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

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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.1 Having started earlier than any other country, the English legis-

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1 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.

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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.
portance 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. 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.

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. 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

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, as 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.\(^{13}\) 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 *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.\(^{14}\)

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.

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\(^{13}\) 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.

\(^{14}\) 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.\(^\text{15}\)

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,\(^\text{16}\) something different from the English law and that has been interpreted as a strong pro-debtors feature.\(^\text{17}\) 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.\(^\text{18}\)

**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

\(^{15}\) Di Martino (2005b).
\(^{16}\) Brown (1900).
\(^{18}\) Radin (1931) and Del Marmol (1936).
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


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see‘ option: in other words, waiting to be conveniently bought-out by senior creditors. 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. 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. 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-

21 As already noticed, no preliminary and independent inquiry into debtors’ behavior and the causes of failures was allowed under the American law.
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

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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. 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.

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.

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

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.

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).

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 formative. 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'.


