Insolvency and Social Protection

Employee Entitlements in the Event of Employer Insolvency

Gordon W. Johnson

Introduction

The recent collapse of Enron, the largest corporate insolvency in United States history, has once more thrown the light back on the topic of employee’s rights to entitlements in the event of corporate bankruptcy. The Enron collapse left over 4,500 staff unemployed globally and with uncertain ability to access entitlements owed to them under their work contracts. Even worse, employees and other investors who had invested their life’s savings in Enron’s stock and pension fund were left with nothing, while many of Enron’s management and upper echelon walked away with large bonuses, severance packages or managed to sell their own Enron stock before the real collapse. A tragedy of epic proportion, it has already led to recent and proposed regulatory reforms in the areas of corporate governance and accounting and auditing practices. The real magnitude of these issues cannot be assessed in quantitative terms. The consequences of these failures also compel that policy makers and governments reexamine the systems that provide for employee protections in the event of their employer’s financial demise.²

Should employee rights receive special attention above and beyond that of other trade creditors? Employees possess a contractual right to entitlements accrued under their work contracts. In terms of relative priority, these

1 Mr. Johnson, Lead Counsel in the Finance, Private Sector and Infrastructure practice group of the World Bank’s Legal Department, is the Bank’s chief legal advisor on corporate insolvency and restructuring systems. The author gratefully acknowledges the assistance of Rachel Hoffman (legal intern, American University Law School), Adrian Kennedy (legal intern, Monash University, Australia), and Sevi Simavi (World Bank Consultant) in preparing this article. The views expressed herein are the author’s alone, and do not necessarily represent the views of the World Bank, its shareholders, directors, or staff. Mr. Johnson may be reached at gjohnson@worldbank.org.

entitlements and rights are no different than those of other unsecured creditors holding contractual rights and claims to payment. Both groups of creditors are on an even legal footing to be paid from the general assets of the company, as distinct from the rights of secured creditors whose in rem rights entitle them to satisfaction from specific assets in the event of a default.

Employees are commonly the silent or lost voice in bankruptcy proceedings, however, and often have little influence or bargaining power (outside the collective bargaining process). Yet, they stand to lose the most. Wages generally constitute a significant portion of employees’ wealth, leaving them with few options to fall back on in the event of their employer’s default. Moreover, the overwhelming majority of employees have not intentionally assumed the risk that their employer might fail to pay them. Unlike creditors who can factor such defaults into their pricing or lending rates, employees typically are left with no recourse. They generally begin and maintain their course of employment without information as to the precise economic condition of their employer. Even if such economic information was available or able to be understood by the staff member, under a standardized contract, there is little an employee can do to factor in the risk of insolvency. In the event that an employee does learn of the financial ill-being of his/her employer before a formal declaration of bankruptcy, that individual may still remain powerless, as job prospects and mobility tend to be limited.

Regular trade creditors, on the other hand, have access to financial and economic data on the debtor and can theoretically, if not realistically, set their terms of trade to reflect their assumed risk. So too, trade creditors will often have a variety of sources of income, whereas employees usually only work for a single organization.

The financial security of employees in the event of employer insolvency is an issue capable of having a far-reaching societal affect. For example, employees holding pension benefits derived from their business’ ongoing operations or stock may discover that their pension plans have been tapped to cover expenses of the business or that their mutual funds (invested with the employer’s stock) are now worthless as they face their retirement years. Thus, the insolvency of a company may cause workers to lose their retirement benefits, as in the case of Enron, placing them at the mercy of taxpayer-sponsored state support and forcing them to extend their employment well into the retirement years.

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4 Id.
Unemployment and insolvency are an even worse combination in the context of troubled economies with high unemployment rates. Developing and transition economies typically have weak social protection systems for unemployed workers, whose numbers spiral when companies in financial distress downsize their workforce to rationalize their costs. In systemically affected countries, there is a greater potential for social unrest.

While employee entitlements clearly deserve special attention, numerous policy questions arise with regard to the treatment of these issues. For example, should general employee claims take precedence over claims of other unsecured creditors? If so, should the increase in risk to trade creditors be passed on to the debtor in the form of higher priced goods and services, putting labor intensive businesses at risk and inadvertently hindering job creation? If no, what other options are there to protect what is perhaps the most vulnerable of creditor groups?

This paper does not support a definitive “model” on legal treatment of employee entitlements in the case of insolvency. Rather, it examines some of the approaches currently adopted by different legal systems in order to protect employee entitlements in the event of employer insolvency. Section II briefly describes the position of two international bodies (the International Labor Organization and the European Union) on employee entitlements in insolvency, followed by a description of the four basic models in use around the world, with the aim of informing the debate on effective protection measures for a country’s most important assets – the employees. Section III discusses a number of strategies and policy considerations in the establishment and use of insurance and guarantee fund systems. The paper recognizes the need for more research and focus on this increasingly important issue in the current global analysis of insolvency principles and practice.6

It should be noted that there are a variety of treatments for employee contracts on the insolvency of a business. While some states, such as Russia, opt for the maintenance of work contracts through the long-term government administration of a failing business, unless otherwise indicated, this paper assumes the South African model of instantaneous termination of employee contracts in the event of bankruptcy. So too, many insolvency laws allow for a company suffering financial difficulties to be taken over or merged resulting in the downsizing or transfer of its workforce. While this process often results in large scale redundancies, and raises issues of whether a subsequent employer is liable for entitlements accrued under former employment, for the sake of

6 For purposes of this paper, the more detailed treatment on a country-by-country basis has been omitted.

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simplicity in this paper, it has been assumed that all staff have been made redundant on the insolvency of the enterprise.

The International Experience

International Labor Organization

As early as 1949, the International Labor Organization ("ILO"), whose members include all the countries discussed in this paper, produced a Protection of Wages Convention in which it addressed the effect of insolvency on workers’ wages.\(^7\) Article 11.1 states:

> In the event of the bankruptcy or judicial liquidation of an undertaking, the workers employed therein shall be treated as privileged creditors either as regards wages due to them for service rendered during such a period prior to the bankruptcy or judicial liquidation as may be prescribed by national laws or regulations, or as regards wages up to a prescribed amount as may be determined by national laws or regulations.\(^8\)

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

In 1982, the ILO issued a Convention regarding the termination of employment.\(^9\) Part II, Article 11, requires that employers provide employees on the verge of unemployment with either reasonable notice of such termination or compensation for the lack of reasonable notice. The ILO also seeks strong and direct participation by the workers’ representatives in employment termination, particularly in light of major restructuring, downsizing or terminations due to employer insolvency.


\(^8\) Id.


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European Union

In contrast to the ILO requirements, the European Union (“EU”) Directives are binding on members. In 1980, the Council of the European Communities issued a Directive regarding the protection of employees in the event of their employer’s insolvency.\(^\text{10}\) It was updated by the European Parliament in 2002.\(^\text{11}\)

Section II, Article 3.1, requires that guarantee institutions secure employees’ outstanding claims relating to their employment. Section II, Article 4.2, compels Member States to ensure that outstanding claims from the last 18 months are paid. Nonetheless, Section II, Article 4.3, authorizes Member States to set limits on the liability for employees’ outstanding claims as long as the States notify the Commission of the methods they used in order to reach those limits.\(^\text{12}\)

Council Directive 98/59/EC requires that any employer considering collective dismissals consult with workers’ representatives first, with a goal of reaching an agreement and thereby curtailing the need for such measures.\(^\text{13}\)

Survey of Country Experience

The ILO and EU requirements have been interpreted and implemented in a myriad of ways. What follows below is a brief analysis of four different systems and variations on models used throughout the world in an attempt to address the social protection concerns raised by employer insolvency.

Model One: Pro-Employee Approach

China has implemented a very pro-employee approach to staff redundancies.\(^\text{14}\) The Chinese model encompasses a compulsory unemployment insurance that goes well beyond mere monetary compensation for entitlements owed, though not all workers are covered by it. The cost burden for the insurance is carried by

\(^{10}\) The Council of the European Communities, Council Directive 80/987/EEC on the approximation of the laws of the Member States relating to the protection of employees in the event of the insolvency of their employer (1980), <http://europa.eu.int/celex/cgi/sga_rqst?SESS=6543!CTXT=5!UNIQ=8!APPLIC=celexext!FILE=VISU_visom_5_0_2IDGP=0!VI_all1#texte> (last checked June 7, 2002).


\(^{12}\) Id.

\(^{13}\) Centre for Environmental Informatics, Employment Protection (1998), <http://cei.sunderland.ac.uk/EU/employmentprotection.cfm> (last checked June 10, 2002).

both employers and employees. The system allows, in addition to receiving priority in insolvency to cover outstanding entitlements, for employees to be paid up to 80 percent of the national minimum wage for up to two years. It also aims to enhance the competitiveness and employability of the unemployed through training and job referrals in an attempt to speed their rejoining the workforce. Austria also has adopted a sector specific training program financed by unemployment insurance, which has improved considerably the employment prospects for its participants.15

Critics have called for the transformation of the current Chinese insolvency system. The system is not always consistent in its effort to maximize pacification and settle affected worker claims.16 Trade creditors’ claims are often ignored, due to the weak enforcement of contract law, and the employee rehabilitation fees paid out can vary between employees within the same company, creating further inequality.17 Thus, there is a lack of consistency in the treatment of claims in bankruptcy. China has been rapidly moving to modernize its laws to embrace and enable the new market-oriented economy, including in the area of insolvency, where a new draft insolvency law has been under development for some time. The current insolvency law has often not been applied to its full and logical extent. In a climate of high unemployment and an unstable economic environment, state-run enterprises in particular are reluctant to declare bankruptcy, and employees themselves attempt to delay the onset of insolvency proceedings due to the loss of the security of what was once considered to be a “job for life”. The unfortunate result of this is that employees are often forced to work for a second enterprise while awaiting the uncertain enforcement of the right to the entitlements still owing from the first.18


17 *Id.* at iii. These fees have been based on a formula that applies a multiplier to an employee’s current salary and takes into account length of service. In that sense, the formula and its application can be said to be generally consistently applied, even though the results may seem unequal.

18 The Chinese system, though admirable in its aims, still requires more rigorous enforcement by rule of law if the issue of protecting unviable enterprises is to be addressed and workers rights properly protected.

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Model Two: Bankruptcy Priority – No Insurance Approach

At the other extreme is the Mexican system, which has no insurance scheme to cover the difference between the entitlements owed and the value of the assets realized.\(^\text{19}\) Like a number of civil law systems, however, it does award first priority in bankruptcy to certain worker entitlements, such as payments of up to three months’ wages in lieu of severance pay. Despite being a new law (having been enacted as recently as 2000), the Mexican insolvency law has come under considerable criticism, especially for furthering the old law’s practice of favoring employees in a biased manner.\(^\text{20}\) This approach undermines the fundamental principle of secured creditors’ rights and increases the insolvency risk in commercial relationships. Moreover, in actuality it does not significantly enhance the protection of workers’ entitlements. Employees of insolvent, asset poor enterprises are often unable to find sufficient assets to assure payment even of the first priority employee claims in an employer’s bankruptcy and must fall back on Mexico’s underdeveloped social security system in a difficult labor market. This problem is compounded as owners and managers of financially distressed but viable companies operate them to the point of no return, while avoiding outside assistance for fear of being subjected to criminal sanctions for fraud.\(^\text{21}\) In this regard, the United States has also fared poorly on workers entitlement protection in international comparisons, due to its pro debtor stance and relegation of certain worker entitlements to third priority status within the unsecured creditor class.\(^\text{22}\)

Model Three: Bankruptcy Priority - Guarantee Fund Approach

Most developed countries use a hybrid system that gives workers’ predetermined entitlements some priority in bankruptcy, but also provides unemployment insurance in acknowledgement that often the remaining assets will be insufficient to cover outstanding entitlements. For example, the Danish system gives the highest priority among unsecured creditors to claims for

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salaries, wages and other employee benefits (behind administrative costs), with a Guarantee Fund as a safety net, should the assets prove to be insufficient. While this does afford the employee greater security in their rights to entitlements, and grants ready access to collateral for the secured creditors, it still raises concerns. Is it equitable, or indeed desirable, to deprive other unsecured creditors (such as trade creditors) – who, after all, possess the same contractually based claims as employees – equal access to the remaining assets? Predictability of outcomes underpins many of the principles of commercial law and should apply to secured and unsecured creditors alike; the process of priorities in bankruptcy can seriously undermine creditor/lender confidence in a system if it is difficult to determine what percentage of remaining assets one is likely to receive. An example of a system that clouds predictability by the retention of complicated priority structures is Australia’s, which delineates no less than fourteen claims that have priority over regular creditors in the unsecured creditors class.

Model Four: No Priority – Guarantee Fund Approach

One of the more predictable systems for creditors is that of Germany. The German model treats all unsecured creditors, including employees, the same and accordingly allows all of them equal access to the remaining available assets of an insolvent enterprise. Worker entitlements not satisfied through bankruptcy are paid out of a national insolvency fund. The only exception to this flat priority structure is the creation of a social welfare plan for those who face severe disadvantages due to their employer’s insolvency. Employees under the welfare plan are then awarded first priority in insolvency, albeit with a limitation to one third of all assets, thereby ensuring greater clarity and, consequently, greater creditor confidence in the process.

Strategy and Policy Considerations

The concept of an entitlement insurance protection scheme has been widely adopted throughout the developed world, and would appear to offer the most protection for worker entitlements while not interfering with the efficient distribution of credit in the market. What follows is a discussion of some

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elements to be considered in the construction of an insolvency social protection system.

**Bankruptcy Priority**

The approach adopted should properly balance policies that promote commercial confidence with those that support social protection measures. Principle 16 of the World Bank’s *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* addresses claims resolution in terms of the treatment of stakeholder rights and priorities. It states that insolvency and creditor rights systems, through commercial laws, should both preserve the legitimate expectations of creditors and, most importantly, encourage greater predictability in commercial relationships by upholding, to the maximum extent possible, the relative priorities of creditors established prior to insolvency. The easiest way to ensure this is to have a “flat” hierarchy of priorities, which only consists of two levels: first, secured creditors maintain recognized priority in their collateral; second, following satisfaction of administration costs, the remaining proceeds are to be distributed equally among the remaining creditors. The World Bank Principle states that there should be few if any deviations from this general rule, and these rules of priority should encourage creditors to manage credit effectively.

Principle 16 articulates a rule of best practice. It is not a straightjacket and indeed there may be exceptional circumstances that would justify a priority. This paper does not examine that question. Rather, it is suggested that the essence of Principle 16 strikes a proper balance and should be the goal even in regard to employee entitlements. Put differently, the contract governing the employment relationship should be treated the same way as other trade or service contracts.

In many developing countries, where private sector growth is imperative to ensure economic and social prosperity, ready access of private enterprises to

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27 *Id.*

28 The priority of administration costs over general unsecured creditors reflects the view that the administrator’s efforts in selling assets inures mainly to the benefit of this class, and consequently should be borne evenly by allowing these expenses to be paid first. This general rule recognizes exceptions where secured creditors gain a benefit from having the administrator maintain and dispose of secured assets, which might be surcharged for the activities associated with the effort to sale such assets. Other rules may also come into play, such as whether the administrator’s fees are actual, reasonable and resulted in a benefit to the estate.


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credit at reasonable terms is paramount. The more predictable and transparent the insolvency process, and the greater the chance of retrieving collateral in the advent of bankruptcy, the more willing lenders should be to lend at rates that reflect lower risk premiums. This is not to say that the repayment of employee entitlements is of less importance than payment of collateral, but rather that there may be more efficient ways of ensuring workers entitlements while still preserving a strong, predictable financing market.\(^{30}\)

### Insurance Funds

One way to ensure the payment of employee entitlements, while maintaining market confidence, is through an insurance fund. Insurance funds can reduce the burden of the unemployed on the state for interim social protection, although they would not entirely displace the necessity of providing protection for purposes of unemployment, retraining and other needs. On an economic level, an insurance fund may provide a higher degree of reliability to the markets, while at the same time affording stronger protection to employees to fulfill social objectives. Of the four models examined above, clearly the most effective are those that establish a guarantee fund as a backstop to the payment of employee claims in bankruptcy. In this author’s view, however, even those models do not go far enough.

The guarantee fund models rely on a “bankruptcy payment first” concept that requires employees to wait for a period of time (in some cases, months or even years) before they can top up the shortfall in their recovery from the guarantee fund. Many employees and their families can be left destitute while they await the accrued entitlements they are owed. This hardship can be magnified if there is a lengthy delay for payment on back wages and claims. Rather than forcing employees to linger during a potentially drawn out liquidation process, where assets have to be identified, realized and distributed, consideration should be given to establishing an immediate right of payment from the insurance or guarantee fund to settle worker claims up front.\(^{31}\) Upon satisfaction of the claims, the guarantee fund would be subrogated to the employee’s claims against the debtor to recoup any distributions to which the employee is entitled.

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\(^{30}\) It goes without saying that the same logic applies to priorities for public debt, which can also distort expectations in commercial relationships by allocating a firm’s insolvency risks to the general creditors. Notably, the United Kingdom recently moved to classify outstanding payments to the Inland Revenue Service as merely another unsecured debt. See section 251 of United Kingdom Enterprise Act 2002.

\(^{31}\) This assumes a claims resolution process either in bankruptcy or through another administrative procedure that would be dispositive of employee claims.
workers would be entitled. For example, if an employer in Belgium is unable to pay entitlements within fifteen days of the close of the business, the ‘Fund for Closures’ immediately commences payment on its behalf.  

Critics of insurance funds claim that they are expensive to run, punish successful companies, and benefit only certain employees. However, all these accusations are difficult to substantiate empirically, as a pure entitlement insurance fund system does not appear to have been comprehensively tested as yet. Although there may be greater cost burdens for business, the burden of the risk of insolvency would appear to be better carried through an insurance fund system prior to insolvency rather than the employees (or the general creditors) afterwards. Shifting the risk to the business and taxpayers in protecting employees is more consistent with the responsibilities and obligations assumed by the debtor and the state.

There are a number of ways in which a country considering such a system can attempt to reduce the cost burden to business. The existing forms of insurance already used widely throughout the developed world, albeit usually in a hybrid system that requires some alteration to be made to the order of priority in bankruptcy, is a good example of this. Some countries may require compulsory insurance through a government-run commission, while other countries require companies to have private insurance to cover worker entitlements in the case of bankruptcy. Still others require contributions by employees, although some question remains as to whether the workers themselves are best placed to bear these costs.

Another alternative used by many countries to minimize the cost of such a scheme to business, and particularly to small business, is by limiting compulsory insurance to only those companies with a predetermined minimum number of employees, e.g., businesses larger than 20 employees. Another option still is to limit the size of the payout either to a predetermined amount or to a percentage of entitlements owed. In Italy, for instance, an employee can only recover up to 80 percent of entitlements owing. Belgium restricts compulsory insurance to the for-profit sector. However, this creates uncertainty as to the security of entitlement payouts for employees in the non-profit sector.


34 EMIRE, Italy: Wages Guarantee Fund (CIG), <http://www.eurofound.eu.int/emire/ITALY/WAGESGUARANTEEFUND%C3%85%20.html> (last checked June 25, 2002).
Another option assumed by states attempting to reduce the cost burden of entitlement payouts is by limiting the types of entitlements that employees can claim. Some states expressly exclude outstanding holiday pay from priority payments, while others use a combination of included/excluded entitlements, such as commissions, outstanding sick leave, and maternity leave. The availability and level of severance pay also varies widely.

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

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

Presently, Japan avoids the use of worker entitlement insurance by allowing for any difference between realization of company assets and the amount outstanding under worker entitlements to be met through consolidated revenue. At a time when the country is facing difficult fiscal choices, insufficient resources could weigh in favor of an economic stimulus package as opposed to immediate satisfaction of back claims. The choice of policy makes for a high wire act of rectifying the past or building for the future. Countries with more scarce resources would no doubt find little justification to follow the past.

Notwithstanding the above, an ideal employee entitlement insurance system would allow for the prompt repayment of 100% of worker entitlements owing. But in the initial stages of building this fund from scratch to a point

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where it could withstand a major insolvency may take considerable time. To overcome this problem, one solution may be the Australian model, which consists of a temporary government fund designed to cover entitlement payouts until the newly implemented insurance system has built sufficient capital to operate in its own right.\(^37\)

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

**Other considerations**

Although beyond the scope of this paper, another element for consideration would be the role of outstanding contributions to pension/superannuation schemes. This raises the issue of employees who are left with a savings portfolio that consists either of currently worthless stock in their former employer, or an employer-administered pension plan which is now subject to liquidation. Consequently, a country looking to implement an insurance scheme would need to consider whether such an scheme should be obliged to cover outstanding payments to pension funds, or whether this would be considered too great a cost burden.

In addition, while not addressed in detail above, many countries also provide a substantial role for worker unions in determining the most appropriate way to deal with mass redundancies and ensuing worker entitlements. There remains room for further discussion as to how a collective bargaining insolvency agreement would affect the order of creditor priority and, indeed, whether they would be necessary under an insurance scheme such as the one proposed above.

Other specific issues worthy of consideration in a law relating to employee entitlements is the place of victims of work-related injuries who perhaps stand to lose the most in countries without well-developed social

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\(^37\) Australian Workplace, *General Employee Entitlements and Redundancy Scheme (GEERS)*, [http://www.workplace.gov.au/Workplace/WPDisplay/0,1251,a3%3D3649%26a0%26a1%26a2%26a3%3D26a1%26D517%2626a2%253D623.00.html](http://www.workplace.gov.au/Workplace/WPDisplay/0,1251,a3%3D3649%26a0%26a1%26a2%26a3%3D26a1%26D517%2626a2%253D623.00.html) (last checked July 17, 2002).

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protection systems if the former employer becomes insolvent. Brazil\textsuperscript{38} and, to a lesser extent, Australia\textsuperscript{39} have made specific provisions for compensation to injured workers to be given higher priority in bankruptcy.

Section III, Article 8, of the Council of the European Communities Directive 80/987/EEC seeks to protect the rights of employees who left a business before its insolvency and had maintained rights with regard to old-age benefits in company pension schemes outside the national statutory social security schemes.\textsuperscript{40}

**Conclusion**

Currently there does not seem to be a perfect legal scheme for handling employee entitlements in the event of employer insolvency. Some are clearly more effective than others. Each of the schemes examined in this paper are flawed in certain ways, as 100 percent of employee entitlements are never fully protected or predictability for creditors is decreased. Employees in insolvency proceedings tend be treated as neither “fish nor fowl” – neither creditors nor equity – with no vested financial stake in the bankrupt entity (outside of employee stock option plans). Yet, employees universally have the most to lose, as their families’ livelihood generally depends upon the wages and benefits for work performed.

Many, maybe most, families around the developing world live on the edge or hand-to-mouth, making the consequences of unemployment even more burdensome for them and the state. Additionally, employees are generally not privy to the exact financial status of their employers, so bad news may be highly unexpected and not well planned for. As perhaps the most vital part of businesses everywhere, the common employee deserves to have legal protection of his/her employment claims.

The purpose of this paper has been to examine the varying legal treatment of employee entitlements in the case of employer insolvency and to encourage developing countries to develop insolvency laws which both achieve market


\textsuperscript{40} The Council of the European Communities, *Council Directive 80/987/EEC on the approximation of the laws of the Member States relating to the protection of employees in the event of the insolvency of their employer* (1980), \texttt{<http://europa.eu.int/celex/cgi/cgi/sga_rqst?SESSE5=6543!CTXT=5!UNIQ=8!APPLIC=celexext!FILE=VISU_visom_5_0_2!DGP=0!VI_all1#texte>} (last checked June 7, 2002).
strength and efficiency while protecting the rights of those most vulnerable in the insolvency process.

This paper does not aim to suggest that an entitlement insurance fund is a cure-all in times of large corporate redundancies. Clearly such a system needs to be supported by active labor market programs, such as retraining, job search assistance and public works programs. Insurance or guarantee fund systems, however, could significantly increase the potential for employees to realize their entitlements while minimizing the insolvency risks for other commercial stakeholders and providers of credit and goods.

Appendix

Table 1