Journal of Comparative Economics 44 (2016) 450–460

Contents lists available at ScienceDirect

Journal of Comparative Economics

journal homepage: www.elsevier.com/locate/jce

Courts at work: Bankruptcy statutes, majority rule and private contracting in England (17th–18th century)

Jérôme Sgard

Sciences Po – CERI, Paris, France

ARTICLE INFO

Article history:
Available online 23 February 2016

JEL Classification:
K35
K41
N43

ABSTRACT

Sgard, Jérôme—Courts at work: Bankruptcy statutes, majority rule and private contracting in England (17th–18th century)

Rather than evolving as a platform for renegotiation and debt discharge, as on the Continent, English bankruptcy emerged as a liquidation-only procedure after majority arrangements among creditors were banned in 1621. Over the course of the 17th and 18th centuries, the courts then developed an alternate, private-law set of rules on the basis of the old English trust and the Composition agreement, which belonged of the medieval cross-European Law Merchant. The main advantage of this little-known institution was its perpetual character and the flexibility of its governance, and its main drawback was obviously the requirement of voluntary initial adhesion. Symmetrically, under the Continental model, collective action was easier to obtain but it did not extend beyond the doors of the court. The discussion brings forward two further themes: the symmetry between adjudication and voluntary adhesion to a collective contract; and the capacity of judges to invent new legal concepts out of diverse set of existing rules, rather than through the simple, bottom-up approach usually emphasised by the literature on the Common Law tradition. *Journal of Comparative Economics* **44** (2) (2016) 450–460. Sciences Po – CERI, Paris, France.

> The law of majority voting is itself something established by convention, and presupposes unanimity, on one occasion at least.
>
> Jean-Jacques Rousseau, The Social Contract (1762)

1. Courts at work

Bankruptcy law is an institution geared to private markets, especially to the debt markets, while being at the same time about abrupt state interventions into core private rights. Take the mainstream tradition that emerged in Italy during the Middle-Ages, before informing virtually all later, modern bankruptcy regimes: each single rule in this generic model is highly problematic from the perspective of private rights. Then as now, a typical bankruptcy process thus starts by suspending both the debtor's "natural right" to contract and his control over his assets, i.e. his property rights. His correspondence and private dealings are thrown open and, for centuries, he might have spent time in jail. Creditors meet and coordinate under the judicial supervision, debts are accelerated and a detailed procedure governs the successive steps in the deliberation process. Typically, a weighted, qualified majority vote eventually decides between liquidation and some restructuration plan so that, after confirmation, capital losses and property rights are coercively redistributed.

E-mail address: jerome.sgard@sciencespo.fr

http://dx.doi.org/10.1016/j.jce.2015.12.007
0147-5967/

This benchmark Continental procedure works therefore as a judicial platform for bargaining, in which large transaction costs are traded off against the negative externalities of a disorderly default: adjudication and procedural safeguards aim at controlling the collective action problems that are inherent to any default with multiple creditors (Jackson, 1986). Otherwise, creditors may run on the assets so that the ex post distribution of capital losses would be both unfair and unpredictable; alternately, minority creditors may block any agreement and force liquidation even when the majority agrees that a continuation agreement would better serve its interests. From a jurisprudential perspective, the majority vote should thus be understood as a signal of where the collective interest probably lies, so that the judge may confirm the underlying settlement and impose the redistribution of property rights on the minority. As such, creditors, even a qualified majority of them, may not interfere in the property rights of fellow merchants and bankers.

Early modern England presents the most significant exception to this classic model of bankruptcy law. In 1621, a principled defence of private property rights led the Parliament to forbid any arrangement with the debtor not based on the voluntary adhesion of *each single participant creditor*. The statutes would just not lend their support to creditors, even a qualified majority of them, as they tried to control holdout investors. As a consequence, the bankruptcy process could only end up in liquidation and the creditors' bargain had to take place outside courts and on a voluntary, hence unanimity basis (Sgard, 2013). Confronted to such an adverse legal framework, debtors and creditors could have opted-out *en masse* of the courts and build alternate private rules far away from them, as is often the case in the informal sector of developing countries (Fafchamps, 1996); or criminal rings could have taken over the job of brokering deals and restructuring property rights – that is the job of "transaction costs engineers" (Gilson, 1984; Milhaupt and West, 2000). To the contrary, merchants kept coming to the courts, so that precedents accumulated and, over time, a new, coherent institution gradually emerged in the shadow of the dysfunctional 1621 statute and eventually gained a high degree of consistency: from about the 1720s onwards, it offered a complex set of decision and coordination rules, assembled into an agency framework with an idiosyncratic firm-like structure. It included procedural and substantive dimensions, it entirely redesigned the structure of property rights, and it interacted at several points with public regulators.

When confronted to financial distress or default, merchants could thus rely upon a coherent, fully-enforceable, two-track regime. On the one hand there was the statutory option founded on adjudication that inevitably led to liquidation; and on the other one was a voluntary case-law option that mitigated parts at least of the underlying collective action problems so as to make bargaining and restructuring easier. Tellingly, in the later part of the 19th century, when this Act was eventually abolished, the voluntary road to settlements not only survived, in parallel with the bankruptcy statutes: it even expanded as the preferred option for restructuring large businesses. Still today its distant heir remains widely practiced and defended under the name of the "London approach" to business failures.[1]

This article analyses how this voluntary road to restructuring emerged from a heterogeneous legal material and gradually acquired its remarkable, self-standing and persistent formal structure. Where did these diverse elements come from and how were they gradually aggregated in a logically coherent set of rules? Which rules coordinated in practice these two tracks at maturity? And how can we account for path-dependent character of this innovation? The coming discussion draws from past legal treatises, commentaries of cases as well as textbooks written by barristers for laymen. Beyond their relatively great number, an interesting feature of these later publications is that they present the most relevant cases in each sub-field as well as collections, or toolboxes, of standardised models of contracts offered to private persons – landowners, merchants, bankers, widows, ship owners, etc. Hence, these books observe legal practices behind the frontier of legal change, rather than just on this line, so that they may lack chronological precision. On the other hand, once described in this type of publications, there is little doubt that these instruments were well accepted, both by the courts and the economic agents.

The next section brings this experience within the broader literature on the evolution of economic institutions and, in particular, the evolution of judge-made law. At this point, and when needed in the rest of the paper, the Continental model of bankruptcy law is used as a default rule and is therefore briefly presented. Sections 3 and 4 then analyse the genealogy of the alternate, private-law route to debt settlements, first by looking at the political and institutional context within which it emerged; then the focus shifts to the formation of this new legal institution, between the mid-17th and the late 18th centuries. Section 5 discusses how it worked at maturity, from a synchronic perspective that emphasises the structure of incentives and constraints to which the parties responded when trading off the respective advantages of adjudication and voluntary adhesion. Section 6 concludes.

2. The shadow of statute and the evolution of case-law

A large and rich literature, both economic and legal, has discussed for decades how norms, formal and informal, substantive and procedural, can be agreed upon and how they may evolve over time. In particular, the role of dispute resolution in the mutual adjustment of norms and actual behaviours explains why the experience of the English Common law has emerged here as key reference. Its open and experimental orientation would be especially adequate to a competitive and changing economic environment, where the law should be able to adjust smoothly to a new technological and market conditions.[2] Social interests and preferences may thus percolate upwards and inform the decisions of judges, whereas statutes

[1] Brierley and Vlieghe (1999), Armour and Deakin (2000) and Willman (2008).

[2] This argument, that builds on notions of flexibility and pragmatism, should be carefully distinguished from another, in fact very different line of contributions that insists on the quasi-constitutional features that would be built into the English Common law. The main theme here is the superior