

Yury Y. Karaleu

School of Business and Management of Technology of Belarusian State University
e-mail: yykorolev@tut.by

INSURANCE FOR HANDLING EMPLOYEE ENTITLEMENTS IN THE EVENT OF EMPLOYER INSOLVENCY (BANKRUPTCY)

UBEZPIECZENIE PRACOWNIKÓW PRZED BANKRUCTWEM PRACODAWCY

DOI: 10.15611/nof.2016.2.03

JEL Classification: G33

Summary: Among the modern types of economic insurances, the insurance of employees to cover their entitlements in the case of insolvency (bankruptcy) of a business may be considered as the most advantageous and future-oriented after the recent financial crisis which commenced in 2007, particularly in view of the growing number of bankruptcy cases in the Belarusian commercial courts. The purpose of this paper is to examine the varying legal treatments of employee entitlements in the case of employer insolvency (bankruptcy) and to encourage developing countries to use insurance to ensure the payment of employee entitlements which will ensure both the market strength and efficiency of the insolvency process.

Keywords: insolvency (bankruptcy), insurance, employee entitlements.

Streszczenie: Kryzys ekonomiczny rozpoczęty w 2007 r. pokazał, że ubezpieczenie pracowników przed upadłością pracodawcy może być jednym z ciekawszych i najbardziej innowacyjnych produktów ubezpieczeniowych. Problem bankructw przedsiębiorstw nie ominął również Białorusi, co jest widoczne w zwiększającej się liczbie zgłoszonych postępowań upadłościowych w białoruskich sądach. Celem niniejszego artykułu jest przeanalizowanie dostępnych narzędzi obrony praw pracowników w przypadku upadłości (bankructwa) pracodawcy, np. wykorzystanie ubezpieczenia do zapewnienia im wypłaty zasiłków.

Słowa kluczowe: upadłość (bankructwo), ubezpieczenie, interesy ekonomiczne pracowników.

1. Introduction

Economic insurance or commercial insurance, helps to eliminate risks, spreads risks from the individual to the larger community, and provides an important source of long-term finance for both the public and private sectors. Among modern types of

economic insurance (life insurance, personal accident insurance, health insurance, etc.) for Belarus it is vital to develop such types of bankruptcy insurance as insurance of the travel agency against insolvency (bankruptcy); insurance of developers' obligations to homebuyers, and insurance of employees in the event of bankruptcy of the company [Karaleu 2014; 2015]. Bankruptcy insurance should be considered as the most future-oriented, particularly in view of the fact that the number of bankruptcy cases in Belarusian commercial courts have increased from 1,648 (as of 01.01.2014) to 2,036 (as of 01.01.2015) and up to 2,486 (as of 01.01.2016) [http://court.by/online-help/bankr_inf]. This tendency is shown in Table 1.

Table 1. Bankruptcy cases in Belarusian commercial courts in 2010-2015

| As of | Supreme Court | Brest region | Vitebsk region | Gomel region | Grodno region | Mogilev region | Minsk region | Minsk city | Total |
|------------|---------------|--------------|----------------|--------------|---------------|----------------|--------------|------------|-------|
| 01.01.2010 | 10 | 107 | 141 | 184 | 46 | 92 | 149 | 671 | 1 400 |
| 01.01.2011 | 3 | 137 | 121 | 126 | 90 | 103 | 159 | 747 | 1 486 |
| 01.01.2012 | 1 | 124 | 116 | 145 | 124 | 89 | 151 | 767 | 1 517 |
| 01.01.2013 | 1 | 123 | 111 | 146 | 73 | 97 | 179 | 827 | 1 557 |
| 01.01.2014 | 1 | 152 | 128 | 185 | 64 | 124 | 229 | 765 | 1 648 |
| 01.01.2015 | 0 | 162 | 135 | 214 | 102 | 169 | 298 | 956 | 2 036 |
| 01.01.2016 | 1 | 147 | 177 | 219 | 124 | 198 | 332 | 1 288 | 2 486 |

Source: [http://court.by/online-help/bankr_inf/b412ed5a6c9cd344.html].

We consider that bankruptcy insurance will help to improve the situation and to provide a new impetus for improvements and the greater efficiency of national enterprises. The absence of social safety nets or adequate programmes where claims are not likely to be covered in bankruptcy by the available assets makes for a high wire act of rectifying the past or building for the future. Countries with more scarce resources would no doubt find little justification for following the path to the past.

Thus the insurance of employees in the event of bankruptcy of the company is the most important of the three mentioned above, and is of paramount importance and should be considered as a key factor for the successful development of the national insolvency (bankruptcy) institutions.

2. The nature of insurance and its role as a tool for insolvency (bankruptcy) proceeding

In all kinds (co-insurance and re-insurance) and types (life insurance, personal accident insurance, health insurance, etc.) of insurances upon the conditions written in their contracts and by taking fees from the insured, the insurer will cover the financial support mentioned in their policy, the following general rule is satisfied.

Although these contracts are different in detail, but in general they are similar and can be easily explained mathematically [Bidabad 2014].

Suppose the insurer receives a_i dollars from the i -th insured to insure asset b_i . Assume that the probability of losing assets is equal to p . Consequently, if the number of insured of this kind of assets are n , and $i = 1, 2, \dots, n$, the amount received by the insurer will be equal to a (1):

$$a = \sum_{i=1}^n a_i. \quad (1)$$

The mathematical expectation of the payments of the insurer to the insured in case of the loss of the assets will be equal to b (2):

$$b = \sum_{i=1}^n p b_i = p \sum_{i=1}^n b_i. \quad (2)$$

If we assume that, that insurance fee is equal to q (3):

$$q = \frac{a_i}{b_i}. \quad (3)$$

Then:

$$\sum_{i=1}^n a_i = q \sum_{i=1}^n b_i. \quad (4)$$

Replacing (1) and (2) in (4):

$$a = \frac{q}{p} b. \quad (5)$$

That is to say the received amount by insurer (a) is equal to the ratio of insurance fee (q) to the probability of loss of the asset (p) multiplied by the amount paid to the insured (b) by the insurance company. The profit of the insurer will be:

$$\pi = a - \frac{q}{p} b. \quad (6)$$

If $\pi = 0$, the relation (5) will satisfy and the insurer will practically have no profit, which means its economic activity has no yield. It is the same when $\pi < 0$, which means its income is less than the payments. So, the activity is profitable when:

$$\pi > 0 \Rightarrow a > \frac{q}{p} b \Rightarrow \frac{a}{b} > \frac{q}{p}. \quad (7)$$

In other words, if the probability of accident is truly estimated, the rate of insurance should be higher than the occurrence of accident probability so that the ratio of income (a) of the insurance company to its cost (b) is larger than one. In this case, the profit rate of the insurance company will be:

$$\frac{q}{p} > 1. \quad (8)$$

This analysis means that the insurance company is a commission-receiver agent and by rendering a service, obtains a percentage for risk coverage. In spite of this obvious risky nature, insurance is often overlooked as a tool for bankruptcy proceedings. At the same time, insurance is a critical asset for companies involved in bankruptcy proceedings as either a debtor or creditor. In fact, insurance issues arise in some way in virtually all bankruptcy proceedings. In some cases, insurance plays a central role as one of the principal funding mechanisms for reorganization.

The most common reason for not getting paid is that a buyer goes bankrupt before payment is due. Through a trade credit insurance policy a company can assure payment, either from their buyer or from their insurer. Bankruptcy, or its equivalent depending on the jurisdiction, is a recognised cause of loss in trade credit insurance policies, and triggers the start of the claims and collections process.

Buyers sometimes opt for a bankruptcy protection arrangement, also known as Chapter 11 in the USA and under different names in other jurisdictions. Such an arrangement allows the buyer to delay payments for an extended period. This occurrence is considered to be insolvency and is covered under a credit insurance policy.

Thus, which is not especially typical for domestic Belarusian practice, insurance is used against the insolvency (bankruptcy) of travel agencies, developers' obligations to homebuyers and the insurance of employees in the event of the bankruptcy of the company. We consider the latter case as the most interesting, future-oriented and vital for Belarus.

3. Global trends and approaches in the insurance of employees in the event of bankruptcy of a company

There is a variety of treatments for employee contracts on the insolvency of a business and too many insolvency (bankruptcy) laws allow for a company suffering financial difficulties to be taken over or merged, resulting in the downsizing or transfer of its workforce. While this process often results in large scale redundancies, and raises issues of whether a subsequent employer is liable for entitlements accrued under former employment, we should consider first global trends and approaches.

The International Labour Organization (ILO), of which Belarus is a member, adopted in 1949 a Protection of Wages Convention in which it addressed the effect of insolvency on workers' wages. Article 11.1 states: 'In the event of the bankruptcy or judicial liquidation of an undertaking, the workers employed therein shall be treated as privileged creditors either as regards wages due to them for service rendered during such a period prior to the bankruptcy or judicial liquidation as may be prescribed by national laws or regulations, or as regards wages up

to a prescribed amount as may be determined by national laws or regulations? [International Labour Organization 1949].

Employees should be able to expect a base level of entitlements in the event of an employer's insolvency. In Part II, Article 12, the ILO clarifies what entitlements workers should expect upon termination of employment. They include a severance allowance or separation benefits based upon length of service and amount of wages to be paid by the employer directly or by an employer contribution fund, as well as unemployment insurance or social security. Part II, Article 6, stipulates that the privilege protection shall include:

- workers' claims for wages for a period of three months or more prior to the insolvency or termination of employment,
- workers' claims for holiday pay due as a result of work performed that year and the year before,
- workers' claims for amounts due for other types of paid absences dating three months or more before the insolvency or termination, and
- severance pay due to workers upon the termination of their employment [International Labour Organization 1992].

Nevertheless, Article 11.3 acknowledges that national laws and regulations are to determine the relative priority of such debts. If the workers' claims are protected by a guarantee institution, however, they may be relegated to a lower privileged status. By giving individual nations the right to limit the privileged nature of employee claims to a certain extent, the ILO may have surrendered a degree of its leverage regarding the rights of workers.

In 1982, the ILO issued a convention regarding the termination of employment. Part II, Article 11, requires that employers provide employees on the verge of unemployment with either reasonable notice of such termination or compensation for the lack of reasonable notice.

The ILO also seeks strong and direct participation by worker representatives in employment termination, particularly in light of major restructuring, downsizing or terminations due to employer insolvency.

In contrast to the ILO requirements, the European Union (EU) directives are binding on members. In 1980, the Council of the European Communities issued a directive regarding the protection of employees in the event of their employer's insolvency which was updated by the European Parliament in 2002. Section II, Article 3.1, requires that guarantee institutions secure employees' outstanding claims relating to their employment.

Section II, Article 4.2, compels member states to ensure that outstanding claims from the last 18 months are paid. Nonetheless, Section II, Article 4.3, authorizes member states to set limits on the liability for employees' outstanding claims as long as the states notify the Commission of the methods they used in order to reach those limits. Council Directive 98/59/EC requires that any employer considering collective dismissals consult with workers' representatives first, with the goal of reaching an agreement and thereby curtailing the need for such measures.

4. Existing models of employees' rights protection in the case of their employer's insolvency

The ILO and EU requirements have been interpreted and implemented in many ways. Researchers set four principal models protecting the rights of the employees raised by employer insolvency.

The pro-employee approach declares the priority of the employee's rights. The model is used in different formats in China, Brazil, Chile, Columbia, Indonesia, and Malaysia. This model is interesting because it provides for a full insurance from unemployment, which is not limited to the compensation payments but allows the employee also to get about 80% of the minimum wage amount set by the state, for a two-year period. The system is also aimed at increasing the competitiveness of the unemployed persons through organizing training and sending them to work for the purpose of the quickest re-employment.

For example, the Chinese model encompasses compulsory unemployment insurance that goes well beyond mere monetary compensation for entitlements owed, though not all workers are covered by it. The cost of the insurance is carried by both employers and employees [Johnson 2006].

For Belarus, this variant is interesting by the fact that it allows to solve two problems simultaneously: to compensate for the salary in case of the employer's insolvency, and to insure against unemployment.

The bankruptcy priority – no insurance approach is the second model which declares the priority of the debtor's rights with no insurance. This model is used for example in Mexico, which has no insurance scheme to cover the difference between the entitlements owed and the value of the assets realised. In spite of the comparatively new legislation in this sphere (having being enacted as recently as 2000), the Mexican insolvency law is noted in the literature that such regulation is based on old legal principles aimed in the first place at protecting the rights of the creditors whose claims are secured by the pledge of property [Rowat 2002]. The employees very often do not have the probability of getting any compensation fee and are to independently refer to the social employment services to find a new job, the labor market is not sufficiently developed. It is obvious that this model is more suitable for liberal economics. In particular, sometimes the legal regulation of the status of the employees in the USA is included into this model, where the employee claims refer to the third category of claims not secured by anything [Posthuma 2000]. But in the USA, the balance of interests is achieved with Articles Sections 1113 and 1114 of the US Bankruptcy Code which lay out special provisions for the treatment of collective bargaining agreements and the handling of insurance benefits for retired employees [US Bankruptcy Code 1978].

Bankruptcy priority – guarantee fund approach is the third model covers the priority of the debtor's rights with the availability of the guarantee funds. This regulation system is spread in developed countries – Italy, Japan, Denmark, Spain

and others. The model can be called a hybrid one, as it gives some priority to the rights of the employees on one hand, but on the other hand it accepts unemployment insurance acknowledging the fact of lack of property for satisfying all the creditors' claims. Its visible advantage is in its guarantees for the compensation payments, together with the unlimited access of other creditors to the possible satisfaction of their claims.

For example, the Danish system gives the highest priority among unsecured creditors to claims for salaries, wages and other employee benefits (behind administrative costs), with a guarantee fund as a safety net, should the assets prove to be insufficient.

Such an approach seems to be optimal for the states with socially oriented economics, including Belarus.

No priority – guarantee fund approach is the fourth model which declares the absence of priorities with the availability of the guarantee funds and is used, in particular, in Germany. With this approach, all the creditors, including employees, are given equal opportunities to satisfy their claims. The claims of the employees which are not satisfied during the insolvency procedure can be compensated for at the expense of the National Insolvency Fund for Retirement Pensions. To compensate for its expenses, the Fund, by way of subrogation, can forward its claims to the insolvent employer together with other creditors.

5. Insurance funds

Insurance or guarantee funds are considered to be as the most effective means of employee claims in bankruptcy cases. Such funds can reduce the burden of the unemployed on the state for interim social protection, although they would not entirely displace the necessity of providing protection for purposes of unemployment, retraining and other needs. Shifting the risk to the business and taxpayers in protecting employees is more consistent with the responsibilities and obligations assumed by the debtor and the state. On an economic level, an insurance fund may provide a higher degree of reliability to the markets while at the same time affording stronger protection to employees to fulfill social objectives.

Critics of insurance or guarantee funds say that they have a number of shortcomings.

The guarantee fund models rely on a 'bankruptcy payment first' concept. This model makes some employees wait for a long period of time – several months or even years before they can top up the shortfall in their recovery from the guarantee fund. Many employees and their families can be left in need and poverty while they await the accrued entitlements they are owed.

Critics of insurance funds claim that they are:

- expensive to run,
- punish successful companies, and
- benefit only certain employees [Johnson 2006].

But all the above mentioned hardships could be successfully finalized. Upon satisfaction of the claims, the guarantee fund would be subrogated to the employee's claims against the debtor to recoup any distributions to which the workers would be entitled. For example, if an employer in Belgium is unable to pay entitlements within fifteen days of the close of the business, the Fund for Closures immediately commences payment on its behalf.

Although there may be greater cost burdens for business, the burden of the risk of insolvency would appear to be better carried through an insurance fund system prior to insolvency rather than the employees (or the general creditors) afterwards. Even so there are a number of ways in which a country considering such a system can attempt to reduce the cost burden to business. The existing forms of insurance already used widely throughout the developed world (even though usually in a hybrid system that requires some alteration to be made to the order of priority in bankruptcy) are a good example of this. Some countries may require compulsory insurance through a government-run social insurance system, while other countries require businesses to have private insurance for providing salaries to employees in the case of bankruptcy, or require contributions from employees.

Another alternative used by many countries to minimise the cost of such a scheme to business is to limit compulsory insurance to only those companies with a predetermined minimum number of employees, e.g. excluding small and medium-sized businesses (SMBs) whose personnel numbers fall below certain national or EU (the World Bank, the United Nations or the World Trade Organization (WTO)) requirements (limits).

One more option is to limit the size of the payout either to a predetermined amount or to a percentage of entitlements owed. In Italy, for instance, an employee can only recover up to 80% of entitlements owing, while Belgium restricts compulsory insurance to the for-profit sector.

Another appropriate option for reducing the cost burden of entitlement payouts is to limit the types of entitlements that employees can claim. Some states deliberately exclude outstanding holiday pay from priority payments, while others use a combination of included and excluded entitlements such as maternity leave or commissions. The availability and level of severance pay could also vary widely.

Some countries do not have worker entitlement insurance that covers some or all of an employee's unpaid wages or retirement claims. In times of crisis, the absence of such a safety net for workers who lose their jobs may create additional hurdles to recovery and may need to be supplemented with an economic stimulus package as opposed to the immediate satisfaction of back claims.

Notwithstanding the above, an ideal employee entitlement insurance system would allow for the prompt repayment of 100% of worker entitlements owing. But the initial stages of building such a system from scratch may take considerable time. To overcome this problem, one solution may be the Australian model, which consists of a temporary government fund designed to cover entitlement payouts until the

newly implemented insurance system has built sufficient capital to operate in its own right. A major consideration of any insurance system is what form of corporate governance it will possess. Ideally, it would be administered entirely by the private sector, but this sounds a little unrealistic for poor countries and for countries with undeveloped financial markets. If it were to be controlled by the state – and indeed in many countries the social security administration may be best placed to operate such a fund – there would nonetheless need to be very tight controls in place to ensure that such a fund is free from corruption and accounted for individually, so profits did not simply become consolidated government revenue.

6. Belarusian practice

Undoubtedly, the creation of insurance funds or guarantee funds is not an easy task and as of today, the guarantee funds which allow to fully or partially cover the debts to the employees do not exist in every country. There are no such funds in Belarus.

According to the Law ‘On Economic Insolvency (Bankruptcy)’ (hereinafter referred to as the ‘Bankruptcy Law 2012’), which was signed by the President of the Republic of Belarus on 13 July 2012, once the bankruptcy case starts, the debtor’s employees become one of the participants of the relations associated with the insolvency. The legislator includes them into the group of creditors. The order of including the employees’ claims into the creditor’ register differs from that of the other creditors. In accordance with Article 141, it is mentioned that the employees will be included into the second group of the scheduled creditors and the manager of the company will have an obligation to start the bankruptcy procedure also in cases where there are salary debts, dismissal payment debts and other debts payable to the employees.

Thus, in accordance with Article 142 of the Bankruptcy Law 2012, the salary payment and dismissal payment claims of the employees working with a labor contract are included into the register ‘automatically’ and there is no need to set up the mentioned claims by the employees. The bankruptcy officer, solely and within seven days, is to include these claims into the register, based on the debtor’s documents confirming the debt to his employees that incurred before the bankruptcy case was started.

In case the bankruptcy officer does not solely include the employee claim into the register, the employee has the right to make a request to the bankruptcy officer asking to include the claim into the register.

Nevertheless there are significant difficulties in the realization of the legal right of the employees to cover their entitlements. In Belarus, the mechanism of the privilege for debtors’ employees is used only within the framework of the insolvency procedure. But in the case of bankruptcy in accordance with Article 147 of the Bankruptcy Law 2012, the claims of the creditors which are not satisfied due to the lack of property of the debtor are considered to be redeemed. This deprives the

employees of their right to get their salaries, and the privileges guaranteed to them turn out to be formal.

7. Conclusion

Currently there does not seem to be a perfect legal scheme for handling employee entitlements in the event of employer insolvency. Some are clearly more effective than others. Each of the schemes examined in this paper are imperfect in certain ways, as all employee entitlements are never fully protected or the predictability for creditors is decreased. Employees in insolvency proceedings tend to be treated as neither creditors nor equity, with no vested financial stake in the bankrupt entity (outside of employee stock option plans). Still, employees universally have the most to lose, as their families' livelihood generally depends upon the wages and benefits for the work performed.

While some countries, such as Belarus, are looking for new mechanisms for protecting employees in the event of the bankruptcy of the company, others opt for the maintenance of work contracts through the long-term government administration of a failing business, unless otherwise using government-run social insurance system or a private insurance system or non-state insurance program. On an economic level, a private insurance system may provide a higher degree of reliability to the markets while at the same time affording stronger protection to employees to fulfill the social objectives.

Bibliography

- Bidabad B., 2014, *Insurance and Chain Bankruptcy Theory*, [https:// http://www.bidabad.com/doc](https://http://www.bidabad.com/doc).
- Bronstein A.S., 1991, *Comparative study in Edward Yemin and Arturo S. Bronstein (eds.): The Protection of Workers' Claims in the Event of the Employer's Insolvency*, Geneva, ILO, pp. 52-54.
- Felsberg e Associados, 2000, *Insolvency Overview: Brazil, Global Insolvency*, Law Database. http://court.by/online-help/bankr_inf/.
- http://court.by/online-help/bankr_inf/b412ed5a6c9cd344.html.
- International Labour Organization, 1949, *C95 Protection of Wages Convention*, [http://www.ilsa.gov.cy/ilsa/dlr/dlr.nsf/724CE3F7692B2AE0C22579360038DEE2/\\$file/Convention%2095.pdf](http://www.ilsa.gov.cy/ilsa/dlr/dlr.nsf/724CE3F7692B2AE0C22579360038DEE2/$file/Convention%2095.pdf).
- International Labour Organization, 1992, *C173 Protection of Workers Claims (Employer's Insolvency) Convention*, http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO::P12100_INSTRUMENT_ID:312318.
- Johnson G., 2011, *Insolvency Systems in South Africa. Comparative Review of Employee Claims Treatment*, United States Agency for International Development, October.
- Johnson G.W., 2006, *Insolvency and Social Protection: Employee Entitlements in the Event of Employer Insolvency*, Legal & Institutional Reforms of Asian Insolvency Systems.
- Karaleu Y.Y., 2014, *Harmonization of Economic Relations in the Sphere of Regulation of the Bankruptcy Process: Belarusian Experience, Problems and Prospects*, The Financial Centers: Travelling Around the World : Plekhanov Russian University of Economics, p. 44.

- Karaleu Y.Y., 2015, *"Slice-Of-Life" customization of bankruptcy models: Belarusian experience and future development*, Research Papers of Wrocław University of Economics, issue 381, p. 115.
- Klimova M.A., 2008, *Protection of the employee labor rights*, Rossiyskaya Gazeta Library, no. 9, p. 88.
- Lyutov N.L., 2014, *Efficiency of the international labor law norms*, M.: Prospekt, p. 240.
- Oh S., 2007, *Comparative overview of Asian insolvency reforms in the last decade*, OECD, *Asian Insolvency Systems: Closing the Implementation Gap*, OECD Publishing, Paris.
- Posthuma R. A., 2000, *Labour and employment laws in Mexico and the United States: An international comparison*, Labour Law Journal, no. 20, p. 21.
- Rowat M., 2002, *Reforming Insolvency Systems in Latin America, Public Policy for the Private Sector*, The World Bank Group, Note no. 187, June 2002.
- Terenytyev A., 2010, *Problems of protecting the employee rights in case of insolvency (bankruptcy) of the employer*, Labor Law Journal, no. 6, p. 59.
- US Bankruptcy Code, 1978, *U.S. Code: Title 11 – BANKRUPTCY*, <https://www.law.cornell.edu/us-code/text/11> (21.04.2014).