The vast majority of countries protect employees' wage claims in case their employer becomes insolvent. When the employer files for bankruptcy, employees are not considered regular non-secured creditors, but rather they are treated favorably through two main models. The first model is a bankruptcy priority given to the employees in the debtor's assets. Under this model, employees receive the value of their claims from the debtor's assets before the other unsecured creditors do, so that unless agreed otherwise, they are paid in full before regular creditors receive any payment. The second model is an insurance based model. Under this model, an external fund, usually a state fund (like social security), pays the employees instead of the debtor, and the fund has a subrogation right against the employer's estate.

Different countries use different combinations of these two models. Some countries, like the United States, use only (or almost only) the bankruptcy priority. In the United States there is a federal wage priority, but only two states have added an additional insurance based layer (and even then on a very limited basis). Other countries, like Germany or Finland, use exclusively the insurance based model. In these countries the bankruptcy code affords no additional protection, but employees are covered by a state agency. Most OECD countries, however, like Canada, the United Kingdom, France or England, combine both models together. Employees enjoy a bankruptcy priority, but when the priority is insufficient the insurance model provides additional protection.

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The paper discusses the two models of employee protection through the prism of the United States bankruptcy law. We make the claim that the bankruptcy wage priority is a bad solution for the plight of the American employee, both because it doesn't adequately protect employees, and because it is economically inefficient. Instead of the bankruptcy priority, we suggest to implement an exclusive insurance-based solution. According to our proposal, all employees and employers pay a fee to a wage assurance fund established by the state, and the fund pays unpaid employees (with a favorable judgment) in case their employer is bankrupt or otherwise avoids payment. The fund will be able to collect the payment it made from the employer (in lieu of the employee), but its status will be as a regular unsecured creditor rather than a priority creditor (the status employees often enjoy).

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

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 their recovery rate decreases. 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 the employees, 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 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 the 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. As will be detailed further on, the reasons for providing preferential treatment to the employees are social. Society believes that workers, perhaps more than other creditors, are dependent on payments they receive from the employer, and it wishes to help them avoid a situation where they work without pay. But exactly because the
reasoning is social, namely the public wishes to give employees preferential treatment, it is also the public that needs to pay for it. Placing the costs on the creditors is inefficient, because the public (through the legislature) chooses the level of priority, but 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 the creditors price the bankruptcy priority, and a high priority level increases interest rates, thereby decreasing investments and slowing down growth. 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 - namely the public. The model is better able to set the preference at the level the public desires, and, thereby, it enhances welfare.

Lastly, an insurance-based solution improves the monitoring on shirking employers. Regularly, without the existence of an insurance-based solution, collection efforts are under provided. They are expensive and time consuming, and not many employees have the required resources to invest in such proceedings. As a result, employers are able to avoid payment relatively easily, and this incentivizes wage theft. An insurance model addresses this problem. Since the insurer has the right to collect from the employer the money it paid the unpaid employees, it can conduct the collection proceedings itself. The insurer aggregates the claims of all unpaid employees, and so it has an incentive to invest the required resources in the collection efforts and can gain knowledge and expertise. Especially due to the prevalence of wage theft in the United States, we believe a strong collection and enforcement arm is in order.
The problem with an insurance-based model seems 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. The article addresses the cost issue, and rejects it from both conceptual and practical perspectives. From a conceptual perspective, we argue that for the same level of preference, an insurance-based model is not more expensive than a bankruptcy priority. 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. We explain that if the public wishes to decrease the premiums, the legislatures should reduce the insurance coverage, rather than use an inefficient model of preference (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 30 cents a month per employee - a relatively small amount even for employees from a low socio-economic level. Although the figure is a very rough estimation, it clarifies that the fund's costs do not render its creation financially unjustified.

The rest of the article proceeds as follows: In the first part we describe the socio-legal situation in the United States. This part reveals a grave, yet largely undisussed, wage collection problem in many of the states,¹ and it outlines the remedies U.S law provides to address this problem. We show that despite U.S.'s focus on the bankruptcy

¹ See, e.g., EUNICE HYUNHYE CHO, TIA KOONSE, ANTHONY MISCHEL, HOLLOW VICTORIES: THE CRISIS IN COLLECTING UNPAID WAGES FOR CALIFORNIA WORKERS (2013), available at http://nelp.3cdn.net/f6fc363a30266f0cd3_pzm6id1xa.pdf (Hereinafter: "HOLLOW VICTORIES"). The data does not include settlements.
wage priority, the priority fails to protect employees and it results in inefficiency. In the second part, we argue that the insurance-based model is superior to a bankruptcy priority in a bankruptcy context, and in the third part, we explain why implementing an insurance-based solution only in a bankruptcy setting is mistaken. The conclusion supports a German-like model, where an insurance-based model is implemented exclusively with no bankruptcy priority whatsoever.

A. The collection of unpaid wages – the problem and available remedies:

(1) The problem

Wage theft, the practice of denying employees of the monetary compensation they rightfully deserve, has become an epidemic in the United States. It is a grave and widespread phenomenon, and some even call it the defining trend of the 21st century in the labor market. 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

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2 The article deals exclusively with employees pre-petition claims. Insofar as the claims are post-petition (claims for workers' salary during the restructuring period), we 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.


range of industries. A study conducted in 2008 in Chicago, Los Angeles and New York City shows that 26 percent of low-wage workers are paid less than the minimum wage, and about 20 percent of the workers are not paid the legally required overtime. More than two thirds of the employees in the sample (a total of 4,387 employees) reported at least one pay related violation conducted a week prior to the survey, and the average

5 See, SUMMARY OF RESEARCH ON WAGE AND HOUR VIOLATIONS, supra note 4; CASA OF MARYLAND, WAGE THEFT: HOW MARYLAND FAILS TO PROTECT THE RIGHTS OF LOW WAGE WORKERS (2007), available at http://cdm.nonprofitsoapbox.com/storage/documents/wagetheft.pdf (Discussing the wage theft epidemic in Maryland); ANNETTE BERNHARDT, RUTH MILKMAN, NIK THEODORE ET AL., BROKEN LAWS, UNPROTECTED WORKERS: VIOLATION OF EMPLOYMENT AND LABOR LAWS IN AMERICA'S CITIES (2009), available at http://www.nelp.org/page/-/brokenlaws/BrokenLawsReport2009.pdf?nocdn=1 (Hereinafter: "BROKEN LAWS, UNPROTECTED WORKERS"); ASIAN AMERICAN LEGAL DEFENSE AND EDUCATION FUND AND YKASEC, "FORGOTTEN WORKERS": A STUDY OF LOW-WAGE KOREAN IMMIGRANT WORKERS IN THE METROPOLITAN NEW YORK AREA (2006), available at http://www.aaldef.org/docs/KWP_2006WorkerSurvey_analysis.pdf (this report conveys 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); REBEKAH LEVIN AND ROBERT GINSBURG, SWEATSHOPS IN CHICAGO: A SURVEY OF WORKING CONDITIONS IN LOW-INCOME AND IMMIGRANT COMMUNITIES, CENTER FOR LABOR AND COMMUNITY RESEARCH (2000), available at http://www.impactresearch.org/documents/sweatshopreport.pdf (this report surveyed working conditions in low-income immigrant communities in Chicago, especially in work places that meet the Department of Labor's definition of sweatshops. The report concludes 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, industrial homework, etc.); MARY BAUER - THE SOUTHERN POVERTY LAW CENTER, UNDER SIEGE: LIFE FOR LOW-INCOME LATINOS IN THE SOUTH (2009), available at http://www.splcenter.org/sites/default/files/downloads/UnderSiege.pdf (this report concludes that many workers in the Latino community encounter discrimination and exploitation by being denied of their basic labor rights (such as minimum wage, basic health and safety protections, etc). The report argues that state and local governments have made the situation worse, by leaving workers without the ability to receive wages that are rightfully theirs); MUJERES UNIDAS Y ACTIVAS & DAY LABOR PROGRAM WOMEN'S COLLECTIVE OF LA RAZA CENTRO, BEHIND CLOSED DOORS: WORKING CONDITIONS OF CALIFORNIA HOUSEHOLD WORKERS (2007), available at http://www.datacenter.org/wp-content/uploads/behindcloseddoors.pdf (this report surveyed low-income immigrant Latina women in California, many of whom are domestic workers, and found that domestic workers experience many labor violations such as not being paid minimum wage and overtime, not receiving paid work breaks, etc.); ROBERT BRUNO, ALISON DICKSON QUESADA, AND FRANK MANZO IV, CLEAN CARS, DIRTY WORK: WORKER RIGHT VIOLATIONS IN CHICAGO CAR WASHED (2012), available at http://www.ler.illinois.edu/labor/images/Clean%20Cars,%20Dirty%20Work_Bruno%20Quesada%20Manzo.o.pdf (this report surveyed employees working at car washes in Chicago and found that violations of basic labor laws (such as wage and hour laws) are common among car wash employees); LONNIE GOLDEN & HELENE JORGENSEN – THE ECONOMIC POLICY INSTITUTE, TIME AFTER TIME: MANDATORY OVERTIME IN THE U.S. ECONOMY (2002), available at http://www.epi.org/publication/briefingpapers_bp120/ (this report confirms that due to the fact that workers in the United States can be dismissed for no reason at all, many employees are "forced" to work overtime out of fear for their dismissal or face other sanctions);

6 See BROKEN LAWS, UNPROTECTED WORKERS, supra note 5, at 2.
wage loss translates into 15 percent of the earnings.\textsuperscript{7} No less than $56.4 million dollars are lost every week due to wage theft in each of the three major cities surveyed.\textsuperscript{8}

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

Cho, Koonse&Mischel conducted a research that looked into the collection of unpaid wages in California.\textsuperscript{9} Their research looks into wage claims filed to the California Department of Labor Standards Enforcement (hereinafter: “DLSE”), and examines how much of their unpaid wages the workers were able to collect. According to their analysis, only 17\% of the employees who complete the entire DLSE process (not including settlements awards) and receive a judgment in their favor are able to recover any payment from the employer.\textsuperscript{10} Between the years 2008 and 2011, the DLSE issued decisions for unpaid wages totaling $282 million, but workers were able to collect a mere $42 million - roughly 15 percent - of those awards.\textsuperscript{11} Collection rates are better if settlement awards are taken into account, but even then, 58\% of the claims are unpaid.\textsuperscript{12}

The situation in other states is not much different. According to the Oregon Center for Public Policy, between June 2010 and June 2012 the Oregon Bureau of Labor and Industries issued monetary fines against employers totaling $4.1 million. Employers,

\begin{itemize}
  \item \textsuperscript{7}Id. at 5.
  \item \textsuperscript{8}Id. at 6.
  \item \textsuperscript{9}HOLLOW VICTORIES, supra note 1
  \item \textsuperscript{10}Between the years 2008 to 2011 18,683 workers prevailed in their wage claims, but just 3,084 of those workers were able to collect any money. SeeHOLLOW VICTORIES, supra note 1, at 13-14.
  \item \textsuperscript{11}HOLLOW VICTORIES, supra note 1, at 2.
  \item \textsuperscript{12}Id. at 15.
\end{itemize}
however, paid only $1.3 million – 31% of the total amount of the judgments issued against them.\footnote{Oregon Center for Public Policy, Fact Sheet: Employers Pay Only a Fraction of Monetary Findings in Wage Theft Cases (2013), available at http://www.ocpp.org/2013/04/05/fs20130405-employers-pay-fraction-wage-theft/ (Hereinafter: "Oregon Center for Public Policy").} 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,\footnote{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. See Houston We Have a Wage Theft Problem, supra note 4, at pages 6 and 14.} but has been able to recover only $700,000 – just 21% of the amount due to the employees.\footnote{See Id. at 6. The agency explains this poor collection rate as follows: "Unscrupulous employers can utilize many tactics to avoid payment even after "conviction" (i.e. a judgment determining the employer owes the employee money – O.K): 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.} The same situation exists in New York,\footnote{Lauren K. Dasse, Wage Theft in New York: The Wage Theft Prevention Act As a Counter To an Endemic Problem, 16 CUNYL. REV. 97, 116 (2012) ("This is extremely important because low-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 had disappeared and is now nowhere to be found");} Florida,\footnote{Andrew Marra, A Problem Getting Paid, Palm Beach Post, Jul. 2013, at 10A. ("But the problem in Florida is, if anything, more serious [than described in the Cho et. al study about California – O.K]. Florida "is a debtor's paradise," said 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."").} Iowa,\footnote{Gordon W. Johnson, Insolvency and Social Protection: Employee Entitlements in the Event of Employer Insolvency 17 (2006), available at www.oecd.org/daf/ca/corporategovernanceprinciples/38184691.pdf. ("Lastly, even 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.").} North Carolina\footnote{North Carolina Justice Center, It Doesn’t Add Up, 25 (2012), available at http://www.ncjustice.org/sites/default/files/Wage_Theft_Report-It_doesnt_add_up.pdf. (Hereinafter: "It Doesn’t Add Up") ("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.").} and presumably many of the other cities and states that do not publish formal statistics about the recovery...
rate of unpaid wages judgments. As Rebecca Dixon, a policy analyst for the National Employment Law Project, explained in her testimony before the New York State Assembly Committee of Labor:

"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."

Indeed many workers, even after they had summoned up the courage to file a complaint and even after winning a judgment - never get paid. The unpaid employees have difficulties 'chasing' after the shirking employer, and even if they do, the employer may have no assets to give them. The employer is bankrupt, the business is gone and the employees have no financial resources from which to recover. According to Cho, Koonse&Mischel 60% of the employers who received a judgment against them in California have abandoned, transferred or sold their business before or soon after the judgment ordering them to pay their employees was given. 50% of these employers did so before the workers could even complete the judicial process.

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20 As part of the research for this article, we sent e-mails to labor commissioners in all 50 states, asking them for data regarding the collection rate of employment claims in their state. Unfortunately, the vast majority of states (42) did not respond to our question, and even those who did respond failed to provide us with the data we were looking for. The labor commissioner in Kentucky and New Hampshire wrote that the data about collection rates is unavailable. Wage commissioners in Alaska, Arkansas, Connecticut, South Dakota and Illinois gave us the amount of collected wages (in cases where wage violations were reported), but did not report the total amount of the claims. The labor commissioner in Nebraska was the only commissioner that provided us with full information. In Nebraska, the total amount of the wage claims (under both the Wage & Hour Act and Wage Payment & Collection Acts) during FY 2012-13 was $785,498, and employees were unable to recover 15.4% of this amount ($120,997).

21 See Testimony of Rebecca Dixon, supra note3, at 3-4.

22 See HOLLOW VICTORIES, supra note1.

23 HOLLOW VICTORIES, supra note1, at 14.
Unfortunately, the employees who suffer from this problem often come from weak socio-economic backgrounds. 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. Although the dollar amounts of the employment claims 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.

The legal system does offer those workers who have a winning judgment in their hands some mechanisms for easier collection when compared with other creditors. These solutions afford employees a priority over other creditors or an additional source from which to collect their debts. The problem is that the main solution offered – the bankruptcy priority – is not very efficient, and that the other, more efficient, solutions have been adopted only by a few states. In the following sections, we outline the available solutions, and show the dominant role the bankruptcy code plays in the legislation and in the literature.

(2) The collection of wage claims – 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. Sections 507(a)(4) and 507(a)(5) of the bankruptcy code provide priority to wage claims, so that a holder of

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25 WINING WAGE JUSTICE, supra note 24, at 111-112.
26 IT DOESN’T ADD UP, supra note 19, at 3.
a wage claim must be paid in full, before other unsecured creditors receive anything for their claims.\(^{27}\) 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.\(^{28}\) Section 507(a)(5) is available for allowed claims for contribution to an employee benefit plan.\(^{29}\) Both priorities, however, are limited in dollar amount and in time. In terms of amount, section 507(a)(4) is limited to claims of up to $12,475. Any amount exceeding this maximum limit will be considered regular unsecured claim, even if it is a claim for wages, salaries or commissions.\(^{30}\) Section 507(a)(5) is limited to $12,475 minus the amounts paid to the employee under section 507(a)(4).\(^{31}\) In terms of time, in order to receive a priority under sections 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.\(^{32}\) 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.

\(^{27}\) 11 U.S.C § 507; 4 COLLIER ON BANKRUPTCY ¶ 507.02 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. 2006);
\(^{28}\) 11 U.S.C § 507(a)(4) (Supp. 2006); See COLLIER, supra note 27 at ¶ 507.06.
\(^{29}\) 11 U.S.C § 507(a)(5) (Supp. 2006); See COLLIER, supra note 27, at ¶ 507.07. 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. According to the Supreme Court decision in Howard Delivery Service (Howard Delivery Service, Inc. v. Zurich American Ins. 547 U.S. 651 (2006)), a workers compensation plan does not qualify as an employee benefit plan, because the premiums do not constitute compensation (direct or indirect) to the employee.
\(^{30}\) See 11 U.S.C § 507(a)(4); The dollar amount limitation is adjusted every three years to account for the changes in the cost of living. See 11 U.S. Code § 104.
\(^{31}\) 11 U.S.C § 507(a)(5)(B).
\(^{32}\) 11 U.S.C § 507(a)(4); 11 U.S.C § 507(a)(5)(A).
Several states, therefore, developed additional mechanisms designed to help employees collect unpaid wages. The enforcement mechanisms adopted by the states can be divided into three categories: wage liens, bond funds and wage assurance funds. All three categories are designed to improve employees' chances of receiving the debt owed to them by their employer, 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. The lien gives employees a direct claim against the employer's property (including real estate or bank accounts), and thereby elevates their position from priority creditors to secured creditors. According to a study conducted by the National Employment Law Project (Hereinafter: "NELP Study"), a general wage lien, which is available to all employees, is adopted only by a handful of states. 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. 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.

33 See WINNING WAGE JUSTICE, supra note 24, at 112.
34 See Matthew Seror, Analyzing the Inadequacies of Employee Protections in Bankruptcy, 13 S. CAL. INTERD. L. J. 141, 150 (2003) (Soror examines the court's treatment of wage liens); Richard H. Nowka and Jeff. S. Taylor, Kentucky Employees' Wage Leins: A Sneak Attack on Creditors, but Beware of the Bankruptcy Trustee, 84 K.Y. L. J. 317, 354 (1996) (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 90 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 (2013)). In other states, like Idaho or Texas, an administrative agency must recognize the employer's liability before the lien is attached (IDAHO CODE § 45-620 (2013); TEX. LAB. CODE § 61.031 (2013)). In addition, some states limit the protection that can be afforded by the lien. Wisconsin, for example, caps the maximum amount of recovery to up to 6 months wages and to no more than $3,000 (Wis. Stat. § 109.09 (2013))).
35 See WINNING WAGE JUSTICE, supra note 24, at 114-115.
36 Id. at 113.
A second mechanism to aid the employees' collection is a wage bond. This option requires employers to post a bond with a state agency, in order to protect the wages and benefits of their workers. 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.\textsuperscript{37} 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.\textsuperscript{38} Only a few states require bonds for other industries, such as the garment industry (California), entertainment (Nevada) or mining (Illinois), and no state requires all employers to post wage bonds for their entire work force.\textsuperscript{39} The problem with a wage bond requirement, and probably the reason why it is implemented in few industries, is that it demands employers to put 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 percent of the amount it guarantees, the cost to the employer can be substantial.\textsuperscript{40}

A third option to assist employees, therefore, is an insurance-based model.\textsuperscript{41} 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.\textsuperscript{42} When an


\textsuperscript{38}See, WINNING WAGE JUSTICE, supra note 24, at 117-118; See Rourke, Westhoff and Brennan, supra note 37, at 9.

\textsuperscript{39}See, WINNING WAGE JUSTICE, supra note 24, at 118.

\textsuperscript{40}See WINNING WAGE JUSTICE, supra note 24, at 117.

\textsuperscript{41}See WINNING WAGE JUSTICE, supra note 24, at 120; See, ROGER BLANPAIN AND A. T. J. M. JACOBS, EMPLOYEE RIGHTS IN BANKRUPTCY, A COMPARATIVE-LAW ASSESSMENT 13 (2002).

\textsuperscript{42}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 for providing the wage assurance to the employees. The second option uses
employee has a judgment in her favor, but her employer cannot (or refuses to) pay the judgment, the fund pays the unpaid employee her wages (or other employment claims) in lieu of the insolvent employer.\textsuperscript{43} The fund is financed by fees imposed on the employees, employers or both.\textsuperscript{44} All employees and employers pay a certain mandatory premium to the fund, and the fund uses the pool of premiums to pay the deserving employees. 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 employer's financial condition. In this sense, just like in all insurance schemes, the wage assurance fund 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 – all those who pay the premiums.

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.\textsuperscript{45} In Oregon, employees can recover from the fund up to $4,000 in wage claims, when their employer ceases doing business and does not have the resources to pay them.\textsuperscript{46} Maine follows a similar model, but employees can recover up to two weeks wages

\begin{footnotesize}
\begin{enumerate}
\item The wage fund solves the employees' collection difficulties, because it is not connected to the employer's assets. Even in case the employer has few or no assets at all, the fund can still pay the unpaid employees.
\item See Blanpain, supra note 41, at 19; See Winning Wage Justice, supra note 24, at 120; Janis Sarra, Recognizing Workers’ Economic Contributions: The Treatment of Employee and Pension Claims During Company Insolvency (2008), available at http://www.iiiglobal.org/component/jdownloads/finish/572/5379.html
\end{enumerate}
\end{footnotesize}
rather than a certain dollar amount limitation. As opposed to the United States, in many other OECD countries the wage assurance funds are much more prevalent. The European Council, for example, issued a directive that obligates all member states to set up a wage assurance fund, in order to help employees when their employer is bankrupt. 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.

(3) 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 employer files for bankruptcy. This focus on bankruptcy law is shared by Congress and by the legal literature. Both largely ignore the other possible solutions for the employees' collection problem, and view this problem through the narrow prism of bankruptcy law.

The emphasis Congress puts on bankruptcy law is reflected by the constant broadening of the bankruptcy priority's scope and by the rhetoric used by Congressmen in

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the legislation process. In terms of scope, ever since the wage priority was first introduced in 1841, the amount of allowed claims has continuously grown. In 1841 the Bankruptcy Act capped the amount of the allowed priority at $25 ($680 in today's purchasing power), and gradually the amount has risen up to the present cap of $12,475.\textsuperscript{50} However, not only have the dollar amount of the allowed claims changed, so did the types of claims and their possible beneficiaries. In several incidents, usually after bankruptcy courts narrowly interpreted the wage priority, Congress responded by amending the Bankruptcy Code. In 1938, Congress clarified that not only salary claims can enjoy the priority, but also commissions received by part-time non-exclusive salesmen.\textsuperscript{51} In 1978, in response to the Supreme Court rulings on Joint Industries and Embassy Restaurants,\textsuperscript{52} Congress added section 507(a)(5) to cover contributions to employees' benefit plans.\textsuperscript{53} In 1994, Congress resolved a split among bankruptcy courts, and included commissions owed to independent contractors in the wage priority\textsuperscript{54}. This trend of increasing the scope of the employees' protection in bankruptcy continues also today. In 2013, Hon. John Conyers Jr. introduced the Protecting Employees and Retirees

\textsuperscript{50} The priority for wage claims was first given in the Bankruptcy Act of 1841. Then the Act capped the allowed amount of the priority at $25 ($680 in today's purchasing power) and to claims that rose within six months prior to the filing (See, Bankruptcy Act of 1841, 5 Stat. 440, § 5). Gradually, however, the amount of the wage priority increased: In 1867 the limit was raised to $50 ($812 in today's purchasing power) (See, Bankruptcy Act of 1867, Ch. 176, 14 Stat. 517, § 27); in 1898 to $300 ($8,690 in today's purchasing power, but only if earned within three months prior to the filing) (See, Bankruptcy Act of 1898, Ch. 541, 30 Stat. 544, § 64b); in 1926 to $600 ($7,900 in today's purchasing power) (See. Act of May 27, 1926, 44 Stat. 662); in 1978 to $1800 ($6,430 in today's purchasing power) (See, Pub.L. No. 95-598 Stat. 2549 (1978)); in 1994 to $4000 ($6,290 in today's purchasing power) (See, Pub. L. No. 103-394 § 108(c) (1994)) and in 2005 the amount again changed to $10,000, if earned 180 prior to filing instead of only three months (Pub. L. 109–8, 119 Stat. 23 (2005)). Today the amount stands at $12,475, due to the cost of living adjustment prescribed in section 104. See generally C. Scott Pryor, The Missing Piece of the Puzzle: Perspectives on the Wage Priority in Bankruptcy, 16 AMER. BANKR. INST. L. REV. 121 (2008).

\textsuperscript{51} See Pryor, supra note 50, at 137.


\textsuperscript{53} See COLIERS, supra note 27, at ¶ 507.07; See Pryor, supra note 50, at 138-140.

\textsuperscript{54} See COLIERS, supra note 27, at ¶ 507.06 [3][b].
in Business Bankruptcy Act to Congress, and suggested broadening the employees’ protection.\textsuperscript{55} According to the bill, the priority payment to employees' claims will be increased from $12,475 to $20,000, and the restriction that the wage and benefits must be earned within 180 days of the bankruptcy filing will be eliminated.\textsuperscript{56} The bill has been assigned to a congressional committee, but died in the previous Congressional session without any vote.\textsuperscript{57} From the discussions that took place in Congress during the legislation of the above amendments, though, it is clear that Congress views bankruptcy law as the only possible tool to protect unpaid employees. Other possible models, and in particular an insurance-based model, are not even considered, and Congress reverts to the bankruptcy wage priority to address the plight of the American worker.\textsuperscript{58}

\textsuperscript{55}Protecting Employees and Retirees in Business Bankruptcies Act of 2013, H.R. 100, 113th Cong. (2013).
\textsuperscript{56}Id. §101;
\textsuperscript{57} See, https://www.govtrack.us/congress/bills/113/hr100#overview.
\textsuperscript{58}See, 147 \textsc{Cong. Rec.} S2343 (2001) (Senator 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."). Also see, 151 \textsc{Cong. Rec.} S1892, 34-6 (2005) (Senators Rockefeller and Leahy (Co-sponsored by senators Dayton and Obama) suggested raising the maximum dollar amount of the preferred employees' claims to $15,000. Their amendment failed, 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, severance pay, or payment benefits the employees are owed for work done prior to the bankruptcy."); Also see, 159 \textsc{Cong. Rec.} E5 (2013) (When introducing the bill for Protecting Employees and Retirees in Business Bankruptcies Act of 2013, Mr. Conyers Jr. explained: "...throughout 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.")
Much of the legal literature, albeit with less pathos, shares the same line of thought. Many legal scholars agree that employees deserve a higher level of protection than other creditors, and they see the bankruptcy priority as a means to obtain such protection.\textsuperscript{59} Other scholars, and in particular Douglas Baird and Daniel Keating, have advocated the opposite view.\textsuperscript{60} Contrary to much of the literature, Baird and Keating object to the bankruptcy priority, and explain that it creates forum shopping and bankruptcy abuse.

We agree with Baird and Keating's argument, but wish to take the argument one step further. We propose the implementation of an insurance-based model, and maintain it is a more efficient and more just solution. The model should apply both in and outside bankruptcy, and help all unpaid employees - those with winning judgment in their hands.

For methodological purposes, though, we divide our argument into two parts. In the

\textsuperscript{59} See, Elizabeth Warren, Bankruptcy Policy, 54 U. CHI. L. REV. 775, 790 (1987) ("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"); David A. Skeel Jr., Employees, Pensions, and Governance in Chapter 11, 82 WASH. U. L.Q. 1469, 1472 (2004) ("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."); Donald R. Korobkin, Employee Interests in Bankruptcy 4 AMER. BANKR. INST. L. REV. 5, 10 (1996) ("...there are situations in which the immediate payment of prepetition employee claims seems especially warranted. 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."); Alan Schwartz, A Theory of Loan Priority, 18 J. LEGAL STUDIES 209, 256-7 (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. This analysis also implies that the current ranking of employees below secured parties in bankruptcy distribution should be re-thought"). Also see, Seror, supra note 34, 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"); Amy Lassiter, 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...").

following section (B), we explain why an insurance-based solution is superior to a bankruptcy priority within a bankruptcy context. We 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. Later on, in part C, we relax the assumption of the debtor's bankruptcy, and explain why we believe the solution should be expanded also to non-bankruptcy situations.

B. Eliminating the Bankruptcy Wage Priority in Favor of an Insurance-based Model:

Looking at this problem from a global perspective, and following a comparative analysis made by Gordon Johnson and Paul Secunda, we divide 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 together. The exact hybrid each country creates may be different, but most OECD countries, like Canada, the United Kingdom, France or England, combine both a bankruptcy priority and a wage assurance fund. A second approach, adopted by Chile, Mexico and the United States, uses only a bankruptcy priority model. In the

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[63] *Id.* at 874-875.

[64] *Id.* at 874.
United States, there is a federal wage priority in bankruptcy, but only two states have a wage assurance fund. A third approach, implemented in Germany and Finland, uses only an insurance-based model, and a fourth approach affords no preference to pre-petition employment claims at all.

We argue in favor of the third approach. Like Germany and Finland, we 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 our view we differentiate between two related questions. Firstly, should employees in their capacity as creditors be preferred over other creditors? Secondly, to the extent that the answer to the first question is affirmative, what type of precedence should the employees receive?

(1) The rationale for 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 preference is mistaken, and that all creditors, including the debtor's workers, should be treated equally.

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. The equality principle states that all the 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

65 Id.
66 See SARRA, supra note 44, at 9-10.
Although deviation from the equality principle can be justified by the employees' socio-economic weakness, an employee, it is argued, is not necessarily weaker or more vulnerable than the other creditors. On the contrary, an employee may have a solid financial background or can easily find an alternative high 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. In other words, the employees' weakness is not necessarily a good enough reason for the violation of the equality principle. All creditors suffer from the debtor's insolvency (with no fault of their own), and without a clear measure of who is weaker or who will suffer more from non-payment, all creditors should bear the costs of the insolvency equally.

Moreover, granting the employees precedence in the event of bankruptcy 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 in order to prevent employees from obtaining a higher payment at their expense. It is therefore preferable to treat all creditors equally.

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68 See Rizwaan Jameel Mokal, *Priority as Pathology: The PariPassi Myth*, 60 CAMBRIDGE L.J. 581, 581 (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 (See, THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 17, 31-32 (1986). Traditional more social approaches view the principle of equality as part of a theory of justice. It connects to the Rawlsian principles of fairness, as it prevents discrimination of one creditor over the other (See, Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, U. ILL. REV. 1 (1994).

69 See, e.g., 147 CONG. REC. S2343 (2001), supra note 58.

70 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.

unsecured creditors equally, so as not to let a priority given to the different claims impact the type of insolvency proceedings chosen.\textsuperscript{72}

Despite these arguments, according to a survey conducted by the International Labor Organization, the vast majority of countries do give preference to the employees.\textsuperscript{73} The model of preference may change from country to country (bankruptcy priority or a wage assurance fund), but the belief that employees are entitled to at least some kind of preference is widespread.\textsuperscript{74} To the best of our knowledge, only two countries, Estonia and the United Arab Emirates, have opted for the fourth model mentioned above, and decided that employees deserve no preference.\textsuperscript{75}

The reasons for this widespread choice, we believe, are threefold. Firstly, the salary that employees receive from the employer generally represents a significant portion of their income. Not receiving wages, certainly 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.\textsuperscript{76} In addition, unlike other creditors (including suppliers and customers), employees cannot diversify their investments to reduce the risk they take in the event of the employer's insolvency. Quite naturally, they work for a single employer, and the collapse of this employer is likely to cause them considerable harm.\textsuperscript{77}

\textsuperscript{72}See Baird, supra note 60, at 817-818; Keating, supra note 60, at 926.

\textsuperscript{73}For a comprehensive survey of the different protection models available in the different countries, see THE INTERNATIONAL LABOR CONFERENCE (ILC), 91\textsuperscript{st} Sess., Report III (Part 1B), Chapter V, 165, available at www.ilo.org/public/english/standards/relm/ilc/ilc91/pdf/rep-iii-1b.pdf. Also see SARRA, supra note 44, at 9.

\textsuperscript{74}See ILC Report, supra note 73, at 167.

\textsuperscript{75}See SARRA, supra note 44, at 10.

\textsuperscript{76}See Keating, supra note 60, at 907.

\textsuperscript{77}See Korobkin, supra note 59, at 6.
Secondly, as against other commercial creditors, it is difficult to perceive of employees as ones who willingly took on the risk of their employer's 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 it, assess its commercial situation and price the risk involved in extending credit. The higher the risk they take, the higher the interest rate they charge or the better the commercial conditions they demand. Employees, on the other hand, are maladjusting creditors. They often have no accurate information about the commercial situation of their employer, and it is doubtful if they can obtain such information independently. 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 the employer is going down. 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, the employer can take advantage of its leverage and not pay its workers their full wages.

Thirdly, non-payment to employees adversely affects the economy and the local communities in which the unpaid workers live. As mentioned, the victims of wage theft are often employees from low socio-economic backgrounds. These employees spend a

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79 See Seror, supra note 34, at 157.
81 See Korobkin, supra note 59, at 6; See Warren and Westbrook, supra note 78, at 1232.
82 See Broken Laws, Unprotected Workers, supra note 5, at 50; See Houston We Have a Wage Theft Problem, supra note 4, at 6.
large portion of their income on basic needs, such as food, clothing and housing, and these funds circulate back to the economy and support businesses and 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 business need to hire less workers, and all affected parties pay less taxes. Due to the enormous proportions of the wage theft phenomenon, the effects on the economy are by no means negligible.

Due to the cumulative strength of these arguments, it is our view that employees should be able to collect their wage claims more easily than other creditors. However, more important than our own 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 our goal, to make the case in favor of such preference or against it. Our claim is, therefore, more limited. We 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. Our 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 we have seen, though, the vast majority of jurisdictions do decide to give employment claims some kind of protection.

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83 See BROKEN LAWS, UNPROTECTED WORKERS, supra note 5 at 50; See HOLLOW VICTORIES, supra note 1, at 5.
84 BROKEN LAWS, UNPROTECTED WORKERS, supra note 5, at 50.
(2) The advantages of an insurance-based model:

When examining the preference of pre-bankruptcy employment claims, it is important to note that such preference does not come without a cost. It comes at the expense of other parties, which finance the payment to the employees – even if not knowingly. The model we select for the preference determines the identity of the party who bears 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 lowerpriority 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 from which they can recover.85

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.86 In case the fund is financed through an obligatory fee imposed on all employees and employers (as we suggest), it is the general public who bears the burden of the preference. The higher the payments to unpaid employees in the event of insolvency, the higher the fees (the premiums) the public will have to pay the fund.

85 See COLLIER, supra note 27, at ¶507.02[4][b].
86 See WINNING WAGE JUSTICE, supra note 24, at 120.
The question of which model of preference is better 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? We argue that the answer is the latter, provided that the public (through the wage assurance fund) has a subrogation right towards the employer.

We base our argument on three different reasons, but before outlining these reasons it is important to specify an underlying assumption of our argument. When arguing for the supremacy of the insurance-based model, we assume that due to the reasons detailed above (or due to 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 we 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 one given in sections 507(a)(4) and 507(a)(5)). The employees 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, our assumption is correct, then, we 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, we believe a bankruptcy priority is inefficient and does not adequately express the public's choices.

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. Similarly, an employer may have very few assets or its assets may already be attached with liens, and in such case the employees' priority will have no effect. The employees will not 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 the debtor's assets, and assuming it is managed properly it should have sufficient assets to pay all 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 we explained earlier, granting the employees a priority claim in the debtor's assets places the cost of the precedence on the unsecured creditors. The debtor's assets are first used to satisfy the employees, and the unsecured creditors can collect less of their own claims. The group of unsecured creditors, however, is a relatively small group, comprising 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.

See, the Enron bankruptcy denying 4,500 of severance pay they rightfully deserved under their employment contract (See, Skeel, supra note 59, at 1469-1470); The "38 Studios" bankruptcy (Jason Schwartz, End Game, Boston Magazine August 2012).
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 can be just as weak (suppliers, customers or private debenture holders etc.).\(^{89}\) 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 the employer's insolvency, especially the damage to the weaker creditors. In addition, just like income taxes, the fees paid to the fund can be collected progressively.\(^{90}\) 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 the employer's creditors are strong adjusting creditors, placing the burden of the employees' preferential treatment on the creditors creates social and economic costs. Preferring employees' claims in bankruptcy reduces the recovery rate of the unsecured creditors and increases the risk of extending loans. Adjusting (financially or otherwise strong) creditors price this risk, and they will probably raise the interest rates to compensate themselves for the extra risk involved. This means that 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.

\(^{89}\) See Keating, supra note 60, at 925-926.  
(even profitable ones). Fewer businesses manage to develop and grow, and more businesses are likely to get into trouble. Furthermore, the financial creditors, who know their debtors' financial status, would probably distinguish among debtors. They are likely to raise interest rates for businesses with a high risk of insolvency, and 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. Putting up interest rates in this way is certainly inefficient and can cost the economy dearly. It would function like a regressive tax on credit—it slows down business growth and reduces investments.

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

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93 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 the creditors monitor the debtor's financial behavior (See George G. Triantis and Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073 (1995)), a dispersed public has no monitoring capabilities. We deal with the monitoring issue more elaborately further on (infra Part C), but at this point it is important to note that although the dispersed public cannot monitor the debtor, the wage assurance fund can. The fund bears the
Here we come to the third reason for supporting the wage assurance fund model, as we hark back to the rationales of the preference of employees as creditors. As detailed above, the reasons for granting preference to employees are essentially social. 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.\(^{94}\) Therefore, as a society we wish to help them in their time of need. As Congressmen Conyers Jr. puts it - society should make sure that its "most important resource—workers and retirees—are treated more fairly" when their business falls into hard times and reorganizes.\(^{95}\) But inasmuch as the reasoning is social, namely society wishes to give preference to the group of employees, it is also society that needs to pay for it. 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 a more efficient level of protection to employment claims can be chosen. Placing the costs of the employees' preferential treatment on the creditors, on the other hand, is liable to create externalities. The public (through the legislature) chooses the level of priority, but the costs of this choice are borne by the unsecured creditors.\(^{96}\)

The creditors, to be sure, or at least the adjusting creditors, do not absorb the cost of the employees' preferential treatment.\(^{97}\) As noted earlier, the wage priority decreases the

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\(^{94}\) See Lassiter, supra note 59, at 954.

\(^{95}\) See supra note 58.


\(^{97}\) See Meckling, supra note 92, at 23-24.
rate of return on their loans, and they price this decrease by increasing the interest rates they charge. 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\(^98\) against the social benefits that result from protecting unpaid employees,\(^99\) and then set the priority at a level in which the priority's marginal cost equals its marginal benefits. In practice, however, this is almost impossible to do. 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 etc.), 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.\(^100\) 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

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\(^98\) The delta in the interest rates means the difference, other things being equal, between the interest rate charged on a loan extended in world with a bankruptcy wage priority and the interest charged on the same loan in a world with no bankruptcy wage priority.

\(^99\) 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.

\(^100\) 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. In order to optimally measure the priority's effects we need two jurisdictions with similar economic conditions, one with such a priority and one without, and then we 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 bankruptcy priority changes), but since other economic conditions also change at the same time – again it will be difficult to isolate the changes caused specifically due to the changes in the priority's scope.
of priorities are often guided by political interests and populist beliefs, rather than by a systematic analysis of costs and benefits.\textsuperscript{101}

The legislative history of sections 507(a)(4) and (5) demonstrates exactly that. As we have seen, Congress continuously raised the amount and the scope of the prioritized wage claims in bankruptcy.\textsuperscript{102} This trend, however, was not based on an in-depth analysis of the employees' needs vis-à-vis the costs associated with the wage priority, but rather it seemed arbitrary and very much influenced by interest groups pressures, especially the unions.\textsuperscript{103} The unions supported the attempts to increase the amount of the claims,\textsuperscript{104} and

\textsuperscript{101} 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). Zelinsky discusses the phenomenon of unfunded mandates imposed on municipalities by state governments. He explains that since state legislators receive political benefits from the mandates but they do not bear their costs, which are borne by the local governments, they have an interest to increase the scope of the mandates. A resembling process can occur 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 the interest rates, but the public cannot connect between the priority and the interest rates it pays. Therefore, politicians have a political interest to increase the scope of the priority beyond its efficient level.

\textsuperscript{102} See supra notes 50.

\textsuperscript{103} Before the legislation of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA" - Pub. L. 109–8, 119 Stat. 23, enacted April 20, 2005), which raised the bankruptcy priority from $5,000 to $10,000, 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, (\textit{see} Congressional Record, March 19th, 2003 - 149 Cong. Rec. H1991 (2003)). There was a proposal to raise the amount to $13,500 (\textit{see} Congressional Record from 30.7.2002 - 148 Cong. Rec. S7580 (2002)), to $15,000 (\textit{see} Congressional Record 9.2.2005 - 151 Cong. Rec. S1199 (2003)), and in 2013 to to $20,000 (\textit{see} Congressional Record from 3.1.2013 - 149 Cong. Rec. E5 (2013)). 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, and why other amounts are any better (\textit{See, e.g.}, Congressional Record 2.3.2005, (151 Cong. Rec. S1926 (2005)). Populist explanations to 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: "reform 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." (\textit{See American Workers in Crisis: Does the Chapter 11 Business Bankruptcy Law Treat Employees and Retirees Fairly?: Hearing Before the Subcomm. on Comm. & Admin. Law on the Judiciary, 110\textsuperscript{th} Congress (2007)). Redmond does not clarify the relevance of
their representatives appeared in congressional hearings arguing in favor of additional reforms.\textsuperscript{105} Congress, it seems, did not pay much attention to the economic costs of the wage priority, except for some vague, and somewhat unclear, concern that it may cause more liquidations.\textsuperscript{106}

The advantage of an insurance-based model in this respect is that it facilitates transparency. Here the costs of employees' preferential treatment are clear,\textsuperscript{107} 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 the social benefits of the wage assurance justify the amount of the premium they pay or not. 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

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\textsuperscript{104}When discussing the amendments of the Senate Bill to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, for example, Senator 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. Strangely enough, Senator Durbin also ordered to include letters of support from some of these interest groups in the Congressional Record. 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 corporate bankruptcy. 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 (\textit{See, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Congressional Record dated March 3, 2005, 151 Cong. Rec. S1989 (2005).}). The same process currently occurs with the Protecting Employees and Retirees in Business Bankruptcy Act of 2013. In the introduction to the Bill it was clearly stated that the Bill is supported by the AFL-CIO and the United Steelworkers (\textit{See, Congressional Record – The Introduction of the Protecting Employees and Retirees in Business Bankruptcy Act of 2013, from 3.1.2013, 159 Cong. Rec. E5 (2013).})

\textsuperscript{105}See \textit{e.g.}, \textit{Protecting Employees and Retirees in Business Bankruptcy Act of 2007: Hearing on H.R. 3652 Before the Subcomm. On Comm. & Admin. Law on the Judiciary, 110th Cong. (2008), in which five out of the six witnesses appearing before the subcommittee were labor representatives.}

\textsuperscript{106} \textit{Id.}

\textsuperscript{107} 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.
assurance is required (for example, the 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, and in particular 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.

We do not know whether our 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, we believe that social welfare will increase. Employees will be able to enjoy the preference independent of the size of their employer's 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.

(3) The importance of the fund's subrogation right
So far, we 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. 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 instead of the insured. 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. The same principle, mutatis mutandis, should be applied in a wage insurance context. Here, since the wage assurance fund pays the employees, the employees should subrogate their rights against the employer (debtor) to the fund. Thus, to extent the wages, in whole or in part, can be collected from the employer's estate, then the fund will be able to recover from the employer what it paid the employees.

We believe giving subrogation rights to the fund is necessary, because it prevents unjust enrichment by 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 have already received the wages they are entitled to, allowing them to take action against the employer may result in their getting double compensation. The fund,

111 See Blanpain, supra note 41, at 19-20. Secunda, supra note 48, at 918-919.
112 Secunda, supranote 48, at 918.
on the other hand, should be allowed to take action against the debtor, because otherwise the debtor, or more precisely its creditors, will be unjustly enriched at the public's expense. When the fund pays the wage claims to the employees, the money comes from the premium paying public instead of from the debtor's estate. This means that each of the debtor's creditors receives a larger portion of the debtor's estate than it would have otherwise received had the employees been considered regular unsecured creditors. This result is wholly unjustified. Society's choice to strengthen the group of employees should not enrich the other creditors.\(^{113}\) The creditors should receive the same portion of 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 re-claim 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).\(^{114}\) A higher classification would lead to the fund receiving payment before the other unsecured creditors, which would decrease these creditors' rate

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\(^{113}\) 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 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 the debtor's perspective, if the fund that pays the employees cannot return and reclaim what it paid - why not file for bankruptcy and let the public pay the labor costs. In this case, the debtor, and thereby indirectly its creditors, is unjustly enriched.

\(^{114}\) 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. However, this is not the case in Denmark, Sweden and Switzerland, and there the fund sues the employer as an unsecured creditor. See Secunda, supra note 48, at 919.
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);\textsuperscript{115} the fund has an unsecured claim against the debtor for the amount it paid;\textsuperscript{116} 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.\textsuperscript{117}

This solution also reduces distorted incentives for various parties. On the one hand, contrary to a bankruptcy priority model, here the creditors and debtor are not harmed. Just like outsidebankruptcy, 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 right, the debtor and creditors do not profit from the proposed solution. The subrogation right allows the fund to claim the debt from the debtor, so that the payment made to the employees does not decrease the debtor's balance of debts. This reduces the debtor's and creditors' perverse incentives to forum shop, and allows for more effective use of insolvency proceedings.\textsuperscript{118}

\textsuperscript{115} We assume payment to the employees in full is justified, because of the reasons detailed supra Part B(2) above.
\textsuperscript{116} The creditors pay the fund what the employees' would have received without any priority.
\textsuperscript{117} See Part B(2) above.
\textsuperscript{118} For a more elaborate analysis of the forum shopping problem, see infra Part C(1).
C. A general implementation of the insurance-based model

We have so far discussed the use of an insurance-based solution only in case of bankruptcy. By definition, sections 507(a)(4) and (5) of the bankruptcy code apply only to wage claims filed in a bankruptcy procedure, and it was easier and perhaps more intuitive to frame the insurance-based model also in the context of bankruptcy.

Many cases of unpaid wages, however, do not involve formal bankruptcy proceedings. The employee receives a judgment in her favor, and although the employer does not file for bankruptcy, it 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.\(^{119}\) In these cases, the collection of the judgment can be even more difficult than the collection inside bankruptcy. In order to collect their pay, the employees have to trace the employer, track down available assets and perhaps try to pierce the corporate veil in order to find additional sources from which to recover. This 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, so that the employer benefits from the wage theft and the employees are robbed of their compensation.\(^{120}\)

In light of the alarming proportions of the wage theft epidemic,\(^{121}\) we believe that it makes little sense to give a priority to employees only in case of bankruptcy. We argue that if a proper legal authority determined (through a judgment) that a debt to an

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\(^{119}\) See Winning Wage Justice, supra note 24, at 111.

\(^{120}\) See Broken Laws, Unprotected Workers, supra note 5, at 4-5, 41.

\(^{121}\) See supra note 4.
employee exists, and if the employee cannot independently collect the judgment from the employer, then it is the obligation of the wage assurance fund to pay the employee, whether his employer filed for bankruptcy or not.\textsuperscript{122}

(1) \textbf{In support of insurance-based solution outside of bankruptcy}

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

Bankruptcy filing is a legal procedure.\textsuperscript{123} It takes place when a debtor files a formal petition to 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.\textsuperscript{124} The forum (bankruptcy or no bankruptcy) in which the debtor (employer) resolves his 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.\textsuperscript{125} The employees,

\begin{footnotes}
\footnotetext[122]{We do not argue that all jurisdictions should adopt an insurance-based model that applies both in and outside 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 our view, should use neither a wage assurance fund nor a bankruptcy priority. What we 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 in and outside a bankruptcy process. (Cf. our claim in the previous part, supra Part A(4))}
\footnotetext[123]{Charles W. Mooney Jr., \textit{A Normative Theory of Bankruptcy Law: Bankruptcy as (is) Civil Procedure}, 61 WASH. & LEE L. REV. 931 (2004); \textit{See} Jackson, supra note 68, at 17.}
\footnotetext[124]{See \textit{DOUGLAS BAIRD, ELEMENTS OF BANKRUPTCY} 129-131 (5th ed. 2010).}
\footnotetext[125]{In theory involuntary bankruptcy proceedings can be an option (see \textit{The Bankruptcy Code}, 11 U.S.C §303). Assuming the employment claims are of sufficient value, the employees can force their employer into bankruptcy even against its will. In practice, however, this rarely happens. First, the employees usually don't have sufficient information about their employer's financial situation. Even if the employer does not}
\end{footnotes}
therefore, should not be punished for their employer's legal choice, and they should receive an equal compensation as their peers whose employer did file. If a social justification exists for preferring employees inside bankruptcy (and current law implies that it does), then the same justification also applies when the employer decides not to file.\textsuperscript{126} 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 his full wage claims (up to the legal limit of the bankruptcy priority), while the cleaning services employee will be left empty handed?\textsuperscript{127} Why should their employer's choice affect their right to receive a preference? We think it is more just that both employees will 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, getting nothing for his past claims.

Secondly, applying preferential treatment only in bankruptcy is inefficient. There is an extensive body of literature, especially law and economics literature, which shows pay them their wages when due, they often don't 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 expensive, and often the unpaid employees are from low socio-economic backgrounds, and with little awareness on ways to enforce their legal rights.

\textsuperscript{126}See Jackson,\textit{supra} note68, at 112.

\textsuperscript{127}See Baird, \textit{supranote} 60: "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."
that bankruptcy-specific changes to substantive laws are harmful.\textsuperscript{128} 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.\textsuperscript{129} This phenomenon, known as forum shopping, also occurs when employees are given preferential treatment inside but not outside bankruptcy.\textsuperscript{130} In this case, employees may prefer a bankruptcy forum (especially when they can easily find an alternative job), in order to render their pre-petition claims preferred, while other creditors may disfavor bankruptcy, even when economically justified, in order 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 creditors group and of the public as whole.\textsuperscript{131}

This inefficiency can be prevented via an insurance-based model that applies both in and outside bankruptcy. If the fund pays the unpaid employees regardless of whether their employer files for bankruptcy or not, then no perverse incentives are created. Both in and outside bankruptcy the employees get paid by the fund; and both in and outside

\textsuperscript{128} See Baird, supra note 60; Jackson, supra note 68 at 20-27; and specifically with regard to employees, Omer Kimhi, Bankruptcy Law as a Balancing System - Lessons from a Comparative Analysis of the Intersection Between Labor and Bankruptcy Laws, AM. BANKR. INST. L. REV. (forthcoming).

\textsuperscript{129} Baird explains this problem through the following example. Imagine there are two cities, each with its own court house. 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 court houses adjudicate cases according to a different set of substantive rules, then the purpose of having two court houses will be defeated. Litigants will choose the court that applies the rules which maximize their chances of success, even when adjudication in that court house imposes unnecessary travelling costs on all parties. The same is true with regard to bankruptcy and non-bankruptcy forums. The goal of 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, Baird, supra note 60, at 818.

\textsuperscript{130} Daniel Keating, Ten Lessons for Congress to Ponder about the Labor/Bankruptcy Intersection, 22 AM. BANKR. INST. L. REV 35 (2014).

\textsuperscript{131} See Kimhi, supra note 128.
bankruptcy employment claims are considered unsecured. The bankruptcy filing changes nothing in 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 in 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'".¹³²

Yet a third reason to implement the insurance-based model both in and outside bankruptcy concerns the monitoring of unpaying 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 the employers, and are connected to a broader business strategy in the workplace rather than to an isolated event.¹³³ 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.¹³⁴ Leaving the monitoring task in a large part in the hands of the unpaid employees encourages these violating employers. Since the employees do not have the resources required for chasing the non-paying employers, they are often unable to initiate effective collection proceedings.¹³⁵ The debt to each individual employee is not big enough to justify a long and expensive legal chase after the employer's assets,¹³⁶ and so solvent employers are able to get away without paying their employees what they

¹³³ See BROKEN LAWS, UNPROTECTED WORKERS, supra note 5, at 4-5.
¹³⁴ See WINNING WAGE JUSTICE, supra note 24, at 111.
¹³⁵ See SARRA, supra note 44, at 28; Secunda, supra note 48, at 919.
¹³⁶ 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.
legally deserve. This enhances the wage theft phenomenon even further, to the detriment of the public as whole.\textsuperscript{137}

A wage assurance fund can help improve the collection efforts. As explained, the fund has a right to collect from the employer the amounts it paid the employees (subrogation right). Since the fund aggregates all unpaid employment claims, the amounts it needsto collect from employers are much higher than the amounts each individual employee is owed. The high amounts render an investment in collection efforts worthwhile. It is beneficial to invest resources in retrieving assets or lifting corporate veils, when the prospective rewards from such actions are significant. In addition, since the fund is a repeat player, it can gain knowledge and expertise in this type of proceedings. Collection efforts may be conducted in a faster and smoother manner, and avoiding payment will become harder. Indeed, anecdotal evidence gathered by Janis Sarra shows that the creation of a wage assurance fund improves collection efforts. Sarra conducted a comparative analysis regarding the treatment of employment claims, and she notes that a number of jurisdictions reported the establishment of the fund addressed the collection problems suffered by the individual employees.\textsuperscript{138} 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,

\textsuperscript{137}Testimony of Rebecca Dixon, \textit{supra} note 3 ("If we want workers to come forward, we have to show that we can get them their unpaid wages").

\textsuperscript{138}See SARRA, \textit{supra} note 44, at 28 ("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"); Also see Secunda, \textit{supra} note 48, at 919.
employers are less likely to avoid payment, especially if heavy fines and penalties are imposed on those who do.\textsuperscript{139}

(2) The cost of an overarching insurance-based model

These arguments, we believe, justify the implementation of an insurance-based model both in and outside bankruptcy. Such implementation is more just to the employees, it decreases forum shopping, and it allows for better monitoring on non-paying employers. The problem in expanding the wage assurance payments also to non-bankruptcy situations, however, seems to be the cost. If the fund has to pay all unpaid wage claims to employees - both in or outside 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 do 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 an insurance on which it needs to pay very high premiums.

This perception of the costs of an insurance-based model is wrong, in our 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 the 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

\textsuperscript{139} 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 we 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).
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.\textsuperscript{140}

To be sure, applying the insurance-based model only in bankruptcy also decreases the premiums,\textsuperscript{141} 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 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 it creates efficiency problems.

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 in and outside bankruptcy, the cost of such coverage will 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 claim we refer to California, for which we have relatively accurate data on unpaid wage claims. According to the research by Cho et al., between the years 2008-2011 the California Division of Labor Standard Enforcement (DLSE) issued decisions obligating the payment of wages and penalties totaling $282,071,969 (not including settlement awards).\textsuperscript{142} From this amount, employees were able to collect

\textsuperscript{140}\textsc{SARRA, supranote 44, at 25.}
\textsuperscript{141} 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.
\textsuperscript{142}\textsc{HOLLOW VICTORIES, supranote 1, at 15.}
$42,436,641,\textsuperscript{143} which means that if a wage assurance fund existed in California it would have 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 17.4 million employees.\textsuperscript{144} This means that if all employees in California paid premiums to cover the entire payment due the unpaid employees, each employee would have to pay a total of $14 for the entire four years (2008-2011), or about 30 cents a month. We believe 30 cents a month is a small amount to pay for the assurance that even when an employer falls onto hard time 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, etc.), 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 that is not connected to the employer's bankruptcy filing, need not be very costly. The efficiency costs of a bankruptcy priority - acost rooted in the increased interest rates charged, may be much higher.

\textbf{D. Conclusion:}

\textsuperscript{143} Id.
\textsuperscript{144} Data taken from http://www.labormarketinfo.edd.ca.gov/.
Congress is rightfully worried about the plight of employees.\textsuperscript{145} The data on wage theft in general, and on uncollected wage claims in particular, is troubling, and indeed something has to be done. The problem is that this issue usually comes up to the legislature or the public's attention when a big bankruptcy occurs, like LTV Steel, Enron, or Detroit.\textsuperscript{146} Then the suggested solution is amending the bankruptcy code, in order 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 a 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

\textsuperscript{145}See references supra note 58.

\textsuperscript{146}See, e.g., 151 Cong. Rec. S1892, 34-6 (2005) (When introducing a bill to increase the bankruptcy priority Senator Rockefeller explains "...over 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."); Also see the debate regarding Detroit's employees (e.g. Richard M Hynes and Steven D. Walt, \textit{Pensions and Property Rights in Municipal Bankruptcy}, 33 REVIEW OF BANKING AND FINANCIAL LAW 609 (2013-14).
more just and efficient solution for unpaid employees, as the level of preference is more accurate and the preference applies both in and outside bankruptcy. The article does not take a stand on whether the insurance-based model should be implemented on a state or a federal level, but it 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, we 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 U.S - should be set aside.