost of the proceedings. This study detected malpractice in most of these cases. The majority of assets were either sold before the bankruptcy petition or they disappeared in other ways. However, inquests were rare in these cases because the necessary information was missing (Jan Brol, quoted in: Gray/Holle 1998, p 224)

Liquidation within a process of privatization was rather widespread in Poland. Between 1990 and 1995, more than half of approximately 1,300 firms were either liquidated via privatization or ended in bankruptcy proceedings. Three quarters were enterprises with up to 200 employees and only 9% were large firms (over 500 employees). However, a constantly increasing tailback caused many cases to have to wait for more than 2 years for these proceedings. The management or the owners (Ministry, etc.) requested the liquidation and had it under their control. It was mainly creditors that incurred
greater losses as there were no clear prescriptions for dealing with their claims. Although the law did, at least in theory, permit the closure of insolvent state-owned firms, in practice this seems rather an option for the current management in order to avoid bankruptcy and to remain in control of the assets of its enterprise. As this prevented creditors from exercising their rights, it excluded the positive role they can play in insolvency proceedings in free-market economy countries.

The most innovative measure was banking conciliation proceedings, i.e. restructuring proceedings managed by a bank. Polish state-owned firms had begun their market-economy reorganization under a heavy burden of debts. These dated back to the centrally planned economy era, and above all to the early years of economic transition. Initially, enterprises solved their liquidity problem by means of bank loans, as it was not clear how far the reforms would ultimately go. Banks preferred to give new loans rather than having to write off old ones as this would have worsened their balance sheet performance. In 1992, it was estimated that 40% of enterprises incurred losses and the percentage of doubtful receivables for banks was 24% (Mizsei 1993, p 10). Restructuring proceedings under the direction of banks were a workout that is reminiscent of ‘Chapter 11’ or of the Hungarian proceedings. Banking restructuring proceedings were aimed to reorganize enterprises whose company value was higher than the estimated revenues from its liquidation. In return for the partial write-off of loans, creditors could not only demand a share in the ownership of an enterprise but also its radical reorganization, all of which increased the chances of a successful redemption of the remaining financial liabilities. Banking restructuring proceedings were limited to 3 years and shifted the competences from courts to banks. Banks had the right to negotiate and to impose the result on reluctant creditors, as long as 50% of creditors agreed to that result. A debtor could submit a request for these proceedings at the bank that had at least 20% of the total debts; in the case of more than 2 billion Zloty, 10% was enough. The advantages were, first, that proceedings could take place without the costly involvement of courts. Also, the creditors’ preferred order changed. The state lost its preferred position and social security contributions, creditors with securities and the employees’ receivables remained outside the agreement and were thus fully satisfied. Smaller claims of the creditors were unable to block the solution and the bank took full responsibility for the proceedings. In cases in which the rehabilitation plan was not successful, the bank was liable to pay for the additional costs resulting from it. Finally, the possibilities of a solution were many, not only with reference to the reduction of debts and the postponement of terms. It was the legislator’s intention that creditors accept a compensation for their claims in the form of interests in the enterprise in order to achieve a reduction of debts. This option, which was applied less than would have been desirable, motivated all those with interests in the enterprise to achieve success because in the case of failure, the threat of legal proceedings
was imminent (Gray/Holle 1998, p 250/1). The enterprises that chose this solution were usually large and highly indebted with banks, but they were more profitable than those that had to opt for liquidation or bankruptcy. In this case, too, creditors formed several committees with similar claims in each. No one of the committees of creditors was allowed to achieve a worse solution than that of the committee representing the bank that managed the proceeding, and for this reason the bank had no interest in separating creditors. To achieve the 50% that was necessary for the approval of the rehabilitation plan, small creditors were often treated better than big ones in that their approval was less expensive. This was also explicable by the fact that banks charged interest on outstanding loans, even in the case of non-redemption, whereas suppliers usually did not. The average duration of the proceedings was approximately 4 months though many were dealt with much more quickly, as negotiations had already begun before the proceedings’ official commencement.

Summary

Between 1990 and 1994, the number of persons in dependent employment decreased by about half a million in the Czech Republic, 1.3 million in Hungary, 2 million in Poland, whereas the number of the self-employed increased by a million in the Czech Republic, half a million in Hungary and over a million in Poland (Balcerowicz, Eva et al 1998, p 92). This shows the extent of the transition process, which was characterized by denationalization, demonopolization, reduction of subsidies, liberalization of trade, restrictive monetary policy, stricter conditions of credit, reduction of employment, restructuring and the introduction of bankruptcy legislation. In this process, resources had to be redirected from individual sectors (agriculture and industry) to others, above all the service sector, and the enterprises themselves had to be reorganized.

In a market economy, the aim of insolvency proceedings is to solve the problems of individual enterprises. The underlying assumption is that a debtor is liable for the difficulties he creates. In times of economic growth, insolvency affects 1 or 2% of enterprises annually and even in serious economic crises, such as in the 1930s, insolvency legislation has fulfilled its function. Only in individual branches/sectors, such as agriculture and banks, have governmental subsidies and special laws been necessary. In transition countries, individual enterprises and their management were no longer considered liable for the financial burden and operational structure they had inherited from the planned-economy era (Hoshi 1998, p 20). According to the standards of the market economy, whole sectors were to be considered insolvent and a large part of the economy bankrupt. In such a situation, where insolvency becomes a widespread problem, the function of insolvency pro-
ceedings changes from a problem of business management to one of economic policy.

Today, it has been almost forgotten that market-economy countries also had similar problems in the twentieth century. Reconstruction after World War II presented many analogies with the reconstruction after the cold war, which is now called ‘transition’. For example, German and Austrian banks and insurance companies during the Nazi era had been forced to invest a large part of their financial resources in government bonds that became worthless after the War. Basically, the whole branch/sector would have had to file a petition for bankruptcy in 1945 because their liabilities surpassed their assets considerably and they were no longer able to pay. The state could not, of course, accept the collapse of the whole financial sector, and this led to financial support, subsidies, mergers, etc., under the direction of the state and finally to reconstruction laws that would re-create order. However, until 1955, Austrian banks and insurance companies were exempt from the obligation to issue a financial statement, as this would have implied the obligation to file a petition for insolvency, according to the current legal situation. Only in 1955, was it possible to draw up a balance sheet for the whole period in addition to the first balance sheet denominated in Austrian schillings. This shows clearly that the transition period after World War II lasted 10 years.

The fear that the valuation of enterprises in accordance with market-economy standards would have caused a catastrophic wave of insolvency petitions across the transition countries has not proved true. This is explicable by the fact that individual countries have accorded different priorities to bankruptcy law. Some countries, such as the Czech Republic, delayed the introduction of bankruptcy law and relied, rather, on rapid privatization. Other countries, such as Hungary, focused on radical insolvency legislation as a means to prepare for privatization; Poland was somewhere in the middle (Grosfeld 1998, p 278). Insolvency regulations, however, were not applied across the board. Thus, e.g., the government supported a recapitalization of banks that enabled them to be more tolerant toward their insolvent clients. Also, state-owned firms that were officially involved in liquidation proceedings were often preserved intact, as this was in the interest of the liquidator, of the management and of the employment market. The positive role of bankruptcy legislation is that it offers orderly proceedings for eliminating sources of losses and redirecting economic resources. It was also meant to have a disciplining and motivating function for management. Now management could no longer rely on governmental support, but rather had to consider the possibility of closing the enterprise and the consequences this would have for them. The aim was to promote a market-economic way of thinking and financial responsibility. Of course, this also depended on legal certainty, i.e. how coherently the legislation was applied in practice. Therefore, not only the length of the proceedings was criticized but also the irregularities that resulted from a still underdeveloped jurisdiction over economic
matters. As this was the biggest/most important change of ownership in the history of these countries, it was not surprising that some people took advantage of the opportunity in every possible way. This concerns not only irregularities but also the current management’s interest in preventing the firm from being liquidated and in trying to preserve its position as long as possible at the expense of others or even in permitting the firm’s privatization. Much criticism is also raised over rehabilitation proceedings being initiated with too little know-how and their concentration in most cases is limited to financial problems without considering the situation of the whole enterprise. Finally, insolvency legislation in transition countries proved very debtor-friendly. This may have been politically necessary in order to prevent production and employment from dropping further, but – despite some exceptions, such as Poland’s rehabilitation proceedings under the guidance of banks – the position of creditors was weak and unsatisfactory. For this reason, creditors were in most cases little involved in reorganization and liquidation proceedings and regarded the financial market as uncertain. This led not only to high interest rates but also to considerably higher security claims than in market-economy countries.

Of course, insolvency legislation is debtor-friendly in the USA and in France, too. But the question is if a country that has yet to develop a money and capital market can allow himself to be debtor-friendly. The USA and France initially gave more importance to creditors in the 19th century. Only in the second half of the twentieth century, when they had developed their financial market enough, did they become more debtor-friendly. Their debtor-friendliness is linked to extensive legal certainty, which makes possible losses predictable and calculable. From this point of view, Central and Eastern European countries still find themselves first and foremost in transition.

References


Security Interest and Insolvency: A Comparative Analysis between Swedish, Estonian, Latvian and Lithuanian Law

Annina H. Persson

The purpose of this study is twofold, first to describe and analyze from a comparative point of view the present status of the law relating to security interest and insolvency in Sweden and the three Baltic states of Estonia, Latvia and Lithuania, and, second, to elucidate the direction that legal development has taken in the four countries.

General survey of the legislation

There is no cohesive legislation regulating security interests in Sweden. The legislation is mainly gathered in the Civil Code, but the provisions are scattered and in some cases of great antiquity. Swedish insolvency rules are governed by the following legislation: (1) on bankruptcy, the Bankruptcy Act; (2) on company reorganization, the Company Reorganization Act; on debt remission for natural persons, the Debt Remission Act. Closely linked to insolvency are the rules on priority rights, the Right of Priority Act and the Enforcement Code.

The law regarding security interests and insolvency in Estonia is contained in a number of different enactments. Interesting provisions can be found in the Law of Property Act. This Act regulates real rights, e.g., ownership and right of security. It regulates content, formation and termination of such rights. Other interesting pieces of legislation for this topic are the

1 Handelsbalken (1736:0123 2).
2 SFS 1987:672.
5 SFS 1970:979.
6 SFS 1981:774.
Bonds Act, the Property Law Implementation Act, the Commercial Pledges Act, the Commercial Code, the Bankruptcy Act and the Enforcement Code.

The law regarding security interests and insolvency in Latvia is also contained in a number of different enactments. Of special interest is the Latvian Civil Code, especially Part 3 Property law (Chapter 3, Sections 927-1129 regarding ownership and Chapter 6, Sections 1278-1380 regarding pledge rights). Other relevant acts are the Latvian Bankruptcy Act for Companies – Law on Insolvency, the Commercial Law and the Law on Commercial Pledge.

The Lithuanian Civil Code, which came into effect in July 2000, is of special interest to security interests. Book 4, Rights in Rem, includes provisions about the transfer of ownership. It also includes provisions on protection of good-faith possessors of things acquired under a contract. It deals also with the form and the content of some real rights, such as mortgage and pledge. Other interesting pieces of legislation are Lithuanian Bank-

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19 See Sec. 4.170 of the Civil Code and the following sections.

20 See Sec. 4.198 of the Civil Code and the following Sections.

Different types of security interest

A security interest can generally be defined as a creditor’s right to use property for a profit in one or more respects and privileged ways. Traditional security interests include pledges on immovable and movable property, floating charges, liens, chattel mortgage (assignments of goods without leaving possession of them), retention of title clauses and guarantees. The form and content of these security interests, with the exception of suretyship and liens will now be analyzed in the light of insolvency law. What kind of assets may be subject to a security interest? How is the security interest perfected? Is it possible for the creditor or another third party to check the title to assets in the debtor’s possession? What remedies are available for the secured creditor in case of the debtor’s default? What impact does the debtors’ insolvency have on the possibility of the creditor to enforce his security interest?

Security interests in movable property

Pledge on movable property – Swedish Law

The fundamental legal provisions on the legal relations between a pledgee and pledger in Swedish law are set out in Chapter 10, Sections 1-7 of the Commercial Code. These rules are mainly focused on a particular group of movables called ‘lösören’ (chattels like cars, animals, furniture, etc.) but can also be applied to other types of movable property if that property is not regulated by other legislation. In principle, all kinds of movable property can

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22 Law on Restructuring of Enterprise, March 20, 2001 no IX-218.
23 Because of different terminology in the four countries, chattel mortgage and floating charge will be discussed under the subheading Pledge on movable property.
24 See, regarding suretyship in the Swedish Commercial Code (1736:0123 2), Chapter 10, Sec. 8-12, the Estonian Law of Obligations Act, effective July 1, 2002, RT I 2002, 53, 336. Amended May 1, 2004, RT I 2004, 37, 255. Chapter 8, Division 1, Sec. 142-155, the Latvian Civil Code, Part 4, Chapter 5, Subchapter 1, Sec. 1692-1715, the Lithuanian Civil Code, Sec. 6.76 and the following sections.
26 These criteria for analyzing the security interest are based on Wood (1995).
be used as collateral. In addition to these general and well-established rules, there are provisions on pledges in Chapter 3 of the Maritime Act concerning ships, Sections 10, 22, 31 and 32 of the Commercial Papers Act on Pledging of Negotiable and Non-Negotiable Instruments and Debts, the Accounting of Financial Instruments Regarding Pledging VPC-Registered Shares and Other Non-Paper-Based Financial Instruments. In general, freedom of contract prevails between the pledgee and the pledger, with very few exceptions. One exception is found in Sec. 37 of the Contract Act (lex commissoria). The provision states that an agreement whereby the pledgee acquires the pledged object for satisfaction of the claim is void. Another exception is if conditions of a contract would be unfair to one of the parties, they could be subject to Sec. 36 of the Contract Act and altered in favor of the discriminated party.

Under Swedish Law, the prerequisites for a valid pledge on movable property are as follows:

1. A pledge agreement – which can be oral or in writing,
2. An identifiable debt for which the pledge constitutes security (pledge debt),
3. The collateral is or will become individualized to such a degree that it can be identified as the property stipulated in the pledge agreement (specialty principle),
4. A certain measure is taken (perfection) – e.g., transfer of the object from the pledger to the possession of the pledgee (possessory pledge), or by informing a third party that is responsible for the security of the collateral (notice) or by entering the pledge in a pledge register (registration). The nature of the property will determine when the pledge is perfected. Sometimes the pledge agreement can be enough.

In this context, it becomes pertinent to mention the Right of Priority Act, which regulates creditors’ right to payment in the event of the debtor’s insolvency. Priority (i.e. which creditor receives payment first) can be either special or preferential. Subject to certain exceptions, special priority rights take priority over preferential rights. The Right of Priority Act provides that pledges on movables carry special priority rights, Sec. 4 p 2.

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27 See Chapter 19, Sec.3 of the Swedish Companies Act (SFS 2005:551).
29 SFS Lag (1936:81) om skuldebrev.
31 See Lag (1915:218) om avtal och andra rättshandlingar på förmögenhetsrättens område. See also other mandatory legislation that could have an impact on pledge, e.g., Sec. 21 of the Consumer Credit Act (SFS 1992:830) and Pantbankslagen (SFS 1995:1000).
Another security interest – similar to the pledge – is the floating charge.\textsuperscript{33} This provides companies with the practical possibility of pledging chattels without having to comply with the rules on possessory pledge. These rules are set out in the Floating Charges Act.\textsuperscript{34} A person who wishes to give a floating charge may, under Chapter 1, Sec. 1 of the Floating Charges Act, issue a charge on his property for a specific sum of money. This is evidenced by a deed of floating charge. It should be noted that several such deeds could be issued over the same assets of a person. The charge that is created first has first priority. A floating charge can attach to all kinds of property belonging to the person creating the charge. However, in order for the creditor to have a secured position, a businessperson must hand over the deed of floating charge as security for a debt. It is the creditor’s responsibility to check that the person handing over the deed is a businessperson. Section 11 of the Right of Priority Act provides that floating charges retain a preferential right, but certain claims with special priority rights are to be satisfied prior to a claim under the floating charge. In the event of the business being insolvent, the creditor will have priority only to 55\% of the net value of the bankruptcy estate after creditors with better priority have received payment.

A third pledge is the chattel mortgage. Under the Bills of Sales Act,\textsuperscript{35} a purchaser can acquire creditor’s protection despite the fact that the property remains in the possession of the seller (chattel mortgage). An assignment of goods by the seller without the goods leaving possession of the seller is usually not valid against the seller’s creditors because of lack of perfection. However, perfection can be accomplished by registration in accordance with the above-mentioned Act. The purchase itself and the physical movable must be documented in writing, the purchase published in daily newspapers and the contract to purchase and evidence of publication registered with the Enforcement Administration. Once the purchaser has fulfilled these requirements, there is an annulment period of 30 days before the purchaser acquires creditor’s protection. A correctly executed security transfer gives the purchaser a right of repossession of the property in the event that the seller is declared bankrupt.

\textbf{Pledge in movable property – Estonian Law}

Part 8 of the Law of Property Act\textsuperscript{36} contains provisions on pledge. The legislation provides for types of pledges of movables: (1) possessory pledge, Sec. 281 and the following sections, (2) registered pledge, Sec. 297 and the following sections and (3) pledges of rights, Sec. 314 and the following sec-

\textsuperscript{33} Concerning commercial pledges, see under subheading 3.2.2.
\textsuperscript{34} SFS 2003:528.
\textsuperscript{35} SFS 1845:50 p 1.
tions. The Commercial Pledges Act contains provisions on commercial pledge, a certain type of registered pledge.

A claim secured by a pledge is preferred to all other claims with respect to the pledged property, unless otherwise provided by law, Sec. 280 of the Property Act. The Bankruptcy Act provides that pledges on movable property carry special priority rights, Sec. 153.37.

Physical transfer of possession of the pledged thing38 (the collateral) from the pledger to the pledgee creates a possessory pledge, if they have agreed on the establishment of the pledge, Sec. 282(1) c.f. Sec. 281.39 If the thing is already in the possession of the pledgee, the pledge is created by entering the pledge agreement. A pledge can also be created on a thing that is transferred to a third person, whereby the pledgee obtains indirect possession of the collateral. A possessory pledge can only be created in movables that are not subject to registration in a public registry.40 The pledge agreement must be in writing if the value of the pledged thing exceeds 500 Estonian kroons. Any claim that can be valued in money may be secured by a pledge, including a conditional or a future claim, Sec. 279.

Not more than one possessory pledge can be established on the same object. However, a possessory pledge can be taken on several objects. In this case, the entire claim is secured by each thing, Sec. 283(1). The possessory pledge is extinguished, e.g., by (1) termination of the claim or (2) by destruction of the movable, (3) the pledgee becoming the owner of the pledged thing, (4) the pledged object no longer being in the possession of the pledgee and the pledgee being unable to reclaim the thing, (5) the pledgee returning the pledged thing to the pledger or notifying the pledger of discharge of the pledge, (6) a third person holding the pledged object returning it to the pledger, Sec. 284-286 and (7) failure to submit a claim in the bankruptcy of the pledger (Bankruptcy Act Sec. 95 cf. 34. If the claim secured by the pledge is not satisfied, the pledgee has the right to sell the pledged thing, Sec. 292(1) and (2). The pledged object must be sold at a public auction unless the pledger and the pledgee agree to sell it in a different manner, Sec. 294(1) and (4). A pledgee is required to notify the pledger of the sale of the pledged thing 1 month in advance. If notification is impossible, it may be waived. In that case, the pledged thing may not be sold before 1 month has passed since creation of the right of sale, Sec. 293(1). An agreement

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37 It should be observed that a Commercial pledge ranks lower than a pledge in general. See further under subheading 4.2.2.
38 See discussion about the concept thing in Pärnu (2001).
39 Sec. 281(1) states, “A movable may be encumbered with a pledge such that the pledged thing is transferred into the possession of the pledgee and the establishment of a possessory pledge is agreed upon. A thing may also be encumbered by a pledge so that the thing is transferred to a third person and the pledgee obtains indirect possession of the pledged thing”.
40 See Paron and Tomachyeva (2003, p 97).
whereby the pledgee acquires the pledged object for satisfaction of the claim is void, Sec. 292(3).

Intellectual property, motor vehicles and aircraft, which are subject to registration in a public registry, may be encumbered with a registered security, Sec. 297.\textsuperscript{41} Creation of a registered pledge over movables requires a written agreement between the involved parties and registration, Sec. 299. The pledged object can remain in the possession of the pledger, but registration is needed. Several registered pledges can be established in the same object and the ranking of a registered security over movables is determined by the time of entry in the register, Sec. 300(1). The priority can be changed on request but only with the consent of the parties involved, Sec. 300(6). If the claim secured by the pledge is not satisfied, the pledgee has the right to demand compulsory execution by auction, Sec. 302(1). The pledged object must be sold at a public auction unless otherwise provided by law, Sec. 302(3). An agreement whereby the pledgee acquires the pledged object for satisfaction of the claim is void, Sec. 302 (2).

Rights such as securities and claims can be pledged under Sec. 314 and the following sections. A written agreement between the pledger and the pledgee is needed, unless otherwise provided by law, Sec. 315. If the right, e.g., is a claim, the pledger shall notify the debtor of the pledged claim, Sec. 317.

An undertaking registered in the commercial register may establish a commercial pledge in the commercial pledge register, Sec. 1 of the Commercial Pledges Act. The pledge will serve as security for a claim (commercial pledge) without the need of transferring possession of the pledged property, Sec. 3. A commercial pledge does not presuppose the existence of a securable claim and is not extinguished by termination of a claim. The provisions of the Property Act concerning registered pledge apply, unless otherwise stated in the Commercial Pledges Act. Thus, several pledges may be established on the same object of pledge for the benefit of one or several creditors, unless otherwise provided by law or the pledge contract, Sec. 277(3) of the Property Act.

Under Sec. 2(1) and (2), a commercial pledge extends to all movable property of a company or movable property relating to the economic activity of a sole proprietor. All property that belongs to the company at the time of the pledge entry being made and property that the undertaking acquires after the pledge entry is made are part of the commercial pledge. However, the pledge does not extend, e.g., (1) shares, stocks, promissory notes or other loan documents, or (2) property on which another registered security has

\textsuperscript{41} Even though ships are not mentioned in the paragraph, it is possible to pledge a ship in the respective registry (see Paron and Tomachyeva 2003, p 98). Furthermore, defects in the law do not permit pledging of motor vehicles by registered pledge.
been established over movable or immovable property under the Property Act, or 3) property that, pursuant to law, cannot be subject to a claim for payment. A commercial pledge may be established on movable property of the Estonian branch of a foreign company.

**Pledge in movable property – Latvian Law**

General provisions applicable to all pledges both on movable and immovable property are found in Sec. 1278-1380 of the Civil Code. Under Sec. 1278 a pledge right is a right to property owned by another so that this property provides security for a creditor’s claim in such a way that he/she is able to receive payment of such claim from the collateral. All pledges must be based on a claim, which the collateral is to secure, Sec. 1280. As already mentioned, in case of non-performance on the part of the debtor, the creditor is entitled to seek satisfaction of his claim by selling the pledged property.

A pledge right may be created by contract, by testamentary disposition or by judicial process, Sec. 1304. It can also be created by law. Under Sec. 1294 all things, where sale is not prohibited, may be a subject of pledge rights, not only existing things but also future things and tangible (movable or immovable) as well as intangible property. However, the pledging of immovable property without transfer of possession is called a mortgage. Likewise, the pledging of a ship without transfer of possession called a ship mortgage, Sec. 1279 and note 1.

The creditor has no right to keep the collateral as his property. An agreement whereby the pledgee acquires the pledged property in place of the claim is invalid, Sec. 1334. On the other hand, the creditor has the right to sell the collateral if the debtor fails to pay the underlying debt within the agreed term, Sec. 1319. The creditor may only sell the collateral on the open market if the debtor has granted him to do so. If such a right has not been granted, the creditor may only sell the collateral at an auction through a court, Sec. 1321.

A possessory pledge is established when the pledger transfers the movable property into the possession of the pledgee, with the intent that it shall be security for the claim, Sec. 1340.

Under Sec. 1358, the general provisions regarding termination of the pledge right (Sec. 1309 and subsequent sections) are also applicable to possessory pledge. The pledge right may also be terminated by renunciation, Sec. 1359.

A commercial pledge can be established by a person, which may pledge property in order to secure liabilities. The Law of Commercial Pledge governs the security interest, but the general provisions of Sec. 1278-1380 in the Civil Code are also applicable, see Sec. 2 (3) of the Law of Commercial Pledge. The object of the commercial pledge may be: (1) a movable tangible

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42 Compare the Commercial Pledge Law and sec. 1279 note 2 in the Civil Code.
or intangible object that belongs to a legal person engaged in business, (2) a pool of such assets and (3) the complete assets of an enterprise, sec. 3 (1). Private persons may pledge movable items subject to registration (e.g., vehicles) as well as an enterprise or a pool of things; shares and bonds may be object of the pledge irrespective of the ownership of the above things, Sec. 3 (2). The commercial pledge where the object is a pool of things shall include the existing as well as future parts of the pool if it is not explicitly clear that the pledger intended to pledge only the part of the pool as it was at the moment of creating the pledge right, Sec. 3 (3).

Under Sec. 4 of The Law of Commercial Pledge, a vessel or a claim arising from a check or a bill of exchange cannot be the object of a commercial pledge. If the complete assets of an enterprise or a pool of things has been pledged, the claims just stated as well as real estate, vessels and publicly traded financial instruments should be considered excluded from the pledge property.

Failing express agreement to the contrary, the commercial pledge will secure not only the principal claim but also auxiliary claims, Sec. 7(1). The parties shall determine the maximum amount of the claim to be secured by the collateral. The part of the claim that exceeds this amount shall be deemed an unsecured claim, Sec. 7(2). A commercial pledge takes effect – in addition to the basis of the agreement between the pledger and the pledgee – when it has been registered in the Commercial Pledge Register, Sec. 9 (1). The application for registration shall be in a special form and have a certain content, Sec. 10-11. It should be signed by the parties and the signature on the application should be verified by a notary, Sec. 12. It should be noted that the registry is public and any person can have access to general data on registered pledges, Sec. 21, (note that it does not permit access to the documents). This makes it fairly easy for a third party to determine whether property is charged or not. It is possible to grant more than one commercial pledge on the same object, unless otherwise agreed between the original pledger and pledgee. The priority between several pledges will be determined in accordance with the registration sequence in the register. However, one can change the priority right, Sec. 27. The collateral can be in the possession of either the pledger or the pledgee, Sec. 24-25. Another alternative is to appoint a third person to act on behalf of the pledgee over the pledged property. Sec. 29-32. If the pledger cannot pay the secured claim, the pledgee may take possession of the collateral and sell it. Furthermore, Sec. 41 grants the creditor the right to exercise his enforcements rights before maturity of the obligation if the court issues an order to start bankruptcy proceedings against the pledger. If the pledger is declared insolvent, the possibility for the pledgee to exercise the pledge right is restricted by the insolvency law, Sec. 36. The collateral may be sold without a public auction if the

pledger has granted such a right to the pledgee and it has been registered in the pledge registry, Sec. 37-38. Otherwise, the object will be sold at a public auction, and the proceeds distributed to the pledgee, Sec. 46.

Pledge in movable property – Lithuanian Law

Pledge regarding movable property is regulated in Chapter XII, Sec. 4.198 - 4.228 of the Civil Code. Sec. 4.198(1) defines a pledge as pledging of a movable thing or property rights securing an existing or future debt when the collateral is transferred to the creditor, a third person or remains with the pledger. If the collateral remains with the pledger, it may be locked, sealed or marked, indicating that it has been pledged. Thus, available security interests are possessory pledge and non-possessory (registered) pledge. A pledge is created by contract or by law, Sec. 4.199(1). If it is a legal pledge, provisions in the Civil Code about legal mortgage also apply to the legal pledge. Sec. 4.199(2). When a pledge is created by law, the law shall specify exactly the thing subject to the pledge. A pledge may secure a performance of any monetary obligation, Sec. 4.200(1). Movable things and property rights (e.g., lease rights) may be the object of a pledge, Sec. 4.201(1) and Sec. 4.204. The pledge covers also accessories of the thing and non-separated fruits, unless otherwise provided in the contract and by law. Things in respect of which enforcement may not be levied under the existing laws, as well as movable things that have been pledged together with an immovable thing may not be the object of a pledge, Sec. 4.201 (2). As property rights are concerned, the property rights that the pledger will acquire in the future may also be the object of the pledge, Sec. 4.204(2). When a property right subject to a pledge is evidenced by securities or special documents, they should be transferred to the pledgee unless otherwise provided by laws or by an agreement of the parties, Sec. 4.204 (3).

Creation of something similar to the commercial pledge in Estonia and Latvia and the floating charge in Sweden can be achieved by applying Sec. 4.202 of the Civil Code. This stipulates that a pledger, having pledged goods in stock that are in circulation (goods, raw material, semi-finished goods and finished goods), has the right to change the composition and form of pledged goods in stock provided their total value is not reduced. When pledged goods are sold while the pledger is engaged in business, the pledge of goods is released and new goods in stock acquired by the pledger become the object of the pledge from the time of acquisition of the goods. The debtor himself or a third person may be the pledger, Sec. 4.206. The pledger must be the owner of the collateral or the owner of the property rights where the rights are the...

44 See further about the legal pledge under subheading 3.3.4.

45 Sec. 4:204 (1) “Rights pertaining to land, forest, other things, i.e. the right to use, the right of lease and other property rights, except for rights related to the personality of the owner of the thing pledged as well as rights that are not transferable by laws or by the contract may be the object of the pledge”.

308
object of the pledge (except when the law stipulates that the pledger may acquire the object in the future). A property right that belongs to several persons may be pledged by written consent from all of them. The law or the contract may stipulate the duty to insure the pledged thing, Sec. 4.205(1). A contract may also provide for the duty of the pledger (a legal person) to insure the object of the pledge in the event of liquidation or insolvency, Sec. 4.205(2).

If it is a possessory pledge, a written pledge contract must be concluded between the parties, Sec. 4.209 cf. Sec. 4.213. A pledge contract may be concluded as an individual contract or as a pledge contract that could be included into the agreement from which the principal obligation arises. If the pledged object is transferred to a third person or remains with the pledger, a pledge contract and a unilateral declaration by the owner of the pledged property is drawn up by perfecting a pledge bond (contract) certified by a notary and registered in the register of mortgages. Non-compliance with the rules makes the contract null and void, Sec. 4.209(3).

A pledge bond should be signed by the debtor, the creditor and the person to whom the collateral is transferred. In certain cases, it is enough if only the pledger signs the pledge bond. A pledge contract must also fulfill certain formal requirements and may include other additional data.

Under Sec. 4.211, a subsequent pledge is possible if the collateral has not been transferred to the pledgee and the pledge bond does not provide otherwise. In such a case, the prior pledge remains valid. If a subsequent pledge is created, the pledger must notify each creditor of all prior and subsequent pledges and obligations secured by the pledge and their amount and make good any losses to the creditors because of failure to discharge his duties. If the same object is the subject of several registered pledges, the priority is determined in accordance with the registration sequence, Sec. 4.212.

The creditor has the right to satisfy his claim from the value of the collateral prior to other creditors, if the debtor fails to discharge his obligation secured by the pledged property, Sec. 4.198(2). A pledgee acquires the right of enforcement towards the collateral on the pledger failing to perform, but not less than 20 days after the expiry of the period for the performance of the obligation. A beneficial term that is not shorter than 10 days may be set up by a mutual agreement of the parties, Sec. 4.216 (1). A creditor is entitled to demand performance of the obligation secured by the pledge before the expiration of the maturity date if a liquidation procedure commences for the pledger (legal person) or if the value of the pledged property decreases with more than 30%, or in certain other cases, as provided in Sec. 4.216 (2).

When the debtor fails to perform the obligation secured by the pledge, the creditor’s claim is met from the value of the collateral, unless the law of con-

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46 See Sec. 4.209 (4) of the Civil Code.
tract provides otherwise, Sec. 4.219(1).47 A creditor must notify the debtor and the pledger (when the pledger is not the same person as the debtor) in writing that if the secured obligation is not performed within the grace period, the enforcement will commence. If it is a registered pledge, a written warning notice should be delivered to the debtor through the Office of Mortgages, which is bound to inform all persons listed in the Register who are entitled to the thing. A creditor can sell the collateral in the manner agreed upon by the creditor, the debtor and the pledger, Sec. 4.219 (5). If the collateral is pledged several times, all parties may mutually agree to transfer the collateral into the ownership of the creditor. If such an agreement cannot be met, the collateral is sold by auction, Sec. 4.219(5).48

Security interest in immovable property

Mortgage in immovable property – Swedish law
Well-established rules regarding mortgage in immovable property are found in Chapter 6 of the Real Property Code49. Under Chapter 6, Sec. 1, a property owner is entitled to obtain, according to the rules in Chapter 22 of the same Act, registration of a certain amount of money as a charge on the property. As evidence of the registration, a mortgage deed is issued by the Land Registration Authority. The deed can be in electronic form. In order for the creditor to obtain a secured position, the mortgage deed must then be transferred to the creditor as a pledge for the creditor’s claim, Chapter 6, Sec. 2. If the deed is electronic, registration of the creditor in the mortgage-deed registry will have the same effect. If the debtor should become insolvent, the creditor is then entitled to payment when the proceeds of an executive sale of the property are distributed. The Right of Priority Act, Sec. 6 (1) provides that there may be special priority rights in real property. There can be several mortgages on the property and the ranking of them is determined by the chronology/time of entry in the register.

Mortgage in immovable property – Estonian law
Immovable property may be encumbered with a mortgage.50 The security interest extends to the entire immovable property that has been registered in the Land Registry.51 Thus, the mortgage extends to the parts, accessories and

47 See Sec. 4.220 of the Lithuanian Civil Code concerning realization of pledged property rights.
48 Special rules apply to securities, see Sec. 4.219 (5) of the Lithuanian Civil Code.
50 It is possible to divide and merge a mortgage (partial mortgage, Sec. 355 of the Property Act, combined mortgage, Sec. 359 of the Property Act, judicial mortgage, Sec. 363 of the Property Act.
fruits of an immovable, Sec. 343 of the Property Act. In the event of the
debtor becoming insolvent, the creditor is entitled to satisfaction of his claim
secured by the mortgage out of the pledged immovable, Sec. 325. The
agreement to establish a mortgage requires notarization, Sec. 326. The mort-
gage is created by a land registry entry based on the agreement and a nota-
rized application.\textsuperscript{52} Only the owner of the property can establish a mortgage,
Sec. 326. The mortgage does not presuppose the existence of a claim to be
secured, Sec. 325(4).

\textbf{Mortgage in immovable property – Latvian law}

Mortgage in immovable property is established by registration in the Land
Register, Sec. 1367 of the Civil Code. In order to have the mortgage regis-
tered certain requirements must be fulfilled, Sec. 1368. The registration must
take place at the relevant institution, i.e. the Land Register Office where the
immovable property is located, Sec. 1368 (1) and Sec. 1369. The form pre-
scribed by law must also be observed in the course of registration and it must
be done in due time, Sec. 1370. The claim must have certain characteristics,
Sec. 1371 and Sec. 1372. A mortgage can only be registered for a specific
amount of money and registration can only be for a specific immovable
property, Sec. 1373. The form for registration must also be observed. When
the debtor is paying off the mortgage, he must make certain that the appro-
priate record is entered in the Land Register, Sec. 1374. Otherwise, the pay-
off is not binding in respect of third persons, only between the parties. If
several creditors have rights in the same object, their right to receive satis-
faction is determined by the order of priority as the mortgage has been re-
corded in the Land Register, Sec. 1379 cf. Sec. 1309 and subsequent sec-
tions.

\textbf{Mortgage in immovable property – Lithuanian law}

Mortgage in immovable property is governed by Chapter XI, Sections 4.170
- 4.197 of the Civil Code.\textsuperscript{53} The object of a mortgage may be individual im-
movable things, registered in a public register, which are not withdrawn
from the civil turnover and can be presented for sale at a public auction. The
mortgaged property (with the exception of land) must be insured, Sec.
4.171(4). Present and future fixtures are objects of the mortgage, unless oth-
ervise provided in the mortgage contract, Sec. 4.171(2). Lithuanian law dis-
tinguishes between contractual and legal mortgage. A legal mortgage arises
on the basis of law or through a court decision: (1) in order to secure state
claims arising from taxes and state social insurance legal relations, (2) in
order to secure claims related to the construction of buildings or reconstruc-

\textsuperscript{52} See Paron and Tomachyeva (2003, p 97).
\textsuperscript{53} See www.infolex.lt/portal/ml/start.asp?act=dobiz&ang=eng&file=realestate.html, 2005-12-
13.
tion, 3) in order to secure property claims in accordance with a court judgment and (4) in other cases provided for by the Civil Code, Sec 4.175(2). A mortgage can be of different types. First, it can be an ordinary mortgage, which is a mortgage of one definite immovable property in order to secure one definite obligation, Sec. 4.179. Second, it can be a joint mortgage, which is a simultaneous mortgage of several immovable properties in order to secure one definite obligation. Third, it can be a mortgage of a thing belonging to another person, which is a mortgage of an immovable property in order to secure the discharge of the debt obligation of the other person, Sec. 4.181. Fourth, it can be a maximal mortgage, which is a mortgage on an immovable property when an agreement is made only to secure the maximum sum of obligations on the basis of a mortgaged property and on the area in which the loan will be used, Sec. 4.182. Fifth, it can be a joint (common) mortgage, which is a mortgage on several immovable properties belonging to different owners in order to secure one debt obligation, Sec. 4.183. Sixth, it can be a conditional mortgage, which is a mortgage of property in order to secure the obligation if it has been agreed that the mortgage becomes effective from the moment of the fulfillment of the condition stipulated in the contract or during the time when the condition, stipulated in the contract, is being fulfilled, Sec. 4.184.

A contractual mortgage is created by contract between the creditor, the debtor and the owner of the mortgaged property (if the debtor is not the owner) or by unilateral application of the owner of the property. Under Sec. 4.185, the mortgage contract, a unilateral application by the owner of the mortgaged property as well as the application to register the legal mortgage, shall be executed as a mortgage bond. The contents of the mortgage bond are quite specific, Sec. 4.186. When the mortgage is contractual, a notary shall in addition to these specific requirements certify the mortgage bond. A mortgage bond must be signed by the creditor, the debtor and the owner of the mortgaged property (when the debtor is not the owner of the property). When the object is mortgaged following unilateral application by the owner of the property, it is sufficient for the contract to be signed by that person. If the mortgage is legal, the mortgage bond is signed by the creditor. The mortgage must then be registered in the Register of Mortgages to be valid. If the debtor fails to discharge his obligation, the mortgagee has the right to sell the mortgaged property at a public auction and satisfy his claim prior to other creditors from the proceeds from sale, Sec. 4.192. In the event of several mortgages on the property, claims of mortgagees are satisfied according to the time of their application for registration of the mortgage, Sec. 4.193(2).
Retention of title clauses

Terminology and classification
From an international point of view, there exist several different types of retention of title clauses (called ROT clauses), which are often used in combination. In most countries, one finds a simple ROT clause that usually stipulates that the property in the goods delivered to the buyer shall not pass to him until he has paid the purchase price in full. This type of ROT clause has a limited value as it gives the creditor security for the price of the goods only. Its lesser value is also because the clause is limited to a particular object. Especially when stock is involved, the buyer may often want to resell the goods. In these cases, the creditor would much rather use a retention of title extended to proceeds. The ROT clause usually stipulates that the seller shall retain his title to the goods until payment has been made in full, but that the buyer may resell the goods in the ordinary course of business if he assigns to the seller all debts or claims arising from such a resale. When raw materials are sold, it happens quite frequently that the buyer would like to mix the goods with his own goods or with those supplied by a third party. In this case, the creditor would like to use a retention of title clause extended to products. The ROT clause can stipulate that when the goods become mixed with other materials, the seller shall be the owner of the resultant product until the price of the goods has been paid in full.

As mentioned before, a simple ROT clause has a limited value, as it only gives the creditor security for the price of the goods. A retention of title clause expanded to other indebtedness is therefore often preferred. It secures not only the price of the particular goods sold, but also other kinds of both existing and future debts of the buyer, arising from the dealings between the parties and sometimes their affiliate companies.

Retention of title – Swedish law
Swedish law does not possess a coherent body of legal rules concerning ROT clauses. Apart from a few scattered sections, such as Sec. 54 p 4 of the 1990 Sales Act 54 or Sec. 7 of the 1978 Installment Act 55, the main rules concerning the validity of the security interest are found in case law. In some cases neither statutory provisions nor case law can be found, which means that a solution to a given question may sometimes be quite uncertain.

It is common for a seller to grant the buyer the right of possession of the object of sale before payment has been made (credit sale). However, such a transaction involves a high degree of risk for the seller. In the Swedish legal system, if the buyer is not willing or able to pay the agreed purchase price,
the seller usually cannot reclaim the goods once they have come into the buyer’s possession. However, if the contract contains a valid ROT clause, the seller can reclaim the goods, even if the buyer is insolvent, Sec. 54 p 4 of the Sale of Goods Act.

Both the Swedish Installment Act and the 1992 Consumer Credit Act contain several sections that influence the possibilities of stipulating a ROT clause in these types of contract. Under Swedish law, a creditor who has delivered goods to the debtor and secured his demand of payment with a ROT clause may seek a judgment through the courts entitling him to have the goods redelivered to him or to reclaim possession of the goods Under the rules on simple procedure (see, e.g., Sec. 11–18 of the Swedish 1978 Installment Act.)

It is possible to stipulate a ROT clause in a contract of sale regarding real estate. However, the application of such a clause to equipment can sometimes be affected by the Land Code. Under the Code, real property refers to land and what pertains thereto, such as buildings, trees and. To a building pertains, in general, anything necessary for use of the building (Chapter 2, Sec. 2). Machinery and other equipment installed in a factory or other industrial property and for use in the business also belong to the property (Chapter 2, Sec. 3). However, it is possible to stipulate a valid ROT clause to apply to a machine that falls into the last category of real property. It is also possible to uphold the validity of such a clause if the ground and the building have different owners. Because of these exceptions, it is of the utmost importance to determine when a certain object falls under Chapter 2, Sec. 3 or Chapter 2, Sec. 2, as in the latter situation the ROT clause has no validity at all against the owner of the building or other creditors (mortgagees on real estate). This is sometimes difficult to determine and has, on occasion, led to many legal disputes and comments.

From a Swedish point of view, it is of the utmost importance that the seller makes sure that the ROT clause has been incorporated in the contract, and he should establish whether any formal requirements must be satisfied. Since a ROT clause in a sale contract is most frequently part of the general conditions of sale, he must make sure that these conditions have been included as terms of the contract. If one examines the formal requirements for a ROT clause, there are no formal requirements connected with such transactions, except regarding consumer sales. Only in such transactions must the ROT clause be in writing. A third condition that has to be fulfilled for the ROT clause to be valid is that the parties should have agreed on the clause before the conclusion of the contract, or at the latest, before the goods have come into the buyer’s possession. If this important requirement is not ful-

filled, the seller does not have priority before the buyer’s creditors. A fourth condition that has to be fulfilled is the requirement that a ROT clause is only valid if the goods have been specified and that it should be possible to distinguish them from among the other goods in the buyer’s possession as collateral. If the secured object cannot be identified, the ROT clause may lose its effect. A fifth condition that must be fulfilled is that the ROT clause should be related to the purchase price. As a consequence of this rule, it is impossible to use goods as collateral for unrelated or future debts. It can happen that a seller co-operates with a financier who grants the buyer a loan for the purchase of goods. If the seller receives the purchase price directly from the financier, the parties can agree that in return for the money the financier will get the right to the security interest when the goods have been transferred to the buyer. However, under Swedish law, such a transaction can make the ROT clause invalid, as it is of the utmost importance that the seller gives the credit. On the other hand, the seller can later discount the contract to the financier in exchange for the security interest.

An important limitation of a ROT clause is that it becomes invalid if the secured object has been incorporated into other goods or real estate. The same holds true if the secured object loses its identity because of processing. The rule is very strict. The ROT clause is declared void if the contracting parties intend to incorporate the object into other goods even though no incorporation has taken place before the debtor’s default or insolvency. The same rule applies if the debtor has the right to sell the goods prior to payment. The ROT clause is invalid if such a right of disposal is given to the debtor. One may conclude that all the above-mentioned conditions mean that only simple ROT clauses are valid in Sweden. Any extended clause that secures the proceeds from a resale or a new product that results from the processing of the goods sold would be considered, in principle, invalid against the buyer and his creditors.

**Retention of title – Estonian law**

Under Estonian law, it is possible in a sales contract for a seller to use a ROT clause in order to secure payment from the buyer for delivered goods, see Sec. 233 of the Law of Obligations. In comparison to Swedish law, ROT clauses for movable objects are not restricted to a specific form. It is possible to stipulate a simple ROT clause that will give the seller the right to separate the sold goods from the buyer’s bankruptcy estate. It is also possible to stipulate a retention of title clause extended to proceeds. The buyer may resell the goods in the ordinary course of business if he assigns to the seller all debts or claims arising from such a resale. On the other hand, it is not

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59 Pihkva (2005, p 13.)
clear if it is possible to make a valid ROT clause extended to products. However, it is possible to stipulate in a sales contract a retention of title expanded to other indebtedness. It secures not only the price of the particular goods sold, but also other kinds of both existing and future debts of the buyer arising from the dealings between the parties and sometimes their affiliate companies. Concerning the legal point of retention of title, Estonian law seems to be influenced by German law.

**Retention of title – Latvian Law**

It is possible to use a simple ROT clause as a security interest in Latvia. This view is founded on Sec. 2033, 2037, 2047, 2069 of the Civil Code. Under Sec. 98061, it should be possible to use a retention of title clause extended to products, allowing the buyer to process the goods before he has paid for them. It is not clear if it is possible to use a retention of title clause extended to proceeds or expanded to other indebtedness.

**Retention of title – Lithuanian law**

It seems that the Lithuanian law regarding ROT clauses is regulated in the same way as in Estonian Law. This view is founded on Sec. 4.37 and the following sections, particularly section 4.49(3) of the Civil Code.62 Sec. 4.49(3) says that a contract may stipulate that the ownership to an object shall pass to the acquirer only after the latter has carried out a condition established in the contract. This shows that it is possible to draw up a simple retention of title clause. Furthermore, it is clear that a retention of title clause extended to products would be valid, Sec. 4.54. Thus, the ROT clause can stipulate that when the goods become mixed with other materials, the seller shall be the partial owner of part of the resulting product (in proportion to what the seller has delivered) until the price of the goods has been paid in full. It is not clear if it is possible to use a ROT clause extended to proceeds or expanded to other indebtedness.

**Analysis of the security interests**

The rules described above give the impression that in all four countries all kinds of assets may be subject to a security interest. In Sweden, the security interest is perfected by transfer of the secured object, by registration, by the contract itself or by noticing the debtor. It is difficult to say which method is the prevailing one. In Estonia, Latvia and Lithuania, one finds all four mentioned methods of perfecting the security interest, but it seems that registration is the main method to perfect. In contrast to Swedish law, the security interest must sometimes be notarized according to the law of the three Baltic

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61 Compare sec. 2007 and 2009 of the Civil Code.
Lithuanian law demands notarization in more cases than in the other two Baltic legal systems. Under Swedish law, notarization is never demanded. The formal requirements regarding the agreement of the security interest are also stricter according to the legal rules in the three Baltic States than according to the Swedish rules. Under Estonian, Latvian and Lithuanian law, it is more common to demand that the security agreement is made in writing and the content of the security document is described in detail in the law. A valid oral agreement, which in many cases is sufficient according to the Swedish rules, is generally not accepted.

A different rule from a Swedish point of view is found in Lithuanian Civil Code sec. 4.200 (2), which says that a pledge is a derivative obligation from a principal obligation. Rights of the pledgee are derived from his rights as a creditor and the exercise of these depends on the fate of the obligation secured by a pledge. In Sweden, the pledge agreement is separate from the principal obligation. The pledge right can exist without an obligation against the debtor personally. If a minor person pledges an object, it can happen that the pledge agreement is valid. The creditor/pledgee cannot demand payment directly from the minor, but he can obtain payment by selling the pledged object. If the principal obligation ceases to exist, it is still possible for the creditor to receive payment by selling the pledged object.63 Another different rule from a Swedish point of view is found in sec. 4.203, which provides that, subject to the pledgee’s consent, the pledger may substitute for the pledged object, defined by individual characteristics, another thing that has not been pledged previously. In the case specified, the pledge of the prior thing is revoked following the execution of the pledge of a new thing. From a Swedish point of view, a change of the pledged object can violate the principle of speciality and also lead to recovery in case of insolvency of the pledger64.

In none of the four countries, can one find any limitations on the secured debt such as exclusions for future debts. Nor can specific rules be found regarding the secured amount, with the exception of the rules for Lithuanian legal mortgage on immovable property and the Latvian legal rules regarding the commercial pledge and mortgages. It is possible to establish a subsequent pledge on the same asset, with the exception of the rules in Estonia regarding possessory pledge. All security interests in the above four countries are available to all kinds of creditors. Nationals and foreign creditors are treated equally. On the other hand, it is possible that the commercial pledge in the Baltic States, like the floating charge in Sweden, is used mainly when the creditor is a bank. It is clear that Estonia, Latvia and Lithuania have more liberal rules than Sweden regarding retention of title clauses. The legal posi-

63 See Bergström and Lennander (2001, p 78).
64 Compare Chapter 4, Sec. 12 of the Swedish Bankruptcy Act.
tion on retention of title clauses in Estonia, Latvia and Lithuania is more like the legal position in the United Kingdom and Germany.\(^65\)

Concerning remedies of the secured creditor, Sweden is the most creditor-friendly country of the four states analyzed. There are no compulsory grace periods and the object secured can be sold privately. If an insolvency procedure has started against the debtor, the trustee will sell the collateral by auction or in another way that is profitable for the bankruptcy estate. The collateral can only be sold by auction, unless the pledgee consents to an alternative sale or it is likely that the trustee will get a higher price and the supervisory authority (which ensures that bankruptcy procedures are carried out appropriately in accordance with the Bankruptcy Act, etc.) consents.\(^66\) In none of the investigated countries, are there requirements that the sale must be in local currency or that the collateral must be sold to the country’s own nationals.

However, Lithuanian, Latvian and Estonian laws are more debtor-friendly than Swedish law in certain regards. One example is that the legislation in the Baltic countries stipulates certain grace periods to enable the creditor to sell the collateral. Under Latvian, Estonian and Lithuanian law, the main method for selling the secured object is by public auction,\(^67\) although the Latvian legal system, e.g., allows the collateral to be sold by private auction. In contrast to Swedish law, with fewer registration systems, it is fairly easy in the Baltic countries for the secured creditor or another third party to check the debtor’s title to certain assets, whether the debtor owns the assets and whether there are any encumbrances on the assets. The registration systems mean good predictability for the creditor.

**Insolvency law**

**Swedish law**

**General observations**

Bankruptcy is a procedure whereby all of a debtor’s (bankrupt’s) property is claimed in the interests of all the creditors. The bankrupt’s property is placed under special administration and sold off and the proceeds are then in principle divided equally between the creditors. The principle of equality is somewhat modified, however, by the rules on priority rights. Bankruptcy is usually known as general execution, as opposed to execution by various meas-

\(^{65}\) See regarding German and English law, Persson (1998).

\(^{66}\) See Chapter 8, Sec. 7 of the Swedish Bankruptcy Act. Compare also Chapter 8, Sec. 6 of the Swedish Bankruptcy Act regarding immovable property.

\(^{67}\) This goes for immovables and for movable property pledged, as well as commercial pledges.
ures pursuant to different Enforcement Codes, which are known as forms of special execution.

Swedish insolvency rules are defined by the Bankruptcy Act, the Company Reconstruction Act and the Debt Remission Act. Closely linked to these laws are the rules on priority rights. Swedish law provides for the following insolvency procedures: Bankruptcy, Company reorganization, Debt remission, Composition in bankruptcy, Suspension of payments and Private composition. Here only the position of different security interest in bankruptcy and reorganization will be discussed.

Swedish bankruptcy law is applicable to both legal and natural persons. The same is true of the Reorganization Act, which can be used by all business operators, both natural and legal persons pursuing some sort of economic activity. Certain activities, however, are exempted from the scope of application of the Act; Chapter 1, Sec. 3 provides that certain financial institutions (such as banks and securities companies) cannot avail themselves of the Act. Furthermore, the Act cannot be used by debtors over whose business activities the state or local authority, etc., exerts considerable influence.

68 See, e.g., the Swedish Enforcement Code, SFS 1981:774 and the Estonian Enforcement Code, Bailiffs Act, RT I 2001, 16, 69, passed on January 17, 2000, amended June 28, 2004, effective 1st March 2005, RT I 2004, 56, 403. Lithuania does not have a separate enforcement law. The enforcement procedure is defined in the Code of Civil Procedure as well as in the Enforcement Instructions confirmed by the Ministry of Justice and used by bailiffs here in Lithuania. The creditor, having obtained a court decision, may request enforcement against the debtor’s property. The bailiff may attach the debtor’s, but only up to 25% of it. Latvia has a similar system to Lithuania’s.

69 SFS 1987:672.
70 SFS 1996:764.
72 SFS 1970:979.
73 Under this act, it is possible under certain circumstances for a natural person not carrying on a business to obtain a discharge, wholly or in part, from liability for payments of debts. See SOU 1990:74 p 335.
74 Compositions in bankruptcy are regulated by Chapter 12, Bankruptcy Act, but they rarely arise after a company is declared bankrupt. The composition becomes binding on each creditor, whether identified or not, who has the right to lodge the proof of his claim as regards unsecured distribution in the bankruptcy.
75 A suspension of payments is a way for the company to win some time for negotiation with creditors. Either payments can be suspended without notice, i.e. the company simply stops paying old debts, or expressly, i.e. the company specifically informs all of its creditors. Suspension of payments is not regulated by legislation. An express suspension of payments can have certain legal consequences (e.g., there will be a presumption of insolvency should a dispute on this point arise when a bankruptcy petition is being heard).
76 A company that has difficulties making payments can try to draw up a private composition with its creditors. Private compositions are not regulated by law but require the agreement of all creditors affected. Another alternative is to petition for company reorganization, the procedure that is regulated by the Company Reorganization Act, SFS 1996:764.
77 Reorganization and liquidation of credit institutions and insurance companies are regulated in a separate law, SFS 2005:1057. See Directive 2001/24/EC of the European Parliament and the Council of April 4 on reorganization and winding up of credit institutions, and directive
The purpose of the Company Reorganization Act is to allow measures to be taken, without resorting to bankruptcy, in order to reconstruct companies in crisis that are still considered to have good prospects of continued profitable activity. A process of reconstruction can be commenced once a court has given its consent.

Reorganization

A reconstruction petition can be presented at the request of the debtor himself, or at the request of a creditor on the condition that the debtor allows the petition, Chapter 2, Sec. 1 and 3 of the Company Reconstruction Act. The prerequisite for presenting a petition for a company reconstruction is that it can be assumed that the debtor cannot pay its debts as they have fallen due for payment or it is clear that the company will very soon be unable to meet its payments, Chapter 2, Sec. 6. A debtor must therefore be insolvent or there must be a risk that it will soon become insolvent. If a particular debtor is involved in company reconstruction proceedings and a creditor presents a bankruptcy petition in respect to that debtor, such a petition shall, at the debtor’s request, be stayed until company reconstruction procedure is concluded, Chapter 2, Sec. 19 of the Company Reconstruction Act, c.f. Chapter 2, Sec. 10a of the Bankruptcy Act.

If the debtor is insolvent or there is a risk that it will very soon be unable to meet its payments, and if the conditions are met as regards the ability for the aim of the company reconstruction to be met, the courts must grant the petition, Chapter 2, Sec. 6 of the Company Reconstruction Act. The district courts must therefore determine whether the conditions for the procedure are met, i.e. that the debtor’s business can become profitable again by virtue of a reconstruction in either business or financial terms. The court then decides whether the petition will be granted, rejected or dismissed. If the petition is granted, the district court shall appoint an administrator and call all parties to a creditors’ meeting, where the creditors will discuss whether the reconstruction should go ahead, Chapter 2, Sec. 10. As the creditors’ interests and claims are at stake, it is important that they be given the opportunity to understand the procedure and thereby influence how it will be implemented. The court can appoint a creditors’ committee at the request of any creditor, Chapter 2, Sec. 16. A creditors’ committee may comprise up to three people. If the debtor has employed at least 25 persons during the last financial year, an employee representative must sit on the creditors’ committee.

Chapter 2, Sec. 17 of the Company Reconstruction Act provides that there are to be no seizures or executions against the debtor under the duration of the company reconstruction, and neither must decisions on sequestration or

2001/17/EC of the European Parliament and the Council of March 19 on reorganization and winding up of insurance companies.
attachments be taken. This prohibition applies in principle to all creditors, including those retaining title (creditors with a retention of title clause). This is clear from Chapter 2, Sec. 17 p 1(3), which provides that assistance pursuant to the 1978 Installment Act may not be given. The prohibition in Chapter 2, Sec. 17 does not apply to certain creditors (e.g., those with claims secured by a pledge or lien and those regarding maintenance allowances), however.

Chapter 2, Sec. 18 constitutes a safeguard securing creditors’ rights. This section provides that a court may, at the request of a creditor, order suitable measures to be taken in order to secure a creditor’s position by taking or permitting a certain measure if there are specific reasons to believe that the debtor will jeopardize the creditor’s rights. The provision of Chapter 2, Sec. 17 does not prevent the effectiveness of such a decision. The safeguard measures that the court can determine are of a civil law nature, namely a penalty under Chapter 15, Sec. 3 of the Code of Judicial Procedure 78, or ordering that the property be placed under special administration. If the debtor does not co-operate in good faith throughout the procedure and follow the administrator’s directions, it may be necessary in certain cases to consider whether the procedure should continue. If the debtor takes or permits a measure to be taken that jeopardizes the creditor’s rights, the question of whether the procedure should be halted and the possibility of instituting bankruptcy proceedings should be considered. The debtor should also be warned that immediate bankruptcy proceedings could be decided should the administrator’s directions continue to be ignored.

Compulsory compositions may arise within the framework of a company reconstruction procedure, Chapter 3, Sec. 1 of the Company Reconstruction Act. The prerequisite for a compulsory composition is that the debtor offers the creditors payment of at least 25% of the amount of their claims, Chapter 3, Sec. 2. Only those creditors whose claims have arisen before a petition for company reconstruction can participate in a compulsory composition. However, those creditors whose claims are secured with a priority right or repossession condition or that can obtain a contribution towards their claims through set-off cannot participate. Only where such a creditor either wholly or partially waives his priority right or right to set-off may he participate in a compulsory composition.

Bankruptcy
If the reorganization fails, bankruptcy proceedings will very often begin. The procedure begins with either the debtor himself or his creditors petitioning the court for the debtor to be declared bankrupt. 79 If it is the debtor that is seeking a bankruptcy declaration, the petition is usually granted accorded to Swedish law. This is because there is a presumption for insolvency under

78 SFS 1942:740.
79 See Chapter 2, Sec. 1 of the Swedish Bankruptcy Act.
Chapter 2, Sec. 7 of the Bankruptcy Act. The provision states that information presented by a debtor evidencing that he is bankrupt shall be accepted if there are no special reasons indicating the contrary. A petitioning creditor must establish his competence, i.e. he must show that he really does have a claim against the debtor. However, this alone is not enough. In addition, the creditor must (if the debtor does not concede as much) show that the debtor is insolvent. Because it can often be difficult for the creditor to prove insolvency, the Swedish Bankruptcy Act includes certain rules of presumption for insolvency. It is stipulated, e.g., that a debtor that has been called upon to pay an overdue debt but has failed to do so within one week, shall be deemed to be insolvent if the creditor demanding payment presents a bankruptcy petition within 3 weeks thereafter and then the debt is still not paid. This rule of presumption applies only to debtors under a duty to keep accounts.

Under Swedish law, the district court appoints a trustee and decides how many there should be. Prior to appointing the trustee, the supervisory authority (which ensures that bankruptcy procedures are carried out appropriately in accordance with the Bankruptcy Act, etc.) provides its opinion on the matter. During the course of the procedure, the trustee must wind up the estate and sell its assets. The trustee shall decide early on whether the business will be continued without selling off the assets or whether it shall be continued in order to sell its property. Furthermore, decisions will be taken as to whether there are transactions that can be recovered.

A bankruptcy procedure ends when the receiver presents a working report and a statement of account, which is known as final account. The report shall detail the measures taken by the receiver and the assets and liabilities must be listed to allow a final assessment to be made of what is left to be shared among the creditors. The receiver must then draw up a distribution proposal in which the costs of the bankruptcy (e.g., the receiver’s fee) are settled first, to be followed by the claims against the bankruptcy estate itself (costs incurred by the estate during the course of the procedure). Super-priority creditors, such as creditors with retention of title are not part of this list, as their property is not part of the bankruptcy estate, which means that they are able to separate the collateral from the estate. Once these two groups of creditors have received their distributions creditors with special priority rights (pledge in movable or immovable property) and those with ordinary priority rights (creditors with a floating charge and claims of employees) are next on the list. Anything left after that goes to the unsecured creditors. The distribution proposal is passed to the supervisory authority for its review. The court then reaches a decision and ratifies the proposal. If no applications are lodged against the proposal, the distribution proposal becomes binding, the distributions are made and the procedure ends. Of course, a bankruptcy procedure

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80 Chapter 2, Sec. 7 of the Swedish Bankruptcy Act.
81 Chapter 2, Sec. 9 of the Swedish Bankruptcy Act.
can end in ways other than by distribution, i.e. by dismissal, which arises if the bankruptcy estate’s assets are not sufficient to cover the costs of the bankruptcy procedure. Bankruptcy procedures can also be withdrawn and a composition in bankruptcy may also arise.

Estonian Law

General observations
Estonian bankruptcy law is mainly governed by the Bankruptcy Act, which came into force on January 1, 2004. Similar to the Swedish Bankruptcy Law, the Estonian Bankruptcy Act is applicable both to legal and natural persons. Contrary to the Swedish legal system, however, reorganization and debt remission are not regulated separately. These procedures are part of the general bankruptcy act. Debt remission is possible as a natural person may be released from his obligations that were not liquidated during the bankruptcy proceedings, Chapter 11 (Sec. 169 and the following sections). Reorganization (compromise) is possible on the proposal of the debtor or the trustee after the declaration of bankruptcy. The reorganization decision is made at a general meeting of creditors (see Chapter 12, Sec. 178 and the following sections).

Bankruptcy
Bankruptcy proceedings begin in a similar way as in Sweden, i.e. with either the debtor himself or his creditors petitioning the court for the debtor to be declared bankrupt, Sec. 4 and Sec. 9 of the Estonian Bankruptcy Act. In Estonian law, the debtor must substantiate the insolvency. If the debtor submits a bankruptcy petition, the debtor is presumed – as in Swedish law – to be insolvent. A petitioning creditor must support his competence and show that the debtor is insolvent. Therefore, the Estonian Bankruptcy Act, like the Swedish Act, includes certain rules of presumption for insolvency.

Upon commencement of bankruptcy, the court will appoint an interim trustee who will, among many other duties, assess the solvency of the debtor and determine and preserve the debtor’s assets, Sec. 22. If bankruptcy is declared, the court shall decide on the time and place of the first general meeting of creditors, appointment of a trustee/trustees and application for securing actions, Sec. 31 (5). The requirements for a trustee are stated in Sec. 56. It should be (1) a natural person whom the examination board for trustee in bankruptcy formed by the Minister of Justice has granted the right to act as

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83 See Sec. 8(1) and (2) of the Estonian Bankruptcy Act.
84 See Sec. 13(1) and Sec. 31(4) of the Estonian Bankruptcy Act.
85 See Sec. 10 of the Estonian Bankruptcy Act.
trustees in bankruptcy and (2) sworn advocates and senior clerks of sworn advocates. The trustee must have the confidence of the creditors and the court and be independent of the debtor. The trustee shall not be an employee of the court or connected with the judge hearing the matter. The right to act as a trustee is granted, among other things, to a person who has passed the examination for trustees in bankruptcy, is proficient in oral and written Estonian and is honest and of good repute, Sec. 57. The appointment of the trustee is subject to approval by the first general meeting of creditors, Sec. 61(1). If a trustee is not approved, the creditors shall elect a new trustee whose approval shall be decided by the court. If the court does not approve this new trustee, it shall appoint a new one. The role of the Estonian bankruptcy court is similar to that of its Swedish counterpart. Its duties are under Sec. 84 to exercise supervision over the lawfulness of the bankruptcy proceedings and perform other duties provided by law. In this regard, Estonia, like Sweden, has bankruptcy legislation that is more creditor-friendly, leaving several issues to be decided by the creditors. It can be mentioned that at the first general meeting of the creditors, a bankruptcy committee should be elected that will safeguard the interest of the creditors, monitor the activities of the trustee and have other duties, Sec. 73 and Sec. 77. The general meeting of the creditors will also decide among other things on the continuation or termination of the activities of the undertaking of the debtor (reorganization/comprise) or a release (debt remission) for natural persons.

Under Estonian law 86, creditors’ claims are paid in the following order:
(1) Super-priority creditors like creditors with retention of title. Objects belong to third parties shall not be included in the bankruptcy estate, which means that creditors with a reservation of title are able to separate the secured object from the estate, Sec. 123 of the Bankruptcy Act.
(2) Payments relating to bankruptcy proceedings, Sec. 146 of the Bankruptcy Act.
(3) After these specified payments, the claims of the creditors should be paid in the following order, Sec. 153 of the Bankruptcy Act
• claims secured by pledge
• claims that are not filed on time but are accepted.

Claims secured by pledge are preferred claims in respect of the money received from the sale of the collateral. Claims that have lower ranking are satisfied only after claims of higher ranking have been paid. Claims secured by pledge are satisfied according to the ranks of the relevant pledges. Certain payments are made even before the claims secured by pledges. Those include claims arising from the exclusion of property from the estate and recovery of property, support to the debtor and his dependants and payments

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86 Paron and Tomachyeva (2003, p 103).
relating to the bankruptcy proceedings. Employee claims are typically paid out of governmental funds, which explain non-priority of salary claims.

**Reorganization (compromise)**

Under Sec. 178 of the Estonian Bankruptcy Act, a compromise means an agreement between a debtor and the creditors concerning payment of debts and involves reduction of the debts or extension of their terms of payment. A compromise is made on the proposal of the debtor or the trustee after the declaration of bankruptcy. A general meeting of creditors or the bankruptcy committee may assign the trustee with the duty to draft a compromise proposal.

A general meeting of creditors should make the decision and the court shall approve it.

A compromise proposal shall set out to which extent and by which date the debtor is to pay the debts. The compromise proposal shall contain proof that the debtor is able to pay the debts to the extent and by the date indicated. If the debtor is a business person, the rehabilitation plan shall be annexed to the proposal, Sec. 179. A compromise is deemed to be made if a certain percentage of creditors whose claims constitute a certain amount vote in favor of the proposal. Compromise can have a major impact on the secured creditors’ position under Sec. 182. If a debtor engages in business or professional activity and according to the compromise the collateral is necessary for continuing the activities of the enterprise of the debtor, the claim secured by the pledge shall not be invoked during the term determined by the compromise. If a pledgee votes against a compromise, the term just specified shall not exceed 1 year. If that happens, the pledgee can in certain cases demand interest, Sec. 182 (3).

**Latvian law**

**General observations**

The Latvian Bankruptcy Act governs the Latvian bankruptcy procedure for companies.

Law on insolvency. 87 The law applies only to undertakings and companies registered in the Enterprise Register, Sec. 2(1). The law is not applicable to insolvency proceedings of credit institutions, insurance companies and insurance broker companies.88 There is no particular law that regulates insolvency of natural persons. Similar to the Estonian legal system, composition (settlement) and reorganization (restoration) are regulated in the bankruptcy law, Chapter IX and X (Sec. 77 and the following sections).

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88 See Law on Credit institutions, passed on October 5, 1995, amended in June 2005.
Reorganization

Under Chapter I, Sec. 1(13), a settlement means a resolution of a state of insolvency manifested as an agreement between the creditors and the debtor regarding the fulfillment of the debtor’s obligations in cases provided for and in accordance with the procedures by the above-mentioned law. A settlement is allowed at all stages of the insolvency process until the beginning of the auction of the debtor’s property, Sec. 77(1). The possibility of a settlement shall, without exception, be examined at the first meeting of creditors if the debtor or the creditors propose entering into it, Sec. 77(2). At the subsequent meetings of creditors, the issue of a settlement shall be re-examined, if it is included in the agenda for the meeting. The administrator is obligated to include the issue of settlement in the agenda of the meeting of creditors, if the draft settlement proposed by the debtor or the creditors has been submitted to the administrator no later than 3 weeks before the meeting of creditors, Sec. 77(3). A settlement may be manifested as: (1) a reduction in the amount of claims, (2) renunciation of contractual penalties or interest and (3) postponement of the term of fulfillment of obligations, Sec. 80. The settlement provisions just mentioned shall not be allowed with respect to claims of priority creditors without their written consent, Sec. 80(2) and Sec. 107. In case of settlement, the rights and interests of secured creditors may not be violated without their direct and unmistakable written consent, Sec. 80(3).

Under Sec. 81, the administrator shall work out the draft settlement, which shall be determined at the meeting of creditors. The settlement must indicate what amount the claims of each group of creditors are to be satisfied with. A settlement is concluded if a certain percentage of the creditors according to the amount of debts vote for it, Sec. 82 (2). If the creditors approve it, the court must also approve it, Sec. 83.

If a settlement is not approved, the creditors’ meeting must decide on restoration or on initiating bankruptcy procedure. Restoration means resolution of a state of insolvency manifested as the carrying out of planned measures with the purpose of preventing a possible bankruptcy of an institution, restoring its solvency and satisfying the claims of creditors, Chapter 1, Sec. 1(18), and Sec. 87.

Restoration is considered at the meeting of creditors if: (1) a settlement has not been proposed at the first meeting of creditors, (2) a settlement has been rejected, (3) a settlement has not been entered into or (4) the settlement has been cancelled, Sec. 89. The administrator shall manage the restoration according to the restoration plan adopted by the meeting of creditors, Sec. 88 (1).

The creditors must vote for application of restoration, which will be adopted if it is voted for by a certain percentage of the creditors according to the amount of claims, Sec. 90. If a decision is taken regarding restoration, the secured creditors may not exercise their rights with respect to the secured
property until the restoration plan is rejected. If the restoration plan is adopted, they must wait until the end of the restoration or until its discontinuation. However, after the restoration plan has been approved, the secured creditors may exercise their rights with respect to the pledged property if it is not indicated in the restoration plan under Sec. 92(5).

**Bankruptcy**

Chapter 1, Sec. 1(2) of the Bankruptcy Act defines bankruptcy as a resolution of an insolvency situation manifested as liquidation of the debtor and satisfaction of the creditors’ claims from resources obtained during the liquidation process, by selling the debtor’s property in accordance with the procedure of the above-mentioned law.

A debtor is insolvent under Sec. 3(1) if a court determines at least one of following elements: (1) the debtor is unable or, because of circumstances that can be proven, will be unable to adequately settle its debt obligation, (2) the debtor has ceased to settle its debts which have come due and the creditor has given the debtor certain notices as stated in section 39 (1) or (3) the debt obligations of the debtor exceeds its assets.

A decision on initiating bankruptcy proceedings shall be taken by a majority vote at a meeting of creditors, Sec. 100(1). A decision on initiating bankruptcy proceedings is deemed to have been taken: (1) if neither settlement nor restoration have been proposed at the meeting of creditors or (2) if a proposed settlement or restoration has been rejected at the meeting of creditors or (3) if a restoration has been interrupted without another resolution being adopted regarding the debtor’s insolvency, Sec. 100(2).

Under Sec. 104 and 105, the assets of the debtor should be sold according to the rules of the Civil Code and the Civil Procedure Law, which means that the assets will be sold by the administrator through a public auction unless otherwise specified in these laws. All property of the debtor shall be included in the auction, except monetary funds and property, which are subject to pledges. It should be noted that full or partial discharge of obligations regarding a debtor by set-off is not allowed, Sec. 106.

Under the Latvian Bankruptcy Act, claims of non-secured creditors are paid in the following order:

(1) The administrative expenses of the insolvency proceedings should be covered by monetary funds of the debtor or money received by selling the debtors property, Sec. 107 (2) and Sec. 109.

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90 Nevertheless, one should take into account the EU Regulation nr 1346/2000 on May 29, 2000 on insolvency proceedings that allows set-off provided that this is permitted by the law applicable to the transaction (i.e. non-Latvian Law).
(2) The remaining funds shall then be distributed firstly in the following order (first level):

- claims of employees,
- payments to farms, individual producers, co-operatives and incorporated companies for agricultural products supplied to processing undertakings,
- claims regarding social security tax up to 1 year prior to the initiation of insolvency,
- state claims for repayment of state-guaranteed credits,
- claims regarding other taxes and fees.

(3) After satisfying completely the first group, the remaining funds should be distributed to the remaining creditors in the following group (second level):

- claims of other creditors such as deferred tax payments, salary debts remaining after payments to the first group have been made and other payments resulting from lawful employment relationships,
- claims for interest of creditors with and without priority
- claims of creditors that have not submitted their claims in due time.

The funds that remain after all other creditors have been satisfied are distributed to the debtor’s shareholders (Sec. 107(6)).

Lithuanian law

General observations
The Enterprise Bankruptcy Law governs the Lithuanian bankruptcy law\(^{91}\). The law applies to all enterprises, public institutions and commercial banks. The insolvency of natural persons is not regulated in Lithuania. The specific aspects of instituting bankruptcy proceedings against banks, other credit institutions, insurance agencies and agricultural enterprises are regulated in the laws regulating such entities.

Reorganization

Under the Law on Restructuring of Enterprises,\textsuperscript{92} it is possible for a company\textsuperscript{93} to preserve its activities and restore its solvency. This procedure is only open if bankruptcy proceedings have not been started yet under the Enterprise Bankruptcy law.\textsuperscript{94} However, it is possible to commence reorganization within the procedure of the Law on Restructuring of Enterprises. It is also possible for the creditor and the debtor to refrain from applying for bankruptcy proceedings, if the debtor is unable to satisfy his obligations and makes a public announcement to this effect or notifies every creditor to this effect in writing. If all creditors approve the reorganization procedure, the creditors may appoint the administrator, who takes over the management of the enterprise and performs the bankruptcy proceedings.\textsuperscript{95}

In accordance with Sec. 2(2), the reorganization of an enterprise shall be the transformation of the structure of the enterprise by dividing or transferring its assets to other economic entities and the alteration of the character of the enterprise’s activities in order to satisfy the claims of the creditors. At the instance of the meeting of creditors or the enterprise, the court may adopt a decision of reorganization if one of the following objectives can be attained: (1) restitution of the enterprise’s solvency and (2) realization of a part of the enterprise’s assets with the aim of fully satisfying its debts to creditors without suspending economic activities.

Bankruptcy

Under Sec. 28 of the Enterprise Bankruptcy law, a creditor or a group of creditors may conclude a settlement agreement with the company during the bankruptcy proceedings. The settlement is concluded when it has been approved at the meeting of creditors by all of the creditors whose claims are not secured by mortgage and by the court, Sec. 28 and 29. A settlement may not be concluded if the court has found a fraudulent bankruptcy.

The enterprises is liquidated if a settlement is not concluded, if a concluded settlement declared invalid or if the enterprise is not reorganized. The decision on liquidation is taken by the court, Sec. 30.

Under article 35 of the Enterprise Bankruptcy law, claims of creditors are paid in the following order:

- The creditors’ claims are satisfied in two stages. During the first stage, the creditors’ claims are satisfied in the sequence provided

\textsuperscript{92} Law on Restructuring of Enterprises of the Republic of Lithuania No IX-218, of March 20, 2001, latest amendments effective from November 2, 2004.
\textsuperscript{93} Sec. 1(4) of the Law on Restructuring of Enterprises provides that the law is not applicable to banks, credit institutions, insurance companies and other financial institutions. See Doing Business in Lithuania, www.Infolex.lt, 2005-12-13.
\textsuperscript{94} Sec. 3 of the Law on Restructuring of Enterprise.
\textsuperscript{95} Sec. 4 of the Law on Restructuring of Enterprises; See www lda.lt/invest.law_tax.company.html. 2005-12-13.
below, not including the computed interest and default interest, while in the second stage the remaining part of the creditors’ claims (interest, default interest) is paid in the same sequence.

- First in line for satisfaction shall stand workers’ claims arising from employment relationships; claims for compensation for damage caused by grievous bodily harm or some other injury, an occupational disease or death because of an accident at work; claims of natural or legal persons for payment for agricultural produce purchased for processing.
- Second in line for satisfaction shall stand claims for payment of taxes and other payments into the state budget, claims for compulsory state social insurance contributions and compulsory health insurance contributions and claims relating to loans obtained on behalf of the state or guaranteed by the state;
- Third in line for satisfaction shall be all claims other than those specified above.

Claims of the creditors of each successive sequence shall be met after full payment of the claims of the creditors of the preceding sequence. If assets are insufficient to satisfy all of the claims of one sequence in full, the said claims shall be paid in proportion to the amount due to each creditor.

Claims connected with employment relationships that have been put forward by workers of an enterprise in bankruptcy or a bankrupt enterprise, referred to in paragraph 2 of this Section, may be met from the resources of the Fund for the Satisfaction of Claims of Workers of Enterprises in Bankruptcy or Bankrupt Enterprises arising out of their Employment Relationships and from the resources of the Guarantee Fund. Claims of natural and legal persons for payment for agricultural produce purchased for processing by enterprises in bankruptcy or bankrupt enterprises may be paid from the resources of the Fund for Payment of Claims of Natural and Legal Persons for Agricultural Produce Purchased for Processing by Enterprises in Bankruptcy and Bankrupt Enterprises. The allowed claims of a worker or a natural or legal person shall be reduced by the amount of the sum paid from the above Funds.

The administrator organizes the sale of the assets of the enterprise and procedure of satisfying the creditors claim, Sec. 33. Creditors’ claims secured by a pledge or a mortgage are first of all satisfied from the proceeds of sale of such pledged assets of the enterprise, Sec. 34.96

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Analysis of the insolvency law

The validity of a security interest will usually be questioned in the case of the buyer’s insolvency (bankruptcy and reorganization). However, the above-mentioned rules in all four countries give the impression that insolvency does not have a great impact on a secured creditor’s position. On the other hand, it is not possible for a secured creditor to file an application for bankruptcy proceedings against the debtor, except when the claim can no longer be presumed to be fully secured by the asset. Usually, the secured creditor can recover payment out of the proceeds of the sale of the secured asset. However, if the secured claim exceeds the value of the secured asset, the creditor is considered to have only an unsecured claim for the excess amount. Usually, the bankruptcy rules do not pose a threat to a creditor with a security interest. On the other hand, the rules concerning the estate’s right to duly recover property disposed of by the bankrupt debtor within certain periods prior to the bankruptcy to the detriment of other creditors may be dangerous. If this situation does not occur, the position of the security interest is safe. In general, one can say that a creditor with a pledge is paid first, with the exception for creditors with a security interest such as retention of title and administrative expenses of the bankruptcy estate.

Bankruptcy does not have a significant impact on the possibility of the creditor enforcing his security interest. However, the rules concerning reorganization of companies can be a threat to the secured creditors’ position. Under these rules, a seller has to defer the reclamation of the goods for a specific period. The seller’s demands can also be limited to the value of the goods. Interest that has accrued owing to the delay is consequently handled without priority in the reconstruction procedures. In comparison with the rules concerning bankruptcy proceedings, the rules concerning reorganization can therefore adversely affect the position of the security interest. Another threat to the creditor could be super-priority loans. In order for a reorganization to be successful, it is sometimes necessary for creditors to lend money or make other investments at the commencement of the reorganization. In order to do so, they may wish to secure their loan for the contingency of the reorganization failing. Under the Swedish rules, a creditor who has given such a loan will, in the event of bankruptcy, take priority over creditors with a floating charge, Sec. 10 p 2 of the Right of Priority Act. In Estonia, a creditor who has made such a loan may even have priority before claims secured by a pledge, Sec. 186 (1) (2) of the Estonian Bankruptcy Act. On the other hand, Latvian law does not have such a provision.

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97 See Chapter 4 of the Swedish Bankruptcy Act, Section 65-72 of the Latvian Bankruptcy Act, Sections 114-119 of the Estonian Bankruptcy Act and Section 5 and 7(3) of the Lithuanian Bankruptcy Law.
Conclusion

The survey shows that the legal rules concerning security interest in the insolvency system of the four countries are quite similar. A more debtor-friendly approach can be seen in Latvia and Estonia than in Sweden, as it is possible for the insolvency administrator in the first mentioned countries to use the secured assets or substitute security in the event of insolvency rescue proceedings. In all four countries, the creditor has a number of different security interests to choose between in order to secure his claim. The legal rules in the three Baltic States are modern in comparison with the Swedish rules. The establishment of registered security interest as the main method to create a security interest is also a step in the right direction, as the legal trend in a more harmonized European system is in favor of registration.99

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334
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