Chapter 11: Strategic Advantage and Social Anathema?

ABSTRACT. The United States is at a crossroad in its treatment of Chapter 11 of the Bankruptcy Code, which deals with reorganization of “bankrupt” organizations. It is vital that the issues surrounding the debate be properly framed. This paper attempts to do just that by reviewing the evolution of bankruptcy law, assessing the impact of Chapter 11 leniency on societal stakeholders, considering bankruptcy as a strategic option, and addressing the ethical and societal issues that arise from the use of Chapter 11 to avoid massive litigation or to abrogate labor contracts. Serious threats to the underlying fibers of the American system of enterprise are exposed and an assessment of these threats is offered.

In the increasingly intense race for profitability — and often survival — in today’s corporate arena, pressure for innovative strategies compels strategists to exercise any and every legal option they have for their companies’ long run benefit. Meeting this head on is the voice of the public, expressing its consternation over the business community’s assertiveness in redefining the competitive nature and societal role of the American business sector. In no other situation is this conflict so clear as in the case of business reorganization, as established under the reorganization chapter of the Bankruptcy Law. Here, several profitable companies are employing Chapter 11 to protect themselves, claiming imminent bankruptcy, from lawsuits and contracts that damage their competitiveness. While legal, such actions are of a questionable ethical nature.

This paper attempts to help frame the societal, ethical, and strategic sides of bankruptcy laws. We start by looking at the evolution of bankruptcy laws.

The evolution of bankruptcy law

In its earliest forms the bankruptcy laws, from which the contemporary U.S. laws derive, were far from conciliatory. Indeed, prior to the adoption of early Roman laws, the debtor who could not pay “was either killed, made a slave, imprisoned or exiled” (Ross, 1974). Evolving bankruptcy law in Italian society existed not to relieve the debtor, but to aid creditors in collecting their claims.

After spreading throughout Europe, these roots of bankruptcy law were transplanted to England by Henry VIII in 1543 (Riesenfeld, 1974). With time, provisions allowing debtors adjudged “honest” to avoid imprisonment were devised, though most debtors were still severely punished and were subject to destruction of their benches or trading places — banca rotta.
Italian law or banquerote in French law, hence the English “bankrupt” (Radin, 1940). English Bankruptcy law, while restricting many harsh penalties such as debtor dissection and detention of deceased debtors, still employed types of debtor imprisonment (May, 1912). It was this package of laws that was imported by the framers of the U.S. Constitution and the Bankruptcy Act of 1800 (Statutes at Large, 1800).

Only toward the end of the nineteenth century did modern protection enter the bankruptcy law, ushered in by the fourth Bankruptcy Act, passed by Congress in 1898 (Kansas Law Review, 1983). As revised by numerous amendments and the Chandler Act in 1938, the newer bankruptcy law provided for reorganizations, as well as liquidations, so that the

“honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy... [is given] a new opportunity in life and a clear field for the future effort, unhindered by the pressure and discouragement of preexisting debt” (Act of June 22, 1938; Local Loan Co. v. Hunt; emphasis added).

Growing criticism of the bankruptcy system during the 1960’s led the Congress to create the Federal Commission on the Bankruptcy Laws of the United States to study and recommend revisions of the 1898 Act (Public Law 91–354). The need for reform was voiced by this body which pointed to costly and nonsubsequential litigation, nonuniformity in application of the law, and the rising volume of consumer bankruptcy since World War II (Trost, et al., 1978). The nonuniformity problem addressed here reflects the impact of numerous state laws on bankruptcy. Ultimately, the Commission recommended a complete revision of the bankruptcy system and of the substantive law. The result was the adoption by Congress of the Federal Bankruptcy Reform Act of 1978 (the Bankruptcy Code – see Public Law 95–598).

The Reform Act made substantial progress toward improving the efficiency and effectiveness of the process. Included in the changes were a consolidation of reorganization provisions under the current Chapter 11, which stands as one of the four operative chapters of the Bankruptcy Code along with Chapter 7 (liquidation), Chapter 13 (for individuals with regular incomes), and Chapter 15 (for municipalities) (Riesenfeld, 1975). Businesses can generally file under Chapter 7, Chapter 13, or Chapter 11, where appropriate. The appositeness of filing under Chapter 11 is of primary concern here; however, before proceeding with a closer look at Chapter 11 and subsequent actions taken regarding reorganization it is necessary to take note of one further change brought about by the Reform Act.

Under the Reform Act, the former referees in bankruptcy were given greater judicial status. Suffice it to point out that these referees were given Article I (of the Constitution) status and Article III powers. [Article I judges are appointed for fourteen years with no salary stability guarantees; Article III judges are appointed for life by the President, as confirmed by the Senate, and are guaranteed no salary cuts.] In 1982, the Supreme Court ruled the Reform Act unconstitutional and only in late June of 1984 following numerous delays and interim actions, did Congress compose a new, and controversial, arrangement of judicial powers for the Bankruptcy Code. The new system gives (Article III) Federal District Judges oversight over bankruptcy court rulings, while maintaining Article I status for bankruptcy judges. Reaction has been quick and harsh, as many have questioned the constitutionality of the new arrangement, as well as the potentially burdensome impact it could have on the court system (Dahl, 1984).

The importance of this debate over the constitutionality of the new bill lies in the inclusion of several Chapter 11 alterations included in the bill that could have a serious impact on “questionable” Chapter 11 filings and thus on its use as a strategic option by corporations. Most importantly, as we shall see subsequently, the societal redefinition of Chapter 11 in terms of the ethics underlying its usage currently hangs in the balance.

Chapter 11 and its evolution

Chapter 11 exists to allow rehabilitation, not