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GETTING MORE THAN JUSTICE ON PAPER: BANKRUPTCY PRIORITIES AND THE CRISIS OF UNPAID WAGES

*Omer Kimhi**

I. INTRODUCTION

Donald Sloat, a fifty-nine-year-old man from Maryland, worked for twenty-two years for Hill Enterprises—a cabinetmaker.[1] Devoted to his job, Mr. Sloat "work[ed] his way up from a carpenter to a project engineer," until he resigned in 2010.[2] Prior to his resignation, his employers often asked him to wait on cashing his paychecks or neglected to pay him at all; and so, at the time he left Hill Enterprises, the company owed him $17,000 in unpaid wages.[3] Unfortunately, Mr. Sloat was unable to recover the money.[4] Shortly after his resignation, the company filed for bankruptcy, and holding almost no assets, it could not pay its creditors.[5] Although Mr. Sloat's wage claims were completely justified, he never received the money he had worked for and, as a result, underwent financial difficulties himself.[6]

What is troubling is that Donald Sloat is not alone. All over the country, employers fail to pay employees their legal rights (wages, pensions, or other benefits), and employees often lose weeks' or even

* Associate Professor, Haifa University School of Law. The author wishes to thank Douglas Baird, Eyal Zamir, Alon Harel, Ronen Perry, Hadar Jabotinsky, and Vincy Fon for their comments on earlier drafts of this Article. The author also thanks Nataly Damary for excellent research assistance.

1. Yvonne Wenger, *'Wage Theft' Prevails in Post-Recession Economy*, BALT. SUN (Feb. 2 2013), http://articles.baltimoresun.com/2013-02-02/news/bs-md-wage-theft-20130202_1_wage-theft-wage-and-labor-catherine-ruckelshaus.
2. *Id.*
3. *Id.*
4. *Id.*
5. *Id.*
6. *See id.* According to the Baltimore Sun, Sloat had to ask his elderly parents for financial assistance and was unable to pay college tuition for his twenty-two-year-old daughter, who was working as a waitress. *Id.*

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months' worth of wages.[7] The wage theft often occurs because employees are reluctant to file a claim against their employer. However, in many cases, even when an employee does file a claim (and even after she receives a judgment in her favor),[8] she still isn't paid.[9] The judgment cannot be enforced, and the employee is left with a winning claim, but with no possibility to collect.[10] This Article discusses this subset of cases—those in which the employee filed a claim against her employer (either within or outside of bankruptcy), her claim was declared justified, but the judgment remained on paper and uncollected.[11] The reason for the failure to collect being the employer declared bankruptcy or otherwise avoided payment.[12]

The data regarding uncollected wage claims, although largely undiscussed, is staggering. According to a study conducted by Eunice Hyunhye Cho, Tia Koonse, and Anthony Mischel, only seventeen percent of Californian workers who prevailed in their wage claims between 2008 and 2011 were able to recover any payment from their employer.[13] In that same time frame, the Department of Labor Standards Enforcement in California ("DLSE") issued awards for unpaid wages of more than $282 million, but workers were only able to collect a mere $42 million of those awards.[14] In Oregon, the situation is only slightly better. According to the Oregon Center for Public Policy, in a recent three-year period, almost three quarters of the monetary findings against employers were not recovered, and the employees were left unpaid for their services.[15] Texas, New York, Florida, and North Carolina do not publish exact numbers, but reports from practitioners indicate that the

7. *See* NAT'L EMP'T LAW PROJECT, WINNING WAGE JUSTICE: A SUMMARY OF RESEARCH ON WAGE AND HOUR VIOLATIONS IN THE UNITED STATES 1 (2013), http://www.nelp.org/content/uploads/2015/03/WinningWageJusticeSummaryofResearchonWageTheft.pdf.

8. I use the term judgment in a broad sense to include any formal legal decision or decree stating that an employee's claim for payment is legally justified. The judgment can be given by a court of law, by an administrative agency, or by a bankruptcy trustee. Pursuant to §§ 704(a)(5) and 1102 of the Bankruptcy Code, the trustee should examine proofs of claims and object to the allowance of any claim that is improper. 11 U.S.C. §§ 704(a)(5), 1102 (2012). For our purposes, a decision by the bankruptcy trustee not to object to an employment claim filed as part of the bankruptcy process is also considered a judgment.

9. *See infra* text accompanying notes 48-67.

10. *See infra* text accompanying notes 48-67.

11. *See infra* text accompanying notes 48-67.

12. *See infra* text accompanying notes 48-67.

13. EUNICE HYUNHYE CHO ET AL., NAT'L EMP'T LAW PROJECT & UCLA LABOR CTR., THE CRISIS IN COLLECTING UNPAID WAGES FOR CALIFORNIA'S WORKERS 2 (2013), http://nelp.3cdn.net/f6fc363a30266f0cd3_pzm6id1xa.pdf. The data does not include settlements. *Id.*

14. *Id.*

15. OR. CTR. FOR PUB. POLICY, EMPLOYERS PAY ONLY A FRACTION OF MONETARY FINDINGS IN WAGE THEFT CASES 1 (Feb. 11, 2015), http://www.ocpp.org/media/uploads/pdf/2015/02/fs20150211WageTheftRecovery_fnl_.pdf.

situation is much the same. Evidence from these states shows that employees with winning judgments in their hands often are not paid because employers file for bankruptcy, hide assets, or simply disappear.[16] One can assume employees in other states do not fare much better.

This phenomenon occurs despite the fact that, at least when the employer is in bankruptcy, current law provides employees with preferential treatment when compared to regular unsecured creditors. Sections 507(a)(4) and (5) of the Bankruptcy Code give wage claims priority over other unsecured claims, so that employees who hold wage claims of up to $12,475 are paid before other unsecured creditors.[17] Congress has continuously increased the amount and the scope of the preference; in 2013, there was even a proposed amendment to the Bankruptcy Code to increase the amount to $20,000.[18] Much of the legal literature supports this trend. Scholars explain that employees are maladjusting creditors, and that the Bankruptcy Code should reflect a concern for the employees by giving them a prioritized claim.[19]

Contrary to this approach, this Article argues that the bankruptcy wage priority is a poor solution for the plight of the American employee.[20] The priority not only does not adequately protect the employees, but it is also economically inefficient.[21] Instead of the bankruptcy priority, this Article suggests implementing an insurance-based solution.[22] According to the proposal, all employees and employers will pay a fee to a wage assurance fund established by the state, and the fund shall pay unpaid employees (with favorable judgments) if their employers are bankrupt or otherwise avoid payment.[23] The fund will be able to collect the payment it made from the employer (in lieu of the employee collecting herself), but its status will be that of a regular unsecured creditor rather than a priority creditor.[24] The insurance-based model, which is implemented by the majority of Organization for Economic Cooperation and Development ("OECD")

16. *See infra* notes 57-63 and accompanying text.

17. 11 U.S.C. § 507(a)(4)–(5) (2012). The limit of $10,000 found in § 507(a)(4)(5) has been increased to the current amount of $12,475, pursuant to instructions from Congress. *See* 11 U.S.C. § 104 (2012); Revision of Certain Dollar Amounts in the Bankruptcy Code Prescribed Under Section 104(a) of the Code, 78 Fed. Reg. 12,089, 12,090 (Feb. 21, 2013).

18. Protecting Employees and Retirees in Business Bankruptcies Act of 2013, H.R. 100, 113th Cong. § 101(1)(A) (2013).

19. *See infra* notes 127-35 and accompanying text.

20. *See infra* Part II.B.

21. *See infra* Part II.B.

22. *See infra* Part III.

23. *See infra* Part III.B.

24. *See infra* Part III.C.

countries, insures that employees who prevailed in their claims will indeed receive their wages, but in return, it demands that the public pays a fee (a premium).[25]

This Article supports the adoption of this insurance-based model over the current bankruptcy priority model with four different justifications.[26] The first justification relates to the fact that the bankruptcy priority, by definition, applies only when an employer files for bankruptcy.[27] An employee whose employer decides not to file receives no preferential treatment and is forced to conduct collection efforts as a regular unsecured creditor.[28] This is an unjust inequality. Data shows that in many cases, employers avoid payment even if they are not formally bankrupt.[29] They disappear, move to a different state, or just do not have any assets and see no need to formally file. There is no reason why employees of such employers should not enjoy preferential treatment, while their peers, whose employers did file, do enjoy such a preference. If a social justification exists for giving preferential treatment to employees inside bankruptcy, then the same justification applies outside bankruptcy, as well. An insurance-based model can be applied both within and outside of bankruptcy. Importantly, the model would not unjustly discriminate against employees whose employers decide against filing, and it would not create perverse incentives and forum shopping for litigants.

Second, an insurance-based model distributes the cost of the preferential treatment to the employees more justly than a bankruptcy priority. A bankruptcy priority places the cost of the preferential treatment on the shoulders of the unsecured creditors. Since the employees are paid before the other unsecured creditors, the latter have fewer assets from which to recover, and thus, their recovery rate decreases.[30] The group of unsecured creditors, however, is random and usually relatively small. Although some of the creditors may be financially strong, others may be weak and maladjusting. Suppliers, customers, and certainly tort claimants are not necessarily stronger (or better adjusting) than employees of the company, and there is no reason to place the burden of the employees' preference on them. Paying the employees' pre-bankruptcy claims through an insurance-based solution

25. *See* Paul M. Secunda, *An Analysis of the Treatment of Employee Pension and Wage Claims in Insolvency and Under Guarantee Schemes in OECD Countries: Comparative Law Lessons for Detroit and the United* States, 41 FORDHAM URB. L.J. 867, 875 (2013); *infra* Part III.B.

26. *See infra* text accompanying notes 27-35.

27. *See* 11 U.S.C. § 507(a)(4)–(10) (2012); *see also infra* text accompanying notes 234-35.

28. *See infra* Part III.A.

29. CHO ET AL., *supra* note 13, at 2; *see also infra* notes 226-35.

30. § 507(a)(4)–(5).

places the cost on the public (all employers and employees). The cost is broadly spread, and the price each premium payer pays is minor. This decreases the economic costs of an employer's insolvency, as the collateral damage caused by the bankruptcy (to suppliers, customers, or other relatively weak creditors) is smaller.

But why is it justified to place the cost of the preferential treatment on the general premium paying public, which has nothing to do with the insolvent employer? Here, we come to the third justification for the implementation of our suggested model—economic efficiency.[31] As will be detailed further on, the reasons for providing preferential treatment to the employees are social.[32] Society believes that workers, perhaps more than other creditors, are dependent on payments they receive from their employers, and it wishes to help them avoid a situation where they work without pay.[33] But exactly *because* the reasoning behind the wage priority is social, it is the public's responsibility to pay for it. Placing the costs on the creditors is inefficient because the public (through the legislature) chooses the level of priority, yet the costs of this choice are borne by the unsecured creditors. As a result, the costs of the preference are not properly taken into account, and the level of preference is not accurately chosen. This may take a toll on the entire economy because creditors, in turn, price the bankruptcy priority. A high priority level increases interest rates, thereby decreasing investments and slowing down growth.[34] An insurance-based model, on the other hand, places the cost of the preference on the same "entity" that decides the level of the preference—the public. The model is better able to set the preference at the level the public desires, thereby enhancing overall economic welfare.

Lastly, an insurance-based solution improves the monitoring of shirking employers.[35] Without the existence of an insurance-based solution, collection efforts are regularly under provided. They are expensive and time consuming, and few employees have the required resources to invest in such proceedings. As a result, employers are able to avoid payment relatively easily, incentivizing wage theft. An insurance-based model addresses this problem. Since the insurer would have the right to collect the money it paid to the unpaid employees from the employer, it can conduct the collection proceedings itself. The insurer could aggregate the claims of all unpaid employees, thus, creating an incentive to invest the required resources in the collection

31. *See infra* Part III.A.
32. *See infra* Part III.A.
33. *See* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 790 (1987).
34. *See infra* text accompanying notes 192-93.
35. *See infra* text accompanying notes 226-35.

efforts, and could gain knowledge and expertise in the matter. Due to the prevalence of wage theft in the United States, a strong collection and enforcement arm is likely in order.

The problem with an insurance-based model appears to be the cost. Since the fund pays all employees that are unable to collect a favorable judgment from their employer, there is a danger that its cost will be very high, and that the high cost will render the solution impractical. This Article addresses the cost issue, and rejects it from both conceptual and practical perspectives.[36] From a conceptual perspective, this Article argues that for the same level of preference, an insurance-based model is not more expensive than a bankruptcy priority model.[37] Both models entail economic costs, but whereas the costs of a bankruptcy priority are indirect and opaque, the costs of an insurance-based model are transparent. In addition, the Article explains that if the public wishes to decrease the premiums, the legislature should reduce the insurance coverage rather than use an inefficient model of preference, that is the bankruptcy priority. From a practical perspective, a rough assessment of the costs of an insurance-based solution shows that they are definitely manageable. When examining California, the state for which we have the most accurate data, we see that full wage assurance coverage should cost about thirty cents a month per employee—a relatively small amount, even for employees from a low socio-economic level.[38] Although the figure is a very rough estimation, it clarifies that the fund's costs do not render its creation financially unjustified.

This Article, thus, makes a valuable contribution—putting forth the insurance-based model and showing its superiority over the current legal regime. Note, though, that the argument pertains to the model used for preferring the wage claims, and not to the question of whether such preferential treatment should be given in the first place.[39] I maintain that if the public believes that employees' wage claims deserve protection (and current legislation suggests that it does), then the tool to use is an insurance-based model and not a bankruptcy priority. If, on the other hand, the public does not believe employees' wages should be protected, then no type of preference should be implemented at all—not even a bankruptcy priority. In any event, the current legal regime, in which only a bankruptcy priority exists, is wrong.

The rest of this Article proceeds as follows: In Part II, the Article describes the employees' collection problem and outlines the possible

36. *See infra* Part IV.B.
37. *See infra* Part IV.B.
38. *See infra* Part IV.B.
39. *See infra* Part III.A.

models of solution.[40] Part III argues that the insurance-based model is superior to a bankruptcy priority in a bankruptcy context and explains why implementing an insurance-based solution solely in a bankruptcy setting would be a mistake.[41]

II. THE COLLECTION OF UNPAID WAGES: THE PROBLEM AND AVAILABLE REMEDIES

A. *The Problem*

Wage theft, the practice of denying employees the monetary compensation they rightfully deserve, has become an epidemic.[42] It is a grave and widespread phenomenon, and some even call it the "defining trend" of the 21st century labor market.[43] A growing body of empirical research shows that, far from being anecdotal, the wage theft phenomenon has spread to various locations and to a wide range of industries.[44] A study conducted in 2008, in Chicago, Los Angeles, and

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40. *See infra* Part II.

41. *See infra* Part III. This Article deals exclusively with employees' pre-petition claims. Insofar as the claims are post-petition (claims for workers' salaries during the restructuring period), I think the claims should be paid from the debtor's assets—at the expense of the other creditors. The employees' work during the restructuring period facilitates the operation of the debtor as a going concern. The debtor's continued existence ought to increase its value and, thus, increase the payment the group of creditors obtains in the insolvency proceedings. Since the group of creditors benefits from the fruits of the workers' labor, it should also finance it. Charging the cost of salaries to the debtor's assets also facilitates a more correct choice between liquidation and restructuring proceedings. It forces the creditors to take into account the costs of restructuring, which in turn makes them select the restructuring option only if the value gained from the continued existence of the debtor as a going concern is indeed higher than the costs of operating the company.

42. Rebecca Dixon, Staff Attorney, Nat'l Emp't Law Project, Testimony on Implementation of the Wage Theft Prevention Act Before the New York State Assembly Standing Committee on Labor 2 (Nov. 21, 2013), http://www.nelp.org/content/uploads/2015/03/NELP-Testimonyforthe-NYS-Assembly-Hearing.pdf.

43. *See* HOUS. INTERFAITH WORKER JUSTICE CTR., HOUSTON, WE HAVE A WAGE THEFT PROBLEM 1, 4-5 (2012) https://stopwagetheft.files.wordpress.com/2012/05/2012-houston-wage-theft-report.pdf; NAT'L EMP'T LAW PROJECT, *supra* note 7, at 2.

44. *See generally* ASIAN AM. LEGAL DEF. & EDUC. FUND, "FORGOTTEN WORKERS": A STUDY OF LOW-WAGE KOREAN IMMIGRANT WORKERS IN THE METROPOLITAN NEW YORK AREA (2006), http://www.aaldef.org/docs/KWP_2006WorkerSurvey_analysis.pdf (maintaining that many low-wage workers from the Korean community in the New York Metropolitan Area are prone to experience labor violations, such as not receiving minimum wage or overtime); MARY BAUER, S. POVERTY L. CTR., UNDER SIEGE: LIFE FOR LOW-INCOME LATINOS IN THE SOUTH (2009), http://www.splcenter.org/sites/default/files/downloads/UnderSiege.pdf (finding that many workers in the Latino community encounter discrimination and exploitation by being denied their basic labor rights, such as minimum wage, basic health and safety protections, and others and arguing that state and local governments have made the situation worse, by leaving workers without the ability to receive wages that are rightfully theirs); ANNETTE BERNHARDT ET AL., NAT'L EMP'T LAW PROJECT, BROKEN LAWS, UNPROTECTED WORKERS (2009), http://www.nelp.org/page/-/brokenlaws/BrokenLawsReport2009.pdf?nocdn=1; ROBERT BRUNO ET AL., UNIV. OF ILL. AT URBANA-

New York City, shows that twenty-six percent of low-wage workers are paid less than the minimum wage, and of the more than twenty-five percent of workers who work over forty hours, more than three quarters are not paid the legally required overtime.[45] More than two-thirds of the employees in the sample (a total of 4387 employees) reported at least one pay-related violation a week prior to the survey, and the average wage loss translates into fifteen percent of earnings.[46] No less than $56.4 million dollars are lost every week due to wage theft in each of the three major cities surveyed.[47]

However, the wage theft phenomenon, albeit grave and important, is only part of the problem. An ancillary problem, the problem with which I deal in this Article, is that even when employees receive a judgment in their favor, in many cases, the judgment remains no more than a piece of paper.[48] The employer avoids, or is unable to pay, the awarded damages, and the employees fail to enforce their rights.[49]

Cho, Koonse, and Mischel conducted research that looked into the collection of unpaid wages in California.[50] Their research investigates wage claims filed to the DLSE and examines how much of their unpaid wages workers were able to collect.[51] According to their analysis, only

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CHAMPAIGN, CLEAN CARS, DIRTY WORK (2012), https://ler.illinois.edu/wp-content/uploads/2015/01/Clean-Cars-Dirty-Work_Bruno-Quesada-Manzo.pdf (surveying employees working at car washes in Chicago and finding that violations of basic labor laws are common among car wash employees); CASA OF MD., WAGE THEFT: HOW MARYLAND FAILS TO PROTECT THE RIGHTS OF LOW-WAGE WORKERS (2007), http://cdm.nonprofitsoapbox.com/storage/documents/wagetheft.pdf (discussing the wage theft epidemic in Maryland); REBEKAH LEVIN & ROBERT GINSBURG, SWEATSHOPS IN CHICAGO (2000), file:///Users/admin/Downloads/center_for_impact_research_30.pdf (surveying working conditions in low-income immigrant communities in Chicago, especially in work places that meet the Department of Labor's definition of sweatshops and concluding that a significant number of employees working in these sweatshops are deprived of their basic rights, such as minimum wage or overtime, and are exposed to other federal violations, such as child labor or industrial homework); MUJERES UNIDAS Y ACTIVAS ET AL., BEHIND CLOSED DOORS: WORKING CONDITIONS OF CALIFORNIA HOUSEHOLD WORKERS (2007), http://www.datacenter.org/wp-content/uploads/behindcloseddoors.pdf (surveying low-income immigrant Latina women in California, many of whom are domestic workers, and finding that domestic workers experience many labor violations, such as not getting paid minimum wage or overtime and not receiving paid work breaks); NAT'L EMP'T LAW PROJECT, *supra* note 7; Helene Jorgensen & Lonnie Golden, *Time After Time: Mandatory Overtime in the U.S. Economy*, ECON. POL'Y INST. (Jan. 1, 2002), http://www.epi.org/publication/briefingpapers_bp120 (confirming that since at-will workers in the United States can be dismissed for no reason at all, many employees are "forced" to work overtime out of fear of their dismissal or facing other workplace sanctions).

45. *See* BERNHARDT ET AL., *supra* note 44, at 2.

46. *Id.* at 2, 5.

47. *Id.* at 6.

48. *See infra* text accompanying notes 50-67.

49. *See infra* text accompanying notes 50-67.

50. *See generally* CHO ET AL., *supra* note 13.

51. *Id.* at 1-2.

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seventeen percent of the employees who complete the entire DLSE process (not including settlement awards) and receive a judgment in their favor are able to recover any payment from the employer.[52] Between the years 2008 and 2011, the DLSE issued decisions for unpaid wages totaling over $282 million, but "workers were able to collect a mere $42 million—roughly [fifteen] percent—of those awards."[53] Collection rates are better if settlement awards are taken into account, but even then, fifty-eight percent of the claims are unpaid.[54]

The situation in other states is not much different. According to the Oregon Center for Public Policy, between July 2010 and June 2013 the Oregon Bureau of Labor and Industries issued monetary fines against employers totaling $6.2 million.[55] Employers, however, paid only $1.8 million—twenty-eight percent of the total amount of the judgments issued against them.[56] The Houston Interfaith Worker Justice Center, a Texas non-profit organization designed to support employees, reports a similar experience. From 2007 to 2012, the organization has documented more than $3.3 million in stolen wages,[57] but has been able to recover only $700,000—just twenty-one percent of the amount due to the employees.[58] The same situation exists in New York,[59]

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52. *Id.* at 13-14. "Between 2008 to 2011, 18,683 workers prevailed in their [wage] claims," but just 3084 of those workers were able to collect any money. *Id.*

53. *Id.* at 2.

54. *Id.* at 14-15.

55. OR. CTR. FOR PUB. POLICY, *supra* note 15.

56. *Id.*

57. HOUS. INTERFAITH WORKER JUSTICE CTR., *supra* note 43, at 6. This amount includes only the data documented by the non-profit agency itself, which, according to the agency's own report, is only a segment of the monetary scope of wage stolen in Houston. *Id.*

58. *Id.* The agency explains this poor collection rate as follows:

> Unscrupulous employers can utilize many tactics to avoid payment even after "conviction" [that is a judgment determining the employer owes the employee money] by closing bank accounts or businesses and reopening under a new name, transferring their assets to a family member or under a different name, or filing for bankruptcy.
>
> While in many cases it is possible to pursue collection, an understaffed agency with limited resources is unlikely to continue an investigation or collection process past the initial rejection. In turn, this leaves the affected worker with only part of their due wages, or worse, a favorable court judgment or TWC order—simply a victory on paper.

Id. at 14.

59. Lauren K. Dasse, Note, *Wage Theft in New York: The Wage Theft Prevention Act as a Counter to an Endemic Problem*, 16 CUNY L. REV. 97, 116 (2012) ("[L]ow-wage workers [often] receive a judgment in their favor but never see the money, because, for example, the employer has transferred his or her assets to someone else, sold the business and moved on, or has disappeared and is nowhere to be found.").

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Florida,[60] Iowa[61], North Carolina,[62] and presumably many of the other cities and states that do not publish formal statistics about the recovery rate of unpaid wage judgments.[63] As Rebecca Dixon, a policy analyst for the National Employment Law Project, explained in her testimony before the New York State Assembly Standing Committee on Labor:

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60. Andrew Marra, *Editorial: Stiffed Workers Still Have Trouble Collecting Pay*, MYPALMBEACHPOST (July 5, 2013, 1:18 PM), http://www.mypalmbeachpost.com/news/news/opinion/editorial-stiffed-workers-still-have-trouble-colle/nYcxk ("Florida 'is a debtor's paradise,' says Gregory Schell, managing attorney of Florida Legal Service's Migrant Farmworker Justice Project. 'Collection is a huge, huge problem, and no matter what system you have, it's hard to collect.'").

61. COLIN GORDON ET AL., IOWA POLICY PROJECT, WAGE THEFT IN IOWA 17 (2012), http://www.iowapolicyproject.org/2012docs/120827-wagetheft.pdf. The situation in Iowa is on scale with the rest of the country:

> [E]ven workers who are successful in winning a claim or suing an employer for back wages often will be faced with the difficulty of collecting a monetary judgment. As Iowa Workforce Development acknowledges in its guidance to potential claimants, "Gaining a judgment does not guarantee payment of your claim. The wages must still be collected. Often, this is not possible." Smaller, "fly by night" employers may have few visible assets, may close up shop in order to avoid paying a judgment, or may disappear in bankruptcy.

Id. (footnote call numbers omitted).

62. SABINE SCHOENBACH ET AL., N.C. JUSTICE CTR. & UNC IMMIGRATION/HUMAN RIGHTS POLICY CLINIC, "IT DOESN'T ADD UP" 25 (2012), http://www.ncjustice.org/sites/default/files/Wage_Theft_Report-It_doesnt_add_up.pdf ("Even if employees are able to access the complaint process, the collection of lost wages is often challenging. . . . Providing a simple way for workers to place liens on employers who fail to pay wages can be an effective tool for fast recovery of wages owed.").

63. As part of the research for this Article, my research assistant and I sent e-mails to labor commissioners in all fifty states, asking them for data regarding the collection rate of employment claims in their state. Unfortunately, the vast majority of states (forty-two) did not respond, and those who did failed to provide most of the data for which we were looking. The labor commissioners in Kentucky and New Hampshire wrote that the data about collection rates was unavailable. E-mail from Karen J. Triplett Meier, Office of Gen. Counsel, Dep't of Workers' Claims, to Nataly Damary, Faculty of Law, Haifa Univ. (May 1, 2013) (on file with the author) (Kentucky); E-mail from Martin Jenkins, Legal Counsel, N.H. Dep't of Labor, to Nataly Damary, Faculty of Law, Haifa Univ. (May 14, 2014) (on file with the author) (New Hampshire). Wage commissioners in Alaska, Arkansas, Connecticut, Illinois, and South Dakota gave the amount of collected wages (in cases where wage violations were reported), but did not report the total amount of the claims. E-mail from Joe Dunham, Statewide Supervising Investigator, Wage & Hour Admin., to Nataly Damary, Faculty of Law, Haifa Univ. (Apr. 26, 2014) (on file with the author) (Alaska); E-mail from Denise P. Oxley, Gen. Counsel, Ark. Dep't of Labor, to Nataly Damary, Faculty of Law, Haifa Univ. (Apr. 24, 2014) (on file with the author) (Arkansas); E-mail from Gary K. Pechie, Dir., Conn. Dep't of Labor, to Nataly Damary, Faculty of Law, Haifa Univ. (Apr. 23, 2014) (on file with the author) (Connecticut); E-mail from James E. Marsh, Dir., S.D. Dep't of Labor and Regulation, to Nataly Damary, Faculty of Law, Haifa Univ. (Apr. 28, 2014) (on file with the author) (South Dakota). The labor commissioner in Nebraska was the only commissioner that provided all of the information requested. E-mail from John H. Albin, Agency Legal Counsel, Neb. Dep't of Labor, to Nataly Damary, Faculty of Law, Haifa Univ. (May 2, 2014) (on file with the author). In Nebraska, the total amount of the wage claims during Fiscal Year 2012-2013 was $785,498, and employees were unable to recover 15.4% of this amount—$120,997. *Id.*

> Right now, it's all too common that a worker successfully brings a wage theft claim, only to see the employer declare bankruptcy, leave town, close shop or otherwise evade paying up. If we want workers to come forward, we have to show that we can get them their unpaid wages.[64]

Indeed, many workers, even after they summon up the courage to file a complaint and ultimately win a judgment, never get paid. The unpaid employees have difficulties chasing after the shirking employer, and, even if they do find the employer, as in the Hill Enterprises example in the Introduction, the employer may have no assets to give them.[65] The employer is bankrupt, the business is gone, and the employees have no financial resources from which to recover. According to Cho, Koonse, and Mischel, sixty percent of the employers who received a judgment against them in California have "abandoned, transferred or sold their businesses" before, or soon after, the judgment ordering them to pay their employees was given.[66] Fifty percent of these employers did so before the workers could even complete the judicial process.[67]

Unfortunately, the employees who suffer from this problem often come from weak socio-economic backgrounds.[68] Those employees, the weakest stakeholders, depend on the wages they receive from their employer for their basic needs, and with little savings, they cannot afford to get less than full compensation.[69] Although the dollar amounts of each employment claim may be small, for these hard working employees every dollar counts, and even one month of unpaid wages can make the difference between relative financial stability and homelessness.[70]

The legal system does offer workers who have a winning judgment in their hands some mechanisms for easier collection when compared to other creditors.[71] These solutions afford employees a priority over other creditors or an additional source from which to collect their debts.[72] The problem is that the main solution offered—the bankruptcy priority—is

64. *See* Dixon, *supra* note 42, at 3-4.

65. *See* Wenger, *supra* note 1.

66. CHO ET AL., *supra* note 13, at 14.

67. *Id.* at 14.

68. *See* NAT'L EMP'T LAW PROJECT, WINNING WAGE JUSTICE: AN ADVOCATE'S GUIDE TO STATE AND CITY POLICIES TO FIGHT WAGE THEFT 111-12 (2011), http://www.nelp.org/content/uploads/2015/03/WinningWageJustice2011.pdf; Dixon, *supra* note 42, at 3.

69. *See* BERNHARDT ET AL., *supra* note 44, at 21-26; NAT'L EMP'T LAW PROJECT, *supra* note 68, at 111-12.

70. *See* SCHOENBACH ET AL., *supra* note 62, at 2-3.

71. *See infra* Part II.B.

72. *See infra* Part II.B–C.

not very efficient, and the other, more efficient, solutions have been adopted only by a few states. In the following sections, we will outline the available solutions and show the dominant role the Bankruptcy Code plays in the legislation and in the literature.[73]

B. *The Current Solutions to the Collection Problem: An Outline*

The most important, and by far the most deliberated, solution to the employees' collection problem is the wage priority given in the Bankruptcy Code.[74] Sections 507(a)(4) and 507(a)(5) of the Bankruptcy Code prioritize wage claims so that the holders of such claims are paid in full, before most other unsecured creditors receive anything for their claims.[75] Section 507(a)(4) is available for allowed unsecured claims for wages, salaries, and commissions, including overtime, vacation, severance, and sick leave pay earned by an individual.[76] Section 507(a)(5) is available for allowed claims for contribution to an employee benefit plan.[77] Both priorities, however, are limited in dollar amount and time.[78] In terms of amount, § 507(a)(4) is limited to claims of up to $12,475.[79] Any amount exceeding this maximum limit will be considered a regular unsecured claim, even if it is a claim for wages, salaries, or commissions.[80] Section 507(a)(5) is limited to $12,475 minus the amount paid to the employee under § 507(a)(4).[81] This means that, in

73. *See infra* Part II.B–C.

74. 11 U.S.C. § 507(a)(4)–(5) (2012).

75. *Id.*; 4 COLLIER ON BANKRUPTCY ¶ 507.06 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2015).

76. § 507(a)(4); COLLIER ON BANKRUPTCY, *supra* note 75, ¶ 507.06[2]. It is also available for sales commissions and bonuses, "so long as the bonus is in the nature of compensation for work performed." COLLIER ON BANKRUPTCY, *supra* note 75, ¶ 507.06[2]. A corporation can also have an allowed claim for sales commissions if the corporation has only one employee, and it is "acting as an independent contractor in the sale of goods and services for the debtor in the ordinary course of the debtor's business." § 507(a)(4)(B).

77. § 507(a)(5). The legislature did not define the term "employee benefit plan," but it is understood to mean "pension plans, health insurance plans, and life insurance plans." COLLIER ON BANKRUPTCY, *supra* note 75, ¶ 507.07[1]. According to the Supreme Court decision in *Howard Delivery Service, Inc. v. Zurich American Insurance Co.*, a worker's compensation plan does not qualify as an employee benefit plan, because the premiums do not constitute compensation (direct or indirect) to the employee. 547 U.S. 651, 655 (2006).

78. *See* § 507(a)(4)–(5).

79. § 507(a)(4); Revision of Certain Dollar Amounts in the Bankruptcy Code Prescribed Under Section 104(a) of the Code, 78 Fed. Reg. 12,089, 12,090 (Feb. 21, 2013); COLLIER ON BANKRUPTCY, *supra* note 75, ¶ 507.06.

80. *See* § 507(a)(4); COLLIER ON BANKRUPTCY, *supra* note 75, ¶ 507.06. The dollar amount limitation is adjusted every three years to account for the changes in the cost of living. *See* 11 U.S.C. § 104 (2012).

81. § 507(a)(5)(B); Revision of Certain Dollar Amounts in the Bankruptcy Code Prescribed Under Section 104(a) of the Code, 78 Fed. Reg. at 12,090.

any event, an employee cannot receive more than $12,475 as a priority claim for both sections. In terms of time, to receive a priority under §§ 507(a)(4) and 507(a)(5) the claims must be earned within 180 days before the date of filing the petition or the date the debtor ceased business, whichever is earlier.[82] Claims for wages or benefit plan contributions earned before this time are treated as general unsecured claims and will not give the employees any priority.[83]

Note, though, that even when wage claims are within the prescribed amount and timing limits, their payment is still conditioned on the value of the debtor's assets. If the debtor (employer) has very few assets, or if its assets are already tied up as security for other creditors, then the value of the estate may be insufficient to pay employees despite their priority.[84] In this case, both the regular unsecured creditors and the employees will get nothing, and the priority will do the unpaid employee little good. Several states, therefore, have developed additional mechanisms designed to help employees collect unpaid wages.[85] The enforcement mechanisms adopted by the states can be divided into three categories: wage liens, bond funds, and wage assurance funds.[86] All three categories are designed to improve employees' chances of receiving the debt owed to them by their employers, but the tools they use to do so are different.

A wage lien is a statutory lien filed in case of non-payment of wages or other employment related claims.[87] The lien gives employees a direct claim against employers' property (including real estate or bank accounts), and thereby elevates their position from priority creditors to secured creditors.[88] It increases the employees' collection rate, and

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82. § 507(a)(4)–(5).

83. *See id.*

84. *See infra* note 188 and accompanying text.

85. *See infra* notes 86-110 and accompanying text.

86. *See* NAT'L EMP'T LAW PROJECT, *supra* note 68, at 112.

87. *See, e.g.*, ALASKA STAT. § 34.35.440 (2014); IDAHO CODE § 45-620 (2015); ME. STAT. tit. 26, § 52 (2014); MINN. STAT. § 514.59 (2014); NEV. REV. STAT. § 78.720 (2013); N.H. REV. STAT. ANN. § 275:51 (2015); VT. STAT. ANN. tit. 9, § 1971 (2015); WASH. REV. CODE § 49.48.086 (2014); WIS. STAT. § 109.09(2) (2015).

88. *See* Richard H. Nowka & Jeff. S. Taylor, *Kentucky Employees' Wage Liens: A Sneak Attack on Creditors, but Beware of the Bankruptcy Trustee*, 84 KY. L.J. 317, 318-20 (1995-1996); Matthew L. Seror, Note, *Analyzing the Inadequacies of Employee Protections in Bankruptcy*, 13 S. CAL. INTERDISC. L.J. 141, 150-52 (2003-2004) (examining the court's treatment of wage liens). The procedure required to attach the wage lien varies from state to state. In some states, like Alaska, the unpaid employee can file for a lien within ninety days of non-payment of wages, even prior to a court or an administrative agency ruling on the employer's liability. ALASKA STAT. § 34.35.440. In other states, like Idaho, an administrative agency must recognize the employer's liability before the lien is attached. IDAHO CODE §§ 45-617, 45-620 (2015). In addition, some states limit the protection

pressures the employer to pay their debts to erase the lien.[89] According to a study conducted by the National Employment Law Project ("NELP Study"), a general wage lien, which is available to all employees, is adopted only by a handful of states.[90] Most states have some form of a mechanic's lien, which covers work that involves the improvement of real property, but the vast majority of employees cannot take advantage of these types of liens.[91] Even when available, by definition, the wage lien is linked to the debtors' assets. Thus, if the debtor does not have any assets, the worker cannot attach a lien and cannot enjoy the security afforded by the wage lien statute.

A second mechanism to aid the employees' collection is a wage bond. This option requires employers to post a bond with a state agency to protect the wages and benefits of their workers.[92] In case of non-payment, the existence of the bond, which is dedicated to this purpose, ensures that the employees have sufficient capital from which to recover.[93] According to the NELP Study, thirty-eight states require that employers post wage bonds, but the requirement typically applies only to public works or construction companies.[94] Only "[a] few states require bonds in other industries, including garment (California), entertainment (Nevada), . . . or mining (Illinois)," and no state requires all employers to post wage bonds for their entire work force.[95] The problem with a wage bond requirement, and probably the reason why it is implemented in so few industries, is that it demands employers to put up a large sum of money upfront. The value of the bond should be of sufficient amount to cover all potential wage claims, and although a bond typically costs only a certain percentage of the amount it guarantees, the cost to the employer can be substantial.[96] New or small businesses will have particular difficulties raising sufficient funds for the bond, and an overarching requirement to post wage bonds is likely to discourage entrepreneurship or push businesses towards insolvency.

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that can be afforded by the lien. Wisconsin, for example, caps the maximum amount of recovery to up to six months of wages and to no more than $3000. WIS. STAT. § 109.09(2).

89. The lien prevents the employer from selling or transferring the assets to which the lien is attached, and thereby it ensures the employee will have assets from which to recover.

90. *See* NAT'L EMP'T LAW PROJECT, *supra* note 68, at 114-15.

91. *Id.* at 113.

92. *See id.* at 112.

93. JOHN W. ROURKE ET AL., ELEVENTH ANNUAL NORTHEAST SURETY AND FIDELITY CLAIMS CONFERENCE: A SURVEY OF PREVAILING WAGE LAWS AND THEIR IMPLICATIONS FOR THE SURETY 2-3 (2000), http://www.forcon.com/userfiles/file/nesfcc/2000/06.Rourke.pdf.

94. NAT'L EMP'T LAW PROJECT, *supra* note 68, at 117; *see* ROURKE ET AL., *supra* note 93, at 9-34 (discussing each state's approach).

95. *See* NAT'L EMP'T LAW PROJECT, *supra* note 68, at 118.

96. *Id.* at 117.

A third option to assist employees, therefore, is an insurance-based model.[97] Under an insurance-based model, the state creates or designates a wage assurance fund from which employees can collect their employment claims in case of non-payment.[98] When an employee has a judgment in her favor, but her employer cannot (or refuses to) pay it, the fund pays the unpaid employee her wages (or other employment claims) in lieu of the insolvent employer.[99] The fund is financed by fees imposed on the employees, employers, or both.[100] All employees and employers pay a certain premium to the fund, and the fund uses the pool of premiums to pay the deserving employees.[101] The fund, therefore, functions as a wage insurer. The insured public (employees and employers) pays a small monthly fee, and in return, the fund guarantees that all employees will be able to collect justified wage claims regardless of their employers' financial condition.[102] The wage assurance fund, thus, shifts the risk allocations; it transfers the risk of non-payment from the employees of a certain employer (debtor) to the general public of employers and employees—those who pay the premiums. Note, though, that as opposed to a regular insurance scheme, this insurance should be mandatory. Employers and employees should not be able to opt out of this insurance policy, and all of them should be required to pay the designated premiums.[103] In a sense, therefore, the premiums resemble a tax or fee. They are deducted from employers' and employees' income, and serve a public purpose—the protection of employees' claims.[104]

97. *Id.* at 120; *see* EMPLOYEE RIGHTS IN BANKRUPTCY 13 (R. Blanpain & A.T.J.M. Jacobs eds., 2002).

98. *See* EMPLOYEE RIGHTS IN BANKRUPTCY, *supra* note 97, at 13. There are several possible models of establishing a wage assurance fund. One option is to create a state fund, which is managed and operated by state officials. Another option is to use private insurance companies, which compete to provide the wage assurance to the employees. This second option uses private market forces to decrease the insurance price, akin to other mandatory liability insurance schemes.

99. The wage fund solves the employees' collection difficulties because it is not connected to the employer's assets. Even in a case where the employer has few or no assets, the fund can still pay the unpaid employees.

100. JANIS SARRA, RECOGNIZING WORKERS' ECONOMIC CONTRIBUTIONS: THE TREATMENT OF EMPLOYEE AND PENSION CLAIMS DURING COMPANY INSOLVENCY 25 (2008), http://www.iiiglobal.org/component/jdownloads/finish/572/5379.html; *see* EMPLOYEE RIGHTS IN BANKRUPTCY, *supra* note 97, at 13, 19; NAT'L EMP'T LAW PROJECT, *supra* note 68, at 120-23.

101. *See* EMPLOYEE RIGHTS IN BANKRUPTCY, *supra* note 97, at 13.

102. *Id.*

103. *Cf.* Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1415, 1418 (1985) (explaining Jackson's views of consumer bankruptcy law as a type of a mandatory insurance policy).

104. In some countries, the fund is subsidized, in whole or in part, by the state. *See* SARRA, *supra* note 100, at 25. Instead of, or in addition to, the premiums paid by employees and employers, the state finances the fund's activities from its own resources. *See id.* I object to this type of funding,

Despite the potential of wage assurance funds to help employees, in the United States, only Oregon and Maine use this mechanism, and even then, on a very limited basis.[105] In Oregon, employees can recover from the fund up to $4000 in wage claims, when their employer ceases doing business and does not have the resources to pay them.[106] Maine follows a similar model, but employees can recover up to two weeks wages rather than a certain limited dollar amount.[107] As opposed to the United States, in many other OECD countries, wage assurance funds are much more prevalent.[108] The European Council, for example, issued a directive that obligates all member states to set up a wage assurance fund to help employees when their employer is bankrupt.[109] The models in which the different funds operate differ from country to country, but in all countries, the funds insure at least part of the employees' unpaid wage claims.[110]

C. *Bankruptcy Law as the Primary Mechanism to Protect Unpaid Employees*

While various mechanisms are available to improve the collection of employment claims, as the description above shows, in the United States there is a focus on the bankruptcy model. Most states do not offer unpaid employees any special collection privileges, and they rely on the priority given by the federal Bankruptcy Code to help employees when their employers file for bankruptcy.[111] This focus on bankruptcy law is shared by Congress and by legal literature.[112] Both largely ignore the other possible solutions for the employees' collection problem and view this problem through the narrow prism of bankruptcy law.

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however, and believe the fund should be financed solely from premiums—just like a regular insurance policy. For reasons that shall be elaborated further below, there should be a legal and visible connection between the amounts paid to the fund by the public and the amounts paid by the fund to the unpaid employees. *See infra* notes 180-97 and accompanying text. State subsidies interfere with this link and are liable to cause imbalances in the fund's finances. *See* Secunda, *supra* note 25, at 936 & n.333.

105. ME. STAT. tit. 26, § 632 (2015); OR. REV. STAT. § 652.409 (2013); *see* NAT'L EMP'T LAW PROJECT, *supra* note 68, at 121.

106. OR. REV. STAT. § 652.414(1)-(2).

107. ME. STAT. tit. 26, § 632(1).

108. *See* Secunda, *supra* note 25, at 875, 903-04.

109. Council Directive 2008/94/EC, 2008 O.J. (L 283) 36-40. Council Directive 2008/94/EC originated from an earlier directive, adopted in 1980—Council Directive 1980/987/EEC, 1980 O.J. (L 283) 23-25. *See* Nicolae Voiculescu, *Developments in the Community Legislative Protection of Employees in the Event of Employer Insolvency*, 8 ANALELE UNIVERSITĂŢII TITU MAIORESCU 76, 76-77 (2009) (Rom.).

110. *See generally* Secunda, *supra* note 25.

111. *See supra* Part II.

112. *See infra* notes 113-48 and accompanying text.

The emphasis Congress places on bankruptcy law is reflected by the constant broadening of the bankruptcy priority's scope and by the rhetoric used by Congressmen in the legislation process.[113] Ever since the wage priority was first introduced in 1841, the amount of allowed claims has continuously grown.[114] In 1841, Congress capped the amount of the allowed priority at $25 ($700 in today's purchasing power), and gradually the amount has risen to the present cap of $12,475.[115] However, not only has the dollar amount of the allowed claims changed, so have the types of claims and their possible beneficiaries. On several occasions, usually after bankruptcy courts narrowly interpreted the wage priority, Congress responded by amending the bankruptcy laws. In 1938, Congress clarified that not only do salary claims enjoy the priority, but so can commissions received by "part-time and non-exclusive salesmen."[116] In 1978, in response to the Supreme Court rulings in *United States v. Embassy Restaurant, Inc.*[117] and *Joint Industry Board of the Electrical Industry v. United States*,[118] Congress added § 507(a)(5) to cover contributions to employees' benefit plans.[119] In 1994, Congress

113. *See infra* text accompanying notes 114-25.

114. Act of Aug. 19, 1841, ch. 9, §§ 2, 5, 5 Stat. 440, 442, 445 (repealed 1843); *see infra* note 115 and accompanying text.

115. *Id.*; Revision of Certain Dollar Amounts in the Bankruptcy Code Prescribed Under Section 104(a) of the Code, 78 Fed. Reg. 12,089, 12,090 (Feb. 21, 2013). *See generally* C. Scott Pryor, *The Missing Piece of the Puzzle: Perspectives on the Wage Priority in Bankruptcy*, 16 AM. BANKR. INST. L. REV. 121 (2008). In 1867, the limit was increased to $50 ($825 in today's purchasing power). Act of Mar. 2, 1867, ch. 176, § 27, 14 Stat. 517, 529-30 (repealed 1878). In 1898, the limit was increased to $300 ($8830 in today's purchasing power), but only if earned within three months prior to the filing. Act of July 1, 1898, ch. 541, § 64(b)(4), 30 Stat. 544, 563. In 1926, the limit was increased to $600 ($8020 in today's purchasing power). Act of May 27, 1926, ch. 406, sec. 15, § 64(b)(5), 44 Stat. 662, 667 (amending the Act of July 1, 1898). In 1978, the limit again increased to $1800 ($6530 in today's purchasing power). Bankruptcy Act of 1978, Pub. L. No. 95-598, § 507(a)(3), 92 Stat. 2549, 2583 (codified at 11 U.S.C. § 507(a)(4) (2012)). In 1994, the limit once again caught up to inflation, as it climbed to $4000 ($6390 in today's purchasing power). Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, sec. 108(c), § 507(a), 108 Stat. 4106, 4112. In 2005, the amount again changed to $10,000, if earned 180 days prior to filing instead of only three months. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), sec. 1401, § 507(a), Pub. L. No. 109-8, 119 Stat. 23, 214. Today the amount stands at $12,475, due to the cost of living adjustment prescribed in § 104 of the *United States Code*. 11 U.S.C. §§ 104(a), 507(a)(4); Revision of Certain Dollar Amounts in the Bankruptcy Code Prescribed Under Section 104(a) of the Code, 78 Fed. Reg. at 12,090. Present purchasing power was calculated using an online calculator. MEASURINGWORTH.COM, http://www.measuringworth.com/ppowerus (last visited Nov. 22, 2015).

116. *See* Pryor, *supra* note 115, at 137.

117. 359 U.S. 29, 29-30, 34-35 (1959) (holding that payments due to a welfare fund intended to cover life insurance, weekly sick benefits, and medical benefits for union members did not fall under the wage priority).

118. 391 U.S. 224, 225, 228-29 (1968) (holding that payments due to an annuity fund for electrical workers did not fall under the wage priority).

119. *See* COLLIER ON BANKRUPTCY, *supra* note 75, ¶ 507.07; *see also* Pryor, *supra* note 115, at

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resolved a split amongst the courts by integrating commissions owed to independent contractors in the wage priority.[120] This trend of increasing the scope of employees' protection in bankruptcy continues in the current Congress. In 2013, Congressman John Conyers, Jr. introduced a bill entitled "Protecting Employees and Retirees in Business Bankruptcy Act of 2013" ("PERBBA") to the Congress, and suggested broadening the employees' protection.[121] According to the PERBBA, the priority payment to employees' claims should increase from $12,475 to $20,000, and the restriction that the wage and benefits must be earned within 180 days of the bankruptcy filing should be eliminated.[122] The PERBBA was assigned to a congressional committee, but died without any vote.[123] From congressional discussions during the legislation of the above amendments, though, it is clear that members of Congress view bankruptcy law as the only possible tool to protect unpaid employees.[124] Other possible models, and in particular an insurance-based model, were not even considered, and Congress reverted to the bankruptcy wage priority to address the plight of the American worker.[125]

138-40 (discussing the Court's hesitance to expand the wage priority from the bench).

120. 11 U.S.C. § 507(a)(4)(B); COLLIER ON BANKRUPTCY, *supra* note 75, ¶ 507.06[3][b].

121. Protecting Employees and Retirees in Business Bankruptcies Act of 2013, H.R. 100, 113th Cong., §§ 1–2 (2013).

122. *Id.* at sec. 101, § 507(a).

123. *See H.R. 100 (113th): Protecting Employees and Retirees in Business Bankruptcies*, GOVTRACK, https://www.govtrack.us/congress/bills/113/hr100#overview (last visited Nov. 22, 2015).

124. *See* 147 CONG. REC. 3737 (Mar. 15, 2001).

125. *See* 147 CONG. REC. 3755 (Mar. 15, 2001) (statement of Sen. Kennedy). Senator Edward Kennedy explains the rationale of the bankruptcy priority and the need to increase the priority as follows:

> Amending the bankruptcy bill to protect the back pay of workers is especially appropriate, because back pay awards help many of the people that this legislation places at risk, low income families, minorities, and women. My amendment helps workers take care of their families. Collecting a back pay award would give them more of the resources they need to afford food, clothing, and health care without turning to credit cards.

Id. Senators John Rockefeller and Patrick Leahy introduced an amendment, co-sponsored by Senators Mark Dayton and Barack Obama, suggesting the maximum dollar amount of the preferred employees' claims be raised to $15,000. *See* 151 CONG. REC. 3180 (Mar. 2, 2005) (statement of Sen. Rockefeller). The amendment failed—as mentioned above, the wage priority limit passed in 2005 was $10,000—but during the debate, they explained as follows:

> In the simplest terms, employees sell their labor to companies. They toil away in offices and plants and factories and mills and mines because they are promised that at the end of the day they will receive a certain compensation. Many workers then have a difficult time recovering what is owed to them by their employer when their company, as so often happens these days, files for bankruptcy.
>
> Under current law, employees are entitled to a priority claim of up to $4,925. That is it. The legislation we are debating would increase that claim to $10,000, which is better. But even that figure is usually not enough to cover the back wages, vacation time,

Much of the legal literature shares the same line of thought, albeit with less pathos. Many legal scholars agree that employees deserve a higher level of protection than other creditors, and they see the bankruptcy priority as the most appropriate means to obtain such protection. Elizabeth Warren (now Senator Warren), for example, justifies the bankruptcy priority for employees by maintaining that many employees are ill suited to bear the costs of defaults and that the bankruptcy priority reflects a concern for these employees.[126] For the same reasons, David Skeel has advocated an increase in the priority amount. Skeel argues that Congress should either increase the ceiling for the priority, or at least treat severance promises separately and give priority treatment to the entire benefit package.[127] Donald Korobkin does not propose to increase the employees' payment ceiling, but suggests allowing earlier payments to employees.[128] Currently, pre-petition debts to the employees are paid when the debtor's estate is distributed;

> severance pay, or payment benefits the employees are owed for work done prior to the bankruptcy.

Id. When introducing the bill for Protecting Employees and Retirees in Business Bankruptcies Act of 2013, Representative Conyers also explained:

> [T]hroughout our Nation's history, hardworking American men and women have labored to make our businesses become the most productive and dynamic in the world. Unfortunately, when some of these businesses encounter financial difficulties and seek to reorganize their debts under Chapter 11 of the Bankruptcy Code, these very same workers and retirees are often asked to make major sacrifices through lost job protections, lower wages, and the elimination of hard-won pension and health benefits . . . .
>
> Particularly now, as our economy continues to struggle and more businesses falter, we must do more to ensure that America's most important resource—workers and retirees—are treated more fairly when these businesses seek to reorganize their financial affairs under the protection of our bankruptcy laws.

159 CONG. REC. E5 (daily ed. Jan. 3, 2013) (statement of Rep. Conyers).

126. Warren, *supra* note 33, at 790. In her analysis, Warren stated:

> Employees are among the creditors least likely to have spread the risks of default. They seldom are able to contract with several different employers, and losing a paycheck will quickly deplete modest savings. The Bankruptcy Code reflects a concern for these creditors, granting a priority to limited employee wage and retirement fund payments.

Id.

127. David A. Skeel, Jr., *Employees, Pensions, and Governance in Chapter 11*, 82 WASH. U. L.Q. 1469, 1472 (2004). In his 2004 article, Skeel stated:

> Because the limited priority applies not only to past due wages, but also to severance pay, employees who are fired before bankruptcy may lose both their job and the funds that might otherwise have tided them over. The most obvious solution to this problem is to increase the ceiling for the priority. A similar but more nuanced approach would treat severance promises separately, and give the entire benefit package priority treatment.

Id.

128. Donald R. Korobkin, *Employee Interests in Bankruptcy*, 4 AM. BANKR. INST. L. REV. 5, 10 (1996) ("In some cases, a worker may face particularly dire consequences if she does not obtain immediate payment of overdue wages. Furthermore, a debtor may need to pay prepetition wage claims as a response to plausible threats of employee defection or work stoppages.").

Korobkin believes that the employees, or at least some of them, should be paid earlier.[129] Even Alan Schwartz, one of the most prominent law and economics scholars, wrote in favor of the bankruptcy wage priority.[130] Schwartz views the wage priority as compensation for the losses employees suffer as a result of the bankruptcy and, in particular, the loss of their employment in liquidation.[131] He suggests increasing the amount of the allowed wage priority and even rethinking its status below secured creditors.[132]

Other scholars, Douglas Baird and Daniel Keating in particular, have advocated the opposite view. Contrary to the literature discussed above, Baird and Keating object to the bankruptcy priority, and explain that it creates forum shopping and bankruptcy abuse.[133] The solution to the employees' plight, they argue, should not be bankruptcy specific, but rather should be rooted in the general labor policy.[134] I agree with Baird and Keating's argument, but wish to take the argument one step further. I propose the implementation of an insurance-based model and maintain that it is a more efficient and a more just solution. The model should apply both within and outside of bankruptcy, and it should help all unpaid employees with winning judgments in their hands.

For methodological purposes, though, this Article divides the argument into two parts. First, I explain why an insurance-based solution is superior to a bankruptcy priority within a bankruptcy context.[135] I describe why a wage assurance fund is a better tool to achieve the very purposes a bankruptcy priority is designed to achieve, and why a premium-paying public should bear the costs of the employees' preferential treatment.[136] Then, the Article relaxes the assumption of the

129. *Id.*

130. Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 256-57 (1989) ("The appropriate legal response to this concern is to increase the value of the wage priority by retaining its current senior rank to unsecured lenders or by raising the $2000 limit. . . . [T]he current ranking of employees below secured parties in bankruptcy distribution should be rethought.").

131. *Id.*

132. *Id.*; *see also* Amy Lassiter, Note, *Mayday, Mayday!: How the Current Bankruptcy Code Fails to Protect the Pensions of Employees*, 93 KY. L.J. 939, 954 (2004–2005) ("It would accord with this principle to elevate employees' claims in bankruptcy to superpriority unsecured claims . . . ."); Seror, *supra* note 88, at 142 ("The special treatment prescribed in the Code for employees is justified by the unique position they find themselves in when their employer goes bankrupt.").

133. Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 826-29 (1987); Daniel Keating, *The Fruits of Labor: Worker Priorities in Bankruptcy*, 35 ARIZ. L. REV. 905, 907, 910-12, 926 (1993).

134. Baird, *supra* note 133, at 822-24; Daniel Keating, *Ten Lessons for Congress to Ponder About the Labor/Bankruptcy Intersection*, 22 AM. BANKR. INST. L. REV. 35, 38-40 (2014).

135. *See infra* Part III.B.

136. *See infra* Part III.A–B.

debtor's bankruptcy, and explains why I believe the solution should be expanded to non-bankruptcy situations as well.[137]

III. ELIMINATING THE BANKRUPTCY WAGE PRIORITY IN FAVOR OF AN INSURANCE-BASED MODEL

Looking at this problem from a global perspective, and following comparative analyses made by Gordon Johnson[138] and Paul Secunda,[139] this Article divides the various approaches to the preference of unpaid wages into four broad categories. This taxonomy uses the two main models of protection discussed thus far—bankruptcy priorities and wage assurance funds—and examines which country uses which model of protection.

According to Secunda, the vast majority of OECD countries use both models of protection in conjunction with each other.[140] The exact hybrid each country creates is different, but most OECD countries, such as Canada, the United Kingdom, France, or England, combine both a bankruptcy priority and a wage assurance fund.[141] A second approach, adopted by Chile, Mexico, and the United States, uses only a bankruptcy priority model.[142] In the United States, there is a federal wage priority in bankruptcy, but only two states have a wage assurance fund.[143] A third approach, implemented in Germany and Finland, uses only an insurance-based model,[144] and a fourth approach affords no preference to pre-petition employment claims at all.[145]

I argue in favor of the third approach. Like Germany and Finland, I believe no bankruptcy priority should be given to pre-petition wage claims, and that the protection should be facilitated solely through an insurance-based model. To clarify this view, I differentiate between two related questions: First, should employees, in their capacity as creditors, be preferred over other creditors? Second, to the extent that the answer to the first question is affirmative, what type of precedence should the employees receive?

137. *See infra* Part IV.A–B.

138. Gordon W. Johnson, *Insolvency and Social Protection: Employee Entitlements in the Event of Employer Insolvency*, *in* ASIAN INSOLVENCY SYS. 223, 226-28 (2007).

139. *See* Secunda, *supra* note 25, at 874.

140. *Id.* at 875.

141. *Id.* at 874-75.

142. *See id.* at 874.

143. *See supra* text accompanying notes 105-07.

144. Secunda, *supra* note 25, at 874.

145. *See* SARRA, *supra* note 100, at 10.

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A. The Rationale of Granting Precedence for Employees' Claims

The notion that employees should be preferred over other creditors is by no means clear. There are those who argue that giving such a preference is mistaken, and that all creditors, including the debtor's workers, should be treated equally.[146]

Giving a priority claim to employees, like giving a priority claim to any other group of creditors, violates one of the most basic principles of bankruptcy law—the equality principle.[147] The equality principle presumes that all unsecured creditors should receive an equal pro-rata share of the bankruptcy estate, and allowing employees to be paid before any other unsecured creditors clearly violates an equal distribution scheme.[148] Although deviation from the equality principle can be justified by the employees' socio-economic weakness,[149] an employee is not necessarily weaker or more vulnerable than the other creditors. On the contrary, an employee may have a solid financial background or may easily find an alternative equal paying job, while other creditors, such as bondholders, suppliers, or customers, may be of poor economic background and may be financially dependent on the debtor.[150] In other words, the employees' perceived weakness is not necessarily a good enough reason for the violation of the equality principle. All creditors suffer from the debtor's insolvency (under no fault of their own), and without a clear measure of who is weaker or who will suffer

146. *See supra* text accompanying notes 133-34.

147. *See* Begier v. IRS, 496 U.S. 53, 58 (1990); David Gray Carlson, *Bankruptcy Theory and the Creditors' Bargain*, 61 U. CIN. L. REV. 453, 462 (1992). For a discussion on the elusive nature of the equality principle and classifications in bankruptcy, see generally Thomas C. Given & Linda J. Philipps, *Equality in the Eye of the Beholder—Classification of Claims and Interests in Chapter 11 Reorganizations*, 43 OHIO ST. L.J. 735 (1982).

148. *See* Rizwaan Jamed Mokal, *Priority as Pathology: The* Pari Passu *Myth*, 60 CAMBRIDGE L.J. 581, 586-87, 590-95 (2001). Different scholars and different strands of bankruptcy literature justify the principle of equality differently. The contractual (procedural) approach to bankruptcy views the principle of equality as part of a creditors' bargain. The creditors hypothetically agree to divide the debtor's assets on an equal pro-rata basis, because this rule reduces their destructive race to the assets and decreases monitoring costs. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 16-17, 30-32 (1986). Traditional, more social approaches view the principle of equality as part of a theory of justice. It connects to the principles of fairness expressed by philosopher John Rawls, as it prevents discrimination of one creditor over the other. *See generally* Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1.

149. *See* 147 CONG. REC. 3755 (Mar. 15, 2001) (statement of Sen. Kennedy).

150. Suppliers, for example, rely on the debtor's continued business. When a supplier's buyer enters bankruptcy, the supplier's own business can also suffer a severe income shock—a shock that is not necessarily easier than that of the debtor's employees.

more from non-payment, all creditors should bear the costs of the insolvency equally.[151]

Moreover, granting employees a priority might create distorted incentives for the parties involved in the bankruptcy. Employees may prefer the employer to declare bankruptcy, so that they receive payment in full, while other creditors are likely to oppose such proceedings to prevent employees from obtaining a higher payment at their expense. It is, therefore, preferable to treat all unsecured creditors equally, so as to not let any priority given to the different claims impact the type of insolvency proceedings chosen.[152]

Despite these arguments, according to a survey conducted by the International Labor Organization, the vast majority of countries do give preference to the employees.[153] The model of preference may change from country to country (whether it be a bankruptcy priority or a wage assurance fund), but the belief that employees are entitled to at least some kind of preference is widespread.[154] Only two countries among those researched, Estonia and the United Arab Emirates, have opted for the fourth model mentioned above, and decided that employees deserve no preference.[155]

The reasons for this widespread choice, I believe, are threefold. First, the salary that employees receive from their employers generally represents a significant portion of their income. Not receiving wages, especially over several months, is likely to put employees in a very difficult position and even impair their ability to pay for basic needs, such as food and housing.[156] In addition, unlike other creditors (including suppliers and customers), employees cannot diversify their employment to reduce the risk they take in the event of their employer's insolvency. Quite naturally, they usually work for a single employer, and the collapse of this employer is likely to cause them considerable harm.[157]

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151. *See* F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1407 (1986); Richard A. Ippolito, *Bankruptcy and Workers: Risks, Compensation and Pension Contracts*, 82 WASH. U. L.Q. 1251, 1260 (2004).

152. *See* Baird, *supra* note 133, at 817-18; Keating, *supra* note 133, at 926.

153. *See* SARRA, *supra* note 100, at 9. For a comprehensive survey of the different protection models available in the different countries, see Int'l Labour Org., Comm. of Experts on the Application of Conventions & Recommendations, International Labour Conference, 91st Session 2003, *Report III (Part 1B): General Survey of the Reports Concerning the Protection of Wages Convention (No. 95) and the Protection of Wages Recommendation (No. 85), 1949*, 165-98, www.ilo.org/public/english/standards/relm/ilc/ilc91/pdf/rep-iii-1b.pdf.

154. *See* Int'l Labour Org., *supra* note 153, at 167.

155. *See* SARRA, *supra* note 100, at 10.

156. *See* Keating, *supra* note 133, at 907.

157. *See* Korobkin, *supra* note 128, at 6.

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Second, as against other commercial creditors, it is difficult to perceive employees as willingly taking on the risk of their employer's potential insolvency. Banks, bondholders, and, to a certain degree, even suppliers and customers, have all elected to invest in the debtor. They could gather information about the company, assess its commercial situation, and price the risk involved in extending credit. The higher the risk they take, the higher the interest rate these creditors charge or the better the commercial conditions they demand. Employees, on the other hand, are maladjusting creditors.[158] They often have limited accurate information about the commercial situation of their employer, and it is doubtful they are able to obtain such information independently.[159] Even in situations in which the employees do have the required information, it is not clear that they are able to use it. Workers usually do not price the risk of their employer's insolvency into their salaries, and they can hardly change their terms of employment when an employer is going down.[160] This is especially true in the case of weaker or older employees, or in areas of high unemployment. In such cases, the balance of power clearly tilts to the side of the employer. When on the verge of insolvency, an employer can take advantage of its leverage and not pay its workers their full wages.[161]

Third, non-payment to employees adversely affects the economy as a whole and the local communities in which the unpaid workers live.[162] As mentioned, the victims of wage theft are often employees from low socio-economic backgrounds.[163] These employees spend a large portion of their income on basic needs, such as food, clothing, and housing, and these funds circulate back into the economy, supporting businesses and, thus, jobs. When an employee is not paid, she has less money to spend on goods and services, and this, in turn, harms the economy—less money circulates into local businesses, these businesses hire fewer workers, and all affected parties pay fewer taxes.[164] Due to the magnitude of the wage theft phenomenon, the effects on the economy are by no means negligible.[165]

158. Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197, 1232 (2005).

159. *Id.* at 1232-33.

160. *See* Lucian Arye Bebchuck & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 885 (1996).

161. *See* Korobkin, *supra* note 128, at 6; Warren & Westbrook, *supra* note 158, at 1232.

162. *See* BERNHARDT ET AL., *supra* note 44, at 50; HOUS. INTERFAITH WORKER JUSTICE CTR., *supra* note 44, at 6.

163. *See supra* text accompanying notes 69-71.

164. *See* BERNHARDT ET AL., *supra* note 44, at 50; CHO ET AL., *supra* note 13, at 5.

165. *See* BERNHARDT ET AL., *supra* note 44, at 50.

Because of the cumulative strength of these arguments, it is my view that employees should be able to collect their wage claims more easily than other creditors. However, more important than my personal opinion about this question is the understanding that there are good claims both in favor and against giving preference to employment claims. The treatment of employment claims is related to more profound questions of economic viewpoint and social justice, and it is not within the scope of this paper, nor is it my goal, to make the case in favor of such preference or against it. My claim is, therefore, more limited. I argue that, to the extent a certain jurisdiction (a country or state) decides that employees' claims deserve preferential treatment, the preference should be implemented through a wage assurance fund and not through a bankruptcy priority. My claim pertains to the model used for preferring employment claims, and not to the question of whether or not such preference should be given in the first place. As this Article has shown, though, the vast majority of jurisdictions do decide to give employment claims some kind of protection.[166]

B. *The Advantages of an Insurance-Based Model*

When examining the preference of pre-bankruptcy employment claims, it is important to note that such a preference does not come without a cost. It comes at an expense to other parties, which finance the payment to the employees—even if not knowingly. The model selected for the preference determines the identity of the party or parties to bear the cost.

A model that grants employees a priority in the debtor's assets, like a bankruptcy priority or a wage lien, places the cost of the payment on lower priority (unsecured) creditors. Since the employees receive the payment from the debtor before the lower priority creditors do, the value that the unsecured creditors will be able to receive decreases. The employees are paid in full, and the unsecured creditors are left with less of the debtor's assets fiom which they can recover.[167]

An insurance-based model, on the other hand, places the cost of the employees' payment on those who pay the premiums to the wage assurance fund.[168] If the fund is financed through an obligatory fee imposed on all employees and employers (as I suggest), it would be the general public who bears the burden of the preference. The higher the

166. *See supra* note 153 and accompanying text.

167. 11 U.S.C. § 507(a)(4) (2012).

168. *See* NAT'L EMP'T LAW PROJECT, *supra* note 68, at 120.

payments to unpaid employees in the event of insolvency, the higher the fees (the premiums) the public will have to pay the fund.

The question of which model of preference is best can, therefore, be phrased as a question of who is the most efficient risk bearer. Who should bear the risk of an employer's inability to pay its employees—the employer's unsecured creditors or the public of employers and employees?[169] I argue that the answer is the latter, provided that the public (through the wage assurance fund) has a subrogation right towards the employer.

I base my argument on three different reasons, but before outlining these reasons, it is important to specify an underlying assumption. When arguing for the supremacy of the insurance based model, I assume that, due to the reasons detailed above (or other reasons), the public believes that employees' claims are entitled to some kind of preference over other creditors' claims. If this assumption is wrong, then I agree there is no justification for an insurance-based model to protect employees. However, if indeed this assumption is wrong, then there is also no justification for a bankruptcy priority (like the ones granted in § 507(a)(4)–(5)).[170] Employees seeking wages should be treated the same way as all other creditors, and all types of preferences, whatever model they are structured in, should be eliminated. If, on the other hand, my assumption is correct, then I argue an insurance-based model is a better way to give employees the preference the public believes they deserve. As opposed to the current legal situation, and much of the scholarship, I believe a bankruptcy priority is inefficient and does not adequately express the public's choices.[171]

The first reason to prefer a payment from a wage assurance fund is that a bankruptcy priority claim does not ensure the workers will actually receive the payments to which they are entitled. While the priority allows the employees to receive their claims before the unsecured creditors, it does not, in any way, guarantee that the employer has sufficient assets from which the employees can recover. Similar to the example given in the Introduction, an employer may have very few assets, or its assets may already have liens attached, and in such cases, the employees' priority will have no effect.[172] The employees will not

169. *See* Jackson, *supra* note 103, at 1399-401; Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 90 (1977); Seror, *supra* note 88, at 153.

170. 11 U.S.C. § 507(a)(4)–(5) (2012).

171. *See supra* notes 113-48 and accompanying text.

172. *Supra* text accompanying notes 1-6; *see also* Skeel, *supra* note 127, at 1478 (discussing the Enron bankruptcy and the billions of dollars lost by Enron employees); Jason Schwartz, *End Game*, BOS. MAG. (Aug. 2012), http://www.bostonmagazine.com/2012/07/38-studios-end-game

Kimhi: Getting More Than Justice on Paper: Bankruptcy Priorities and th

receive even their prioritized claims because the debtor has no assets to give. Payment from a wage assurance fund, on the other hand, ensures the employees' recovery. The fund is not related to a debtor's assets and, assuming it is managed properly, should have sufficient assets to pay all wage claims. Thus, if the public indeed believes employees should be paid for work they rendered, then a wage assurance fund is a better way to achieve this goal.

A second reason for preferring the insurance-based model concerns the manner in which the cost of such preference is distributed. As explained earlier, granting employees a priority claim in a debtor's assets places the cost of the precedence upon the unsecured creditors.[173] A debtor's assets are first used to satisfy the employees, and the unsecured creditors are left to collect smaller portions of their own claims. The group of unsecured creditors, however, is often relatively small, comprised of a random assortment of creditors. Some of the creditors may be financially strong, but others are likely to be socio-economically weak—some of them, like tort victims, may even be non-adjusting creditors. Placing the burden of the employees' preference on those creditors is not socially justified. Even if we acknowledge that the employees are entitled to a preference, it is wrong to place the cost of such preferential treatment on the shoulders of other creditors who may be just as weak (suppliers, customers, private debenture holders, or others).[174] Paying the employees' pre-bankruptcy claims through a wage assurance fund, on the other hand, spreads the cost of the preferential treatment widely. In this model, the cost is placed on all those who pay the premiums to the wage assurance fund (all employers and employees), so the amount each of them pays is relatively small. This decreases the damage created by an employer's insolvency, especially the damage to its weaker creditors. In addition, just like income taxes, the fees paid to the fund can be collected progressively.[175] Higher income earners can pay higher fees than those with lower incomes, so that the cost of the preferential treatment is spread more justly.

Moreover, even if we assume that all of an employer's creditors are strong-adjusting creditors, placing the burden of the employees' preferential treatment on the creditors creates social and economic costs.

(discussing the bankruptcy of ex-professional baseball player Curt Schilling's video-game company, 38 Studios, and the company's failure to pay employee wages and benefits).

173. *See supra* text accompanying note 168.

174. *See* Keating, *supra* note 133, at 925-26 ("What legislators often forget is that the creation of a priority for one class necessarily implicates the return that will be available for other, equally sympathy-evoking claimants.").

175. Beverly Moran, *Wealth Redistribution and the Income Tax*, 53 HOW. L.J. 319, 322-26 (2010).

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Preferring employees' claims in bankruptcy reduces the recovery rate of the unsecured creditors and, thus, increases the risk of extending loans. Adjusting creditors, strong financially or otherwise, price this risk, and they will probably raise the interest rates to compensate themselves for the extra risk involved. This means that, all other things being equal, giving employees a preference over adjusting creditors results in higher credit prices in the economy. High credit rates slow down the economy because they reduce the commercial incentive to invest money in productive projects (even profitable ones).[176] As a result, fewer businesses manage to develop and grow, and more businesses are likely to get into financial trouble.[177] Furthermore, the financial creditors, knowing debtors' financial status, would probably distinguish among debtors. The creditors are likely to raise interest rates for businesses with a high risk of insolvency and are less likely to do so for stable businesses whose chances of entering financial distress are slim. Interest rates will thus rise specifically for the businesses that most depend on additional credit—small and medium-sized businesses, businesses in trouble, start-ups, and the sort.[178] Increasing interest rates in this way is certainly inefficient and could cost the economy dearly. It functions like regressive tax on credit, slowing down business growth and reducing investments.

Nevertheless, even if placing the burden of employees' preferential treatment on the creditors creates costs for the economy, why should we instead place this burden on the general public? Imposing a mandatory insurance on the public is also costly, and as opposed to debtors' creditors, the public is not involved with a debtor and need not pay for its financial mistakes.[179] Why then is it right to force an insurance-based model on the public?

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176. Steve Parrish, *What Happens if Interest Rates Go Up?*, FORBES (Aug. 20, 2013, 12:07 PM), http://www.forbes.com/sites/steveparrish/2013/08/20/what-happens-if-interest-rates-go-up.

177. Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1812-14 (1998). *See generally* Thomas J. Healey & Sandesh Dhungana, *A World with Higher Interest Rates* (Mossaver-Rahmani Ctr. for Bus. & Gov't, M-RCBG Associate Working Paper Series No. 22, Sept. 2013), http://www.hks.harvard.edu/centers/mrcbg/publications/awp/awp22.

178. William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, 41 L. & CONTEMP. PROBS., Autumn 1977, at 13, 23-24.

179. The fact that the public, as opposed to the creditors, has no direct relationship with the debtor may also affect the monitoring of its financial behavior. Whereas creditors monitor debtors' financial behavior, a dispersed public has no monitoring capabilities. *See* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073, 1076-78 (1995). We deal with the monitoring issue more elaborately further on, *see infra* notes 233-38 and accompanying text, but at this point it is important to note that although the dispersed public cannot monitor a debtor, a wage assurance fund can. The fund bears the cost of the employees' preference (it pays the unpaid employees), and it has an interest to monitor employers and to make sure that they generally pay employees on time.

Here we come to the third reason for supporting the wage assurance fund model, as we harken back to the rationales of the preference to employees as creditors.[180] As detailed above, the reasons for granting preference to employees are essentially social.[181] Workers, perhaps more than other creditors, are dependent on their salary for their basic needs; they cannot diversify their investment in their employer, and they are maladjusting creditors.[182] Therefore, as a society we wish to help workers in their time of need. As Congressmen Conyers put it: "[W]e must do more to ensure that [our] *most important resource—workers and retirees—are treated more fairly* when . . . businesses seek to reorganize their financial affairs . . . ."[183] But inasmuch as the reasoning is social, it is also society that needs to pay for this fair treatment. If the public believes employment claims should be paid even in case of an employer's insolvency, it should finance this belief through fees to the wage assurance fund. This way, both the costs and benefits of the employees' preference are borne by the public, and employment claims are more efficiently protected. Placing the costs of the employees' preferential treatment on the creditors, on the other hand, creates externalities.[184] In the United States, the public (through the legislature) chooses the level of priority, but the costs of this choice are borne by the unsecured creditors.[185]

The creditors, to be sure, or at least the adjusting creditors, do not absorb the cost of the employees' preferential treatment.[186] As noted earlier, the wage priority decreases the rate of return on their loans, and they account for this decrease in return by increasing the interest rates they charge.[187] In theory, this pricing mechanism can also bring an optimal level of *preference*. The legislature should weigh the economic costs that result from the delta in interest rates[188] against the social benefits that result from protecting unpaid employees,[189] and then set the

180. *See supra* Part III.A.

181. *See supra* Part III.A.

182. *See* Lassiter, *supra* note 132, at 954-55.

183. 159 CONG. REC. E5 (daily ed. Jan. 3, 2013) (emphasis added) (statement of Rep. Conyers).

184. *See supra* Part I.

185. Economic literature teaches us that externalities cause inefficiency in the allocation of resources. *See* Carl J. Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141, 143-50 (1979).

186. *See* Meckling, *supra* note 178, at 23-24.

187. *See supra* notes 175-86.

188. The delta in the interest rates means the difference, other things being equal, between the interest rate charged on a loan extended in a world with a bankruptcy wage priority and the interest charged on the same loan in a world with no bankruptcy wage priority.

189. The social benefits are derived from the security each employee has that she will be paid for work she rendered, even in case of her employer's bankruptcy, and perhaps for some people, also from living in a more egalitarian society, which pays unprotected employees their wages.

priority at a level in which the priority's marginal cost equals its marginal benefit. In practice, however, doing so is almost impossible. Credit prices are influenced by a myriad of factors, and it is difficult to isolate the effect of a higher bankruptcy wage priority on the interest rates and on the economy's performance as a whole. The effect depends, among other factors, on the condition of each individual debtor (its risk of insolvency, its number of employees, the salaries it pays, and other considerations), and it is difficult to verify to what extent economic changes were the result of a change in the bankruptcy wage priority or of the other factors.[190] Without measuring the priority's costs, however, the decision regarding the amount and scope of the prioritized claims is distorted. The legislature is liable to set the level of protection too high or too low, because it is unaware of (or worse, it disregards) the price the economy pays for this choice. Decisions concerning the level of priority are often guided by political interests and populist beliefs, rather than by a systematic analysis of the costs and benefits.[191]

The legislative history of § 507(a)(4)–(5) demonstrates exactly that reliance on politics and popular opinion. As we have seen, Congress has continuously raised the amount and the scope of the prioritized wage claims in bankruptcy.[192] This trend, however, was not based on an in-depth analysis of the employees' needs *vis-à-vis* the costs associated

190. It is very hard to estimate what the interest rates would be in a world with no bankruptcy wage priority, because no such world actually exists. To optimally measure the priority's effects we would need two jurisdictions with similar economic conditions, one with such a priority and one without, and then we would need to look at the difference in interest rates between these two jurisdictions. Since two jurisdictions with similar economic conditions cannot be found, the measurements of the priority's effect will be inaccurate. Economists can try to bypass this difficulty, for example, by measuring the effects of the changes in the scope of the bankruptcy priority in a single jurisdiction over time (when the scope of the bankruptcy priority changes). Since other economic conditions also change at the same time, it will be difficult to isolate the changes caused specifically due to the changes in the priority's scope.

191. *Cf.* Edward A. Zelinsky, *Unfunded Mandates, Hidden Taxation, and the Tenth Amendment: On Public Choice, Public Interest, and Public Services*, 46 VAND. L. REV. 1355 (1993). The fact that the public is sometimes unaware of costs created by legislation, and that political officials use the public's lack of knowledge to their advantage, was demonstrated by Edward Zelinsky with regard to unfunded mandates imposed on municipalities by state governments. *Id.* at 1369. Zelinsky explains that since state legislators receive political benefits from the mandates but do not bear the costs, which are borne by the local governments, they have an interest to increase the scope of the mandates. *Id.* at 1374-75. A similar process occurs in the context of the wage priority. The legislators, in this case the federal legislators, receive political benefits from increasing the scope of the bankruptcy wage priority (for example, from labor unions or consumer organizations), but they do not necessarily bear the priority's costs. The priority's costs are embedded in interest rates, but the public does connect the wage priority and the interest rates it pays. Therefore, politicians have a political interest to increase the scope of the priority beyond its efficient level.

192. *See supra* notes 113-15 and accompanying text.

with the wage priority, but rather it was fairly arbitrary and very much influenced by pressures from interest groups, especially the unions.[193] The unions supported the attempts to increase the amount of the claims,[194] and their representatives appeared in congressional hearings arguing in favor of additional reforms.[195] Congress, it seems, did not pay

193. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") raised the bankruptcy priority from $4000 to $10,000. 11 U.S.C. § 507(a)(4) (2012); BAPCPA, sec. 1401, § 507(a), Pub. L. No. 109-8, 119 Stat. 23, 214. However, there were various other proposals to increase the amount of the allowed wage claims. The proposal for the $10,000 increase was first introduced in March 2003. 149 CONG. REC. 6560 (Mar. 19, 2003) (statement of Rep. Cannon). There was a proposal to raise the amount to $13,500 in 2002. 148 CONG. REC. 15,369 (July 30, 2002) (statement of Sen. Carnahan). In 2005, another proposal was made, this time for $15,000. 151 CONG. REC. 1853 (Feb. 9, 2005) (statement of Sen. Rockefeller). In 2013, there was a proposal to increase the limit to $20,000. 159 CONG. REC. E5 (daily ed. Jan. 3, 2013) (statement of Rep. Conyers). None of these proposals (including the one accepted) justifies the maximum amount of the claims proposed, and none of the proponents discuss the costs of raising the limit of bankruptcy wage priority. It is unclear from the congressional documents why the wage priority was set at $10,000, or why other amounts are any better. 151 CONG. REC. 3180 (Mar. 2, 2005) (statement of Sen. Rockefeller). Populist explanations for the need to increase the wage claims priority, on the other hand, are abundant. In a congressional hearing conducted in 2007, for example, Fred Redmond, a representative of the United Steelworkers, explained to Congress why an additional reform is warranted:

> [R]eform should assign higher priority to the payment of employee and retiree obligations, allowing them to be paid before other creditors who are more able to absorb losses than is a worker and a worker's family. These other creditors with deeper financial resources include highly compensated lawyers and investment bankers.

American Workers in Crisis: Does the Chapter 11 Business Bankruptcy Law Treat Employees and Retirees Fairly?: Hearing Before the Subcomm. on Commercial & Admin. Law of the H. Comm. on the Judiciary, 110th Congress 21 (2007) (testimony of Fred Redmond, International Vice President, Human Affairs, United Steelworkers (USW)). Redmond does not clarify the relevance of lawyers or investment bankers to the wage priority amount and neglects the fact that other creditors price the wage priority given to employees. *Id.*

194. When discussing the amendments to the BAPCPA in the Senate bill, for example, Senator Richard Durbin explicitly mentioned the interest groups that support his proposed amendment to increase the bankruptcy wage priority. Among the interest groups he listed were labor and consumer unions. 151 CONG. REC. 3413-14 (Mar. 3, 2005) (statement of Sen. Durbin). Strangely enough, Senator Durbin included letters of support from some of these interest groups in the Congressional Record. *Id.* Thus, the Congressional Record explicitly states that the national consumer organizations "applaud" Senator Durbin "for offering [the] amendments to the Senate bankruptcy bill . . . that would better protect employees . . . in the event of a corporate bankruptcy." *Id.* The American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"), one of the largest federations of labor unions in the United States, wrote in its letter that it strongly supports Senator Rockefeller's amendment to raise the current wage priority cap. *Id.* The same process occurred with regard to the PERBBA. Protecting Employees and Retirees in Business Bankruptcies Act of 2013, H.R. 100, 113th Cong. (2013). In the introduction to the PERBBA, Senator Conyers clearly stated that PERBBA is supported by the AFL-CIO and the United Steelworkers. 159 CONG. REC. E5 (daily ed. Jan. 3, 2013) (statement of Rep. Conyers).

195. *See, e.g., Protecting Employees and Retirees in Business Bankruptcies Act of 2007: Hearing on H.R. 3652 Before the Subcomm. on Commercial & Admin. Law of the H. Comm on the Judiciary*, 110th Cong. 22 (2008) (statement of Babette Ceccotti, AFL-CIO). Also testifying were representatives of the Air Line Pilots Association, International and the Pension Rights Center. *Id.* at 105, 121.

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much attention to the economic costs of the wage priority, except for some vague, and somewhat unclear, comment in a hearing that it may cause more liquidations.[196]

The advantage of an insurance-based model, in this respect, is that it facilitates transparency. Here, the costs of employees' preferential treatment are clear,[197] and they are borne directly by the premium paying public (all employees and employers). The premiums are deducted from the public's income, and so, it is relatively simple for people to form an opinion as to whether or not the social benefits of the wage assurance justify the amount of the premium they pay. If the majority of the public believes the premiums are too high, the legislature can decrease the limits of the insured wage or even eliminate the insurance entirely. If the majority of the public believes a better wage assurance is required (for example, the public may think that wage assurance should not be limited by any dollar amount, or it should include severance pay or healthcare payments), then the public should be willing to pay higher premiums. Although, no doubt the legislature will still be subject to interest group pressures, in particular from the unions. At least under the insurance-based model, the consequences of its decisions are visible. The amount and the scope of the allowed claims from the fund are strongly linked with the premium payments imposed on the public, and there are better chances that the legislature's decision would reflect the public's choices as to the socially optimal level of employee protection.

I do not know whether this proposal to adopt an insurance-based model, if accepted, will increase or decrease the wage protection currently provided by the Bankruptcy Code. But whatever the effect may be, I believe that social welfare will increase. Employees will be able to enjoy the preference independent of the size of their employers' bankruptcy estate, the cost of the preferential treatment will be distributed more evenly, and, most importantly, the determined level of the preference will better reflect the public's needs and wishes. In other words, the insurance-based model serves the same purposes as the bankruptcy priority, but it does so more efficiently. It is more just in terms of the distribution of cost, and it is more accurate in terms of the level of protection chosen.

196. *See id.* at 117 (statement of Michael L. Bernstein, Partner, Arnold & Porter LLP).

197. The fund's costs are the amount of wage claims the fund pays to the unpaid employees plus the administrative costs of running the fund. As opposed to the costs associated with a bankruptcy priority, these amounts are easily verifiable and can be published to the public.

C. *The Importance of the Fund's Subrogation Right*

So far, I have justified the insurance-based model, but the model will not be complete without allowing the fund to claim from the debtor what it has paid out to the employees—the right of subrogation.

The right of subrogation is a prevalent right in insurance contracts.[198] In an insurance context, when an insurer indemnifies an insured person for damages suffered from a tortfeasor, the right of subrogation entitles the insurer to take legal actions against the tortfeasor in the place of the insured.[199] The insured subrogates his claim against the tortfeasor to the insurer, and the insurer stands in her shoes as against the tortfeasor to recover what it already paid to the insured.[200] The same principle, *mutatis mutandis*, should be applied in a wage insurance context.[201] Here, since the wage assurance fund pays the employees, the employees should subrogate their rights against the employers (debtors) to the fund. Thus, to the extent the wages, in whole or in part, can be collected from employers' estates, then the fund will be able to recover from the employers what it paid the employees.[202]

I believe giving subrogation rights to the fund is necessary because it prevents unjust enrichment for any of the different parties involved. First, after getting paid by the fund, clearly the employees should not be allowed to sue the employer themselves. Once the employees receive the wages to which they were entitled, allowing them to take action against employers would result in their receiving double compensation.[203] The fund, on the other hand, should be allowed to take action against the debtors, because otherwise the debtors, or more precisely their creditors, will be unjustly enriched at the public's expense. When the fund pays the wage claims to employees, the money comes from the premium paying public instead of from debtors' estates. This means that each of the debtors' creditors receives a larger portion of the debtor's estate than it would have otherwise received had the employees been taken as regular unsecured creditors. This result is wholly unjustified. Society's choice to strengthen the group of employees should not enrich the other creditors.[204] The creditors should receive the same portion of the

198. Mark C. Weber, *Taking Subrogation Seriously: The Blue Cross-Blue Shield Tobacco Litigation Reconsidered*, 67 BROOK. L. REV. 381, 385-86 (2001).

199. *See id.*

200. *Id.*

201. Johnson, *supra* note 138, at 229-31.

202. Secunda, *supra* note 25, at 918-19.

203. *Id.* at 918.

204. Making the public pay the employment claims unjustly enriches the creditors because the creditors are compensated for the risk of the debtor's insolvency, while the public actually bears the

debtor's estate they would have received if the employees' claims had not been paid by the fund, while the public should have the right to reclaim the amounts it paid in lieu of the employer. This result is achieved when the fund receives the subrogation right.

The fund's subrogation claim against the debtor, though, should be classified as a simple unsecured claim (rather than a preferred claim, which is the case when the employee files the claim).[205] A higher classification would lead to the fund receiving payment before the other unsecured creditors, which would decrease these creditors' rates of recovery. This is exactly the result we intended to avoid. It places the cost of the employees' preference on the creditors and increases interest rates. Classifying the subrogation right as a regular unsecured claim, on the other hand, properly distributes the risk of insolvency. The employees are paid in full by the fund (up to the limit afforded by the legislator);[206] the fund has an unsecured claim against the debtor for the amount it paid;[207] and the difference between what the fund pays and what it receives (as an unsecured creditor) is paid by the premium paying public. This difference represents the preference the employees receive when compared to other unsecured creditors, and since this preference is a social choice, the public should pay for it.[208]

This solution also reduces distorted incentives for various parties. On the one hand, contrary to a bankruptcy priority model, here creditors and debtors are not harmed. Just like outside bankruptcy, the wage claims (now claimed by the fund as a subrogation claim) are considered unsecured, and so, the creditors' rate of return is not decreased. On the other hand, as opposed to a situation where the fund has no subrogation

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cost of the unpaid wages. The loans' interest rates are calculated under the assumption that employment claims will be paid out of the bankruptcy estate, but the public, rather than bankruptcy estate, pays these claims. Moreover, a problem still exists even if interest rates are adjusted to reflect the creation of a wage assurance fund (to reflect the fact that once a debtor files for bankruptcy, the fund pays the claims to the employees with no subrogation right). The problem is that such a rule perversely incentivizes the debtor to file for bankruptcy, even if the bankruptcy is unwarranted, in order to enjoy the public funds. Whereas outside bankruptcy the employer has to pay the employees' wages itself, inside bankruptcy the public pays the wages. From a debtor's perspective, if the fund that pays the employees cannot reclaim what it paid from the employer, why not file for bankruptcy and let the public pay the labor costs? In this case, the debtor, and thereby indirectly its creditors, are unjustly enriched.

205. As opposed to the view we present here, in most places the wage assurance fund receives the employees' bankruptcy priority and is not classified as unsecured. *See* Secunda, *supra* note 25, at 919. However, this is not the case in Denmark, Sweden, and Switzerland, where the fund sues the employer as an unsecured creditor. *Id.*

206. We assume payment to the employees in full is justified, because of the reasons detailed in Part III.B above.

207. The creditors pay the fund what the employees' would have received without any priority.

208. *See supra* Part III.B.

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right, debtors and creditors do not profit from the proposed solution. The subrogation right allows the fund to claim the debt from a debtor, so that the payment made to its employees does not decrease the debtor's balance of debts. This reduces debtors' and creditors' perverse incentives to forum shop and allows for more effective use of insolvency proceedings.[209]

IV. A GENERAL IMPLEMENTATION OF THE INSURANCE-BASED MODEL

The Article has, so far, discussed the use of an insurance-based solution only in case of bankruptcy. By definition, § 507(a)(4)–(5) of the Bankruptcy Code applies only to wage claims filed in a bankruptcy proceeding.[210] It was easier, and perhaps more intuitive, to first frame the insurance-based model in the context of bankruptcy.

Many cases of unpaid wages, however, do not involve formal bankruptcy proceedings.[211] The employee receives a judgment in her favor, and, although the employer does not file for bankruptcy, the company tries to avoid payment of the judgment. The employer disappears, hides assets, or reorganizes as a new entity, and the employee finds herself without pay.[212] In these cases, the collection of the judgment can be even more difficult than the collection inside bankruptcy. To collect their pay, the employees have to trace the employer, track down available assets, and, perhaps, try to pierce the corporate veil to find additional sources from which to recover. This process requires time and money, and for unpaid employees, who often come from poor socio-economic backgrounds, it may be impossible to spend the resources required to collect what they deserve. As a result, they often give up the collection efforts altogether, and thus, the employer benefits from the wage theft and the employees are robbed of their compensation.[213]

In light of the alarming proportions of the wage theft epidemic,[214] I believe that it makes little sense to give a priority to employees only in the case of bankruptcy. I argue that if a proper legal authority determined, through a judgment, that a debt to an employee exists, and if the employee cannot independently collect the judgment from the

209. For a more elaborate analysis of the forum shopping problem, see *infra* Part IV.A.

210. 11 U.S.C. § 507(a)(4)–(5) (2012).

211. *See* NAT'L EMP'T LAW PROJECT, *supra* note 68, at 111.

212. *Id.*

213. *See* BERNHARDT ET AL., *supra* note 44, at 4-6.

214. *See supra* text accompanying notes 42-47.

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employer, then it is the obligation of the wage assurance fund to pay the employee, whether her employer filed for bankruptcy or not.[215]

A. *In Support of an Insurance-Based Solution Outside of Bankruptcy*

The first argument for the implementation of an insurance-based model for outside bankruptcy, as well, is that giving employees preferential treatment only inside bankruptcy is unjust. This practice discriminates against employees whose employer did not file for bankruptcy, because the act of filing for bankruptcy has little relevance to the protection that the employment claims deserve.

Filing for bankruptcy is a legal procedure.[216] It takes place when a debtor files a formal petition with the bankruptcy court, and it is not necessarily linked to the debtor's default. A debtor may be insolvent and still decide not to file for bankruptcy, or an employer may be solvent and still try to avoid paying the employees the compensation that it owes them.[217] The forum (bankruptcy or non-bankruptcy) in which the debtor (employer) resolves its economic problems is usually decided by the employer, and the employees have little or no influence on their employer's decision as to the filing.[218] The employees, therefore, should not be punished for their employer's legal choice, and they should receive a level of compensation equal to their peers whose employer did file.[219] If a social justification exists for preferring employees inside

215. I do not argue that all jurisdictions should adopt an insurance-based model that applies both within and outside of bankruptcy. It may very well be that some jurisdictions do not believe that employees should receive a preferential treatment at all, and those jurisdictions, according to my view, should use neither a wage assurance fund nor a bankruptcy priority. What I do argue is that it is wrong to give employees preferential treatment *only* in bankruptcy. If a jurisdiction believes that employees' claims should be protected, then such protection should be given both within and outside of a bankruptcy process. *See supra* Part III.A.

216. Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy as (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931, 937-38 (2004); *see* JACKSON, *supra* note 148, at 16-17.

217. *A Chapter 11 Debtor Need Not Be Broke*, COM. BANKR. ALTS. (Feb. 3, 2014), http://commercialbankruptcyalternatives.com/articles/a-chapter-11-debtor-need-not-be-broke.

218. In theory, involuntary bankruptcy proceedings are an option for the employees. 11 U.S.C. § 303 (2012). Assuming the employment claims are of sufficient value, the employees could force their employer into bankruptcy, even against its will. *Id.* In practice, however, this rarely happens. First, the employees usually do not have sufficient information about their employer's financial situation. Even if the employer does not pay employees their wages when due, they often do not realize that insolvency is looming, and they prefer keeping their job rather than dragging their employer into court. After the employer collapses, often an involuntary bankruptcy will not help the employees. The employer has no assets, or it disappears and cannot be located. Second, employees do not have the legal knowledge, the time, or the money to initiate involuntary bankruptcy proceedings. Initiating bankruptcy proceedings can be very expensive, and often the unpaid employees are from low socio-economic backgrounds, with little awareness of the methods by which they may enforce their legal rights.

219. This is especially true since the majority of failing businesses do not enter bankruptcy.

bankruptcy (and current law implies that it does), then the same justification also should apply when the employer decides not to file.[220] Take, for example, two employees—one working for a high-tech firm, and the other for a cleaning services company. Both employees are not paid for two months, but the high-tech firm files for bankruptcy and reorganizes, while the cleaning services company simply vanishes and moves to another state. Is there any reason why the high-tech employee should receive her full wage claims (up to the legal limit of the bankruptcy priority), while the cleaning services employee will be left empty-handed?[221] Why should their employers' choices affect their right to receive a preference? I think it would be more just for both employees to be entitled to payment, even if capped by a certain dollar amount, rather than one employee receiving a priority while the other, often the weaker employee, gets nothing for her past claims.

Second, applying preferential treatment only in bankruptcy is inefficient. There is an extensive body of literature, especially law and economics literature, which shows that bankruptcy-specific changes to substantive laws are harmful.[222] When the two forums, bankruptcy and non-bankruptcy, implement a different set of substantive rules, the debtor and its creditors may seek the forum that maximizes their claims as individuals rather than the forum that maximizes the debtor's estate.[223] This phenomenon, known as forum shopping, also occurs when

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Edward R. Morrison, *Bargaining Around Bankruptcy: Small Business Workouts and State Law*, 38 J. LEGAL STUD. 255, 260 (2009).

220. *See* JACKSON, *supra* note 148, at 112-13.

221. *See* Baird, *supra* note 133, at 817-18. Douglas Baird also questions the justification for preferring employees only in a bankruptcy setting. In reply to Elizabeth Warren, who advocates the bankruptcy priority he explains:

> Warren argues, for example, that bankruptcy law should favor those who are least able to bear the costs of a business failure. For this reason, she argues, employees rightly enjoy their limited priority under existing bankruptcy law. Warren, however, needs to explain why those who are least able to bear these costs should nevertheless bear them when the firm closes or fails outside of bankruptcy.

Id. at 817.

222. *See* JACKSON, *supra* note 148, at 20-27; Baird, *supra* note 133, 824-28. Specifically with regard to employees, see Omer Kimhi & Arno Doebert, *Bankruptcy Law as a Balancing System: Lessons from a Comparative Analysis of the Intersection Between Labor and Bankruptcy Laws*, 23 AM. BANKR. INST. L. REV. 491, 512-19 (2015).

223. *See* Baird, *supra* note 133, at 817-27. Baird explains this problem through the following example: Imagine there are two cities, each with its own courthouse. The reason for building the two courts is to allow the residents of each city to resolve their disputes close to where they reside without having to spend unnecessary travelling costs. If, however, the two courthouses adjudicate cases according to a different set of substantive rules, then the purpose of having two courthouses will be defeated. Litigants will choose the court that applies the rules that maximize their chances of success, even when adjudication in that courthouse imposes unnecessary travelling costs on all parties. The same is true with regard to bankruptcy and non-bankruptcy forums. The goal of

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employees are given preferential treatment inside but not outside of bankruptcy.[224] In this case, employees may prefer a bankruptcy forum (especially when they can easily find an alternative job) to render their pre-petition claims preferred, while other creditors may disfavor bankruptcy, even when economically justified, to avoid the employees' preference. Due to these perverse incentives, an inefficient legal forum may be chosen, and the debtor's value is decreased to the detriment of the creditor group and of the public as whole.[225]

This inefficiency can be prevented via an insurance-based model that applies both within and outside of bankruptcy. If the fund pays the unpaid employees regardless of whether their employer files for bankruptcy or not, perverse incentives are not created. Both within and outside of bankruptcy the employees get paid by the fund and employment claims are considered unsecured. The bankruptcy filing changes nothing for the status of employment claims, and no party should have an incentive to support or object to a filing merely due to the employees' preference. As the Supreme Court explained, a uniform treatment of substantive rights within and outside bankruptcy serves to "*reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.*'"[226]

Yet a third reason to implement the insurance-based model, both within and outside of bankruptcy, concerns the monitoring of non-paying employers. Employers who refuse to pay their employees' wages are sometimes repeat offenders. The wage theft violations are usually the result of a deliberate decision by employers, and are connected to a broader business strategy in the workplace rather than to an isolated event.[227] As part of this culture, employers also attempt to frustrate the collection of judgments given in favor of their employees. They vanish, hide assets, or shut down operations entirely, only to reorganize as a new legal entity while harming additional employees and creditors.[228]

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creating a bankruptcy specific collection system is to maximize the debtor's value when it becomes insolvent. If, however, substantive laws change as a result of the bankruptcy filing, then the debtor and creditors will choose the forum that implements the law most favorable to their individual claims. They may invoke bankruptcy in order to gain advantages from the substantive law modifications, even when the bankruptcy reduces the debtor's value for all other claimants. This creates economic inefficiency, and in a sense reintroduces the very problem bankruptcy is designed to solve. *See id.*

224. *See supra* note 223 and accompanying text.

225. *See* Kimhi & Doebert, *supra* note 222, at 514.

226. Butner v. United States, 440 U.S. 48, 55 (1979) (emphasis added) (citing Lewis v. Mfrs. Nat'l Bank, 364 U.S. 603, 609 (1961)).

227. *See* BERNHARDT ET AL., *supra* note 44, at 4-5.

228. *See* NAT'L EMP'T LAW PROJECT, *supra* note 68, at 111.

Leaving the monitoring task in the hands of the unpaid employees is encouraging these violating employers. Since employees do not have the resources required for chasing the non-paying employers, they are often unable to initiate effective collection proceedings.[229] The debt to each individual employee is not usually large enough to justify a long and expensive legal chase after her employer's assets;[230] and so, solvent employers are able to get away without paying their employees what they legally deserve. This pushes the wage theft phenomenon even further, to the detriment of the public as a whole.[231]

A wage assurance fund can help improve the collection efforts. As explained, the fund should have a right to collect from the employer the amounts it pays the employees (a subrogation right).[232] Since the fund can aggregate all unpaid employment claims, the amounts it would need to collect from employers are much higher than the amounts each individual employee is owed. The higher amounts render an investment in collection efforts worthwhile. It is beneficial to invest resources in locating assets or piercing corporate veils when the prospective rewards from such actions are significant. In addition, since the fund would be a repeat player, it could gain knowledge and expertise in this type of proceeding. Collection efforts may be conducted in a faster and smoother manner, and avoiding payment will become harder for the employers. Indeed, anecdotal evidence gathered by Dr. Janis Sarra shows that the creation of a wage assurance fund improves collection efforts.[233] Dr. Sarra conducted a comparative analysis regarding the treatment of employment claims, and she notes that a number of jurisdictions reported the establishment of a fund addressed the collection problems suffered by the individual employees.[234] This will not only help unpaid employees to get the money they deserve, but also deter future employers from committing wage theft. If payment is more likely to be enforced on refusing employers, employers will be less

229. *See* Secunda, *supra* note 25, at 919.

230. The collection efforts can include investigations to track down assets or to locate the debtor, attachment of liens, litigation in order to pierce corporate veils, and additional actions designed to force refusing employers to pay. All these actions cost money, which the employees may not have.

231. Dixon, *supra* note 42 ("If we want workers to come forward, we have to show that we can get them their unpaid wages.").

232. *See supra* text accompanying notes 198-209.

233. *See* SARRA, *supra* note 100, at 28.

234. *Id.* ("[A] number of jurisdictions reported that the fund's ability to recover on the employees' behalf addresses the collective action problems faced by individual employees who may not have the information, resources or bargaining power to realize on their claims individually.").

likely to avoid payment, especially if heavy fines and penalties are imposed on those that do.[235]

B. *The Cost of an Overarching Insurance-Based Model*

These arguments, I believe, justify the implementation of an insurance-based model both within and outside of bankruptcy. Such implementation is more just to the employees, decreases forum shopping, and allows for better monitoring of non-paying employers. The problem in expanding the wage assurance payments to non-bankruptcy situations, however, seems to be the cost. If the fund has to pay all unpaid wage claims to employees—either within or outside of bankruptcy, then the cost of the insurance-based model might be too heavy. Due to the extended obligations towards employees, the fund's costs may increase, and consequently, so will the premiums the public needs to pay. This, it may be argued, can be problematic, because there is no point in forcing the public to purchase insurance on which it needs to pay very high premiums.

This perception of the costs of an insurance-based model is wrong, in my opinion, on two counts: conceptually and practically. From a conceptual perspective, the cost of an insurance-based model is a function of the scope of the insurance coverage. The smaller the coverage, the fewer payments the fund needs to pay to the employees and the lesser the premiums the public needs to pay to the fund. This means that if the legislature wants to decrease the premium level, it can reduce the scope of the insurance coverage, without restricting its application only to a bankruptcy process. The legislature can limit the amount of the allowed claims, the type of the allowed claims, or the timing in which the allowed claims can arise.[236] To be sure, applying the insurance-based model only in bankruptcy also decreases the premiums,[237] but it achieves this goal with the wrong tool. It is better to limit the fund's costs through parameters that are connected to the amount or the type of the allowed claims, rather than through parameters

235. It is true that in some cases (perhaps even in most cases) the employer will not have the means to reimburse the fund because it is indeed insolvent. But in these cases, it is also socially just that the fund will pay the unpaid employees. As I argued earlier, the employees should not bear the cost of their employer's insolvency alone, and the cost should be widely spread among the premium payers (employees and employers).

236. SARRA, *supra* note 100, at 25.

237. In this case the fund's payments to unpaid employees are reduced because it pays only employees whose employer filed for bankruptcy—not all employees whose employers fails to pay them. A reduction in the fund's payments to unpaid employees results in a reduction of the premium paid by the public.

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that pertain to the employer's legal decision to file for bankruptcy or not. As we have explained, limiting the preference to an arbitrary group of employees—those whose employer decided to file for bankruptcy—while denying it to all other employees is unjust and creates efficiency problems.[238]

The second, more practical, basis for our position is the fact that even if a fund paid all unpaid wages in full with no limitations, both within and outside of bankruptcy, the cost of such coverage would be trivial. A broad scope of insurance coverage does not necessarily mean a high premium because the costs of the wage assurance fund are shared among a very large population—all employees and employers.

To demonstrate this assertion, we look to California, for which relatively accurate data on unpaid wage claims is available.[239] According to the research by Cho, Koonse, and Mischel, between the years 2008 and 2011, the DLSE issued decisions obligating the payment of wages and penalties totaling $282,071,969 (not including settlement awards).[240] From this amount, employees were able to collect $42,436,641.[241] Thus, if a wage assurance fund existed in California, it would have had to pay employees a total of $239,635,328. According to data from California's Employment Development Department, the labor force in the state consists of about 17.9 million employees.[242] This means that if all employees in California paid premiums to cover the entire payment due to the unpaid employees, each employee would have to pay a total of $14 for the entire four years (2008-2011), or about thirty cents a month. I believe thirty cents a month is a small amount to pay for the assurance that, even when an employer falls onto hard times and defaults, the compensation for work rendered by its employees will be paid in full. This amount does not take into account that employers should also share the premium burden, that the fund can recover additional funds from shirking employers, or that the fund can collect penalties and fines imposed on non-paying employers.

Clearly, this is not a very accurate measure. The calculation does not take into account various factors (such as administrative costs, litigation costs, temporal fluctuations, and others), and it obviously changes from state to state. However, the calculation does give us a rough estimate, and shows that an insurance-based solution, even one

238. *See supra* Part IV.A.

239. CHO ET AL., *supra* note 13, at 14.

240. *Id.*

241. *Id.*

242. *Labor Market Information*, CAL. EMP. DEV. DEP'T, http://www.labormarketinfo.edd.ca.gov (last visited Nov. 22, 2015).

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that is not connected to the employer's bankruptcy filing, need not be very costly. The efficiency costs of a bankruptcy priority—costs rooted in the increased interest rates charged—may be much higher.

V. CONCLUSION

Congress is rightfully worried about the plight of employees.[243] The data on wage theft in general, and on uncollected wage claims in particular, is troubling, and indeed, something must be done. The problem is that this issue usually comes up to the legislature, or to the public's attention, when a big bankruptcy occurs, like that of LTV Steel, Enron, or the city of Detroit.[244] Then the suggested solution is to amend the Bankruptcy Code to once again increase the wage priority, rather than create a complete and overarching solution. But the wage collection problem is not a bankruptcy specific problem, and as such, it does not require a bankruptcy specific solution. If the values most Americans hold dictate that employees' wage claims should receive preferential treatment, then these values should hold true whether the employer filed for bankruptcy or whether it collapsed or disappeared without filing.

The insurance-based model this Article advocates creates a link between the values the public holds and the preferential treatment employees receive. The model acknowledges that the employees' preference, in whatever form it takes, has costs, and it suggests placing these costs directly on the public, which is the stakeholder that decides the level of such preference. Since, as opposed to the bankruptcy priority, the costs and benefits of the wage insurance model are clear, the legislature is better able to adjust the level of insurance coverage according to the public's needs and wishes. This allows for a more just and efficient solution for unpaid employees, as the level of preference is more accurate and the preference applies both within and outside of bankruptcy. This Article does not take a stand on whether the insurance-based model should be implemented on a state or a federal level, but it

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243. *See supra* note 125 and accompanying text.

244. *See, e.g.*, 151 CONG. REC. 3179 (Mar. 2, 2005) (statement of Sen. Rockefeller); Richard M. Hynes & Steven D. Walt, *Pensions and Property Rights in Municipal Bankruptcy*, 33 REV. BANKING & FIN. L. 609, 621-23 (2014).

> [O]ver the last years, as the economy came down from the highs of the 1990s, we have seen devastating corporate bankruptcies and how they can affect workers and their families. I have seen that in my State, and we have all seen that in our States. From the enormous Enron bankruptcy at the end of 2001 to the bankruptcies in my State, Ohio, and Pennsylvania, of Wheeling-Pitt, Weirton Steel, Horizon Natural Resources, and involving also Kentucky, every bankruptcy has brought heartache for workers who had dedicated themselves to employers, many of them for many years.

151 CONG. REC. 3179 (statement of Sen. Rockefeller).

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does show that most of the OECD countries have already adopted this type of model (though in most cases, alongside a bankruptcy wage priority).

The idea of a wage insurance model, I believe, is neither socialist nor capitalist. The scope of the preferred insurance may depend on the economic viewpoint, but the wish for a transparent system, in which employees receive the same level of preference, whether their employer filed for bankruptcy or not, should be shared by all. An insurance-based model is a better tool to provide for wage protection, and the bankruptcy priority—currently the sole model widely implemented in the United States—should be set aside.

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