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Chapter 11 Bankruptcy: The Ambulance at the Bottom of the Corporate Fraud Cliff

Jacob Strain*

Offering Chapter 11 bankruptcy privileges to corporations that have gone bad because of fraudulent activity actually increases the incentives and opportunities for corporations to become involved in corporate fraud.

Flying over the Boca Raton Resort in Florida offers one a good opportunity to observe an enormous luxury home being built by Scott Sullivan, the former chief financial officer of the WorldCom corporation that recently filed the largest Chapter 11 bankruptcy in U.S. history. Since being indicted with falsifying WorldCom’s accounting books by more than 3.8 billion dollars, Sullivan has been rushing to complete his family’s mansion before his trial is finished. Under a Florida state law called Homestead Exemption, family homes are protected from creditors so long as they are occupied. If Sullivan were to declare bankruptcy, he would doubtlessly keep the “lavish 15 million dollar estate, complete with a movie theater and six jacuzzis.”

As the Homestead Exemption Law is working for Scott Sullivan, Chapter 11 bankruptcy laws allow corporations involved in corporate fraud to retain their own corporate “jacuzzis” and “movie theaters”—despite their fraudulent activity. In fact, according to the FDIC, the largest Chapter 11 filings in history (including WorldCom, Enron, Global Crossing, Adelphia Communications, ImClone Systems, Tyco International, Dynegy, Computer

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Associates, Qwest, and dozens of other companies) were all consequences of corporate fraud. These corporations have all fallen off the corporate fraud cliff and have entered into the Chapter 11 bankruptcy. Without attacking the ethical implications of corporate liability, the purpose of this research is to show that offering Chapter 11 bankruptcy privileges to corporations that have gone bankrupt because of fraudulent activity actually increases the incentives and opportunities for corporations to become involved in corporate fraud. Furthermore, this research will explore possible solutions to this problem and determine if American business can be trusted.

THE PURPOSE OF CHAPTER 11 BANKRUPTCY LAWS

The infamous Chapter 11 bankruptcy code is a series of laws passed by Congress in 1978 whose original purpose was to dispel the confusion of former corporate bankruptcy laws. These new laws have allowed bankrupt corporations to continue operating and avoid liquidation. Corporations who file for Chapter 11 are given court protection from their creditors so that they are able to reorganize the company with a plan to meet their financial obligations. The petition for Chapter 11 includes a schedule of debts, assets, and income potential. After the chapter is filed, a judge supervises a reorganization process of the company. The regular management of the corporation runs the everyday business operations, but all significant decisions must be authorized by the bankruptcy court.

In some cases the company is saved, creditors are repaid, workers remain employed, shareholders stay safe, pension plan holders are protected, and the economy as a whole benefits. In these successful cases, Chapter 11 is an ideal method for saving a good company that has run into bad luck.

CHAPTER 11 UNDERMINES THE MONETARY CONSEQUENCES OF FRAUD

Unfortunately, Chapter 11 has become the everyday method for saving companies whose distress results from shady business practices. “A natural and characteristic consequence of fraud is monetary damage because criminal conduct can cause a healthy company to fall into financial despair.” Yet, allowing corporations involved in fraud to enjoy the protection of Chapter 11 bankruptcy suppresses those monetary consequences which act as an important deterrent of fraud. Ironically, one of the best ways to deter a corporate scandal is by permitting one of its typical consequences—financial ruin.

Criminologists agree that monetary consequences are an effective means of deterring corporate fraud. This assumption is based on the belief that corporate criminal activity is a profit-motivated behavior and can best be deterred by monetary punishment. In this regard, Chapter 11 bankruptcy creates an extensive problem. For example, the Enron scandal resulted in the second largest Chapter 11 bankruptcy in U.S. history. Under its Chapter 11 bankruptcy reorganization plan, the Enron corporation will pay creditors less than one-fifth of the estimated $67 billion they are owed. Offering Chapter 11 bankruptcy to corporations that have debts incurred from corporate swindling greatly removes the deterring monetary consequences of their illegal actions.

Despite the evidence that Chapter 11 bankruptcy undermines the natural monetary consequences of fraud, bankruptcy laws uphold that the chapter should be offered to businesses involved in corporate crime based on the assumption that there are two kinds of debt: debt incurred from fraud and legitimate debt. It is believed that an incriminated corporation should be able to receive court protection for legitimate debt just as a nonincriminated company would. Under the current laws, debts generated from

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fraudulent or criminal actions are not dischargeable and remain owed to the creditor. However, in most cases, judgments of chargeable debts incurred from misconduct are grossly understated.

Once corporate misconduct has occurred, it is extremely difficult to differentiate between debt incurred from the offense and from legitimate debt. In the case of WorldCom, the corporation found itself $30 billion in debt because of fraudulent activity, yet the court fines based on debt produced from misconduct were only $750 million. It is highly improbable that with a total debt of that magnitude, resulting primarily from corporate misconduct, only 2.5 percent of the debt resulted from fraudulent behavior. In many instances, corporations like WorldCom are permitted to file for Chapter 11 bankruptcy even when much of their debt has been generated by misconduct. Though Chapter 11 laws obligate businesses to pay their debts contrived from wrongdoing, there is little evidence that such debts are being paid.

Until fraudulent debts can be correctly calculated and collected, Chapter 11 bankruptcy privileges should be withheld from corporations liable for fraud. In withholding these privileges, corporations would be motivated to take more precautionary measures in protecting themselves against corporate misconduct.

CHAPTER 11 UNDERMINES EFFECTIVE PREVENTATIVE MEASURES

Regulation is essential in the prevention of corporate fraud. Toby Bishop, president and chief executive officer of the Association of Certified Fraud Examiners, discusses a fundamental approach to dealing with corporate fraud: "We need to focus on improving our prevention and detection measures to reduce the chance of it [fraud] occurring and to catch it sooner when it does occur, as it inevitably will." Ideally, corporations themselves would take such prevention and detection measures.

Many business professionals agree that the most effective way to regulate fraud within a corporation is through a Human Resource Management (HRM) program. For most corporations, the HRM personnel determine whether a company develops an ethical or unethical climate. HRM departments place great emphasis on policies and programs that compel employees to exhibit ethical behavior while protecting the corporation from criminal activity. HRM tasks include employee screening and selection, employee training, establishing ethics codes, creating employee reward systems, developing whistle-blowing policies, creating and maintaining ethical working conditions, and firing employees.

However, Chapter 11 bankruptcy hinders the development of self-regulatory programs in many firms by providing companies involved in fraud with a safety net. As stated in a legal dictionary under bankruptcy, "The concept [behind Chapter 11] is to give someone a fresh start, but it has often led to careless, profligate business operations and casual running up bills with those giving credit being badly hurt by bankruptcies." One of the hazards of the availability of Chapter 11 bankruptcy (and bankruptcy in general) is the associated negligence. Chapter 11 bankruptcy provides a safety net for incorrigible corporations and can prompt other corporations to take higher risks for gain at a lower cost of losing.

One of the more common risks taken among corporations is the elimination or underfunding of self-regulatory programs such as the HRM. Firms tend to cut funding of HRMs and other safety programs, particularly at times when the business is struggling. Corporations may also feel that they do not need to thoroughly self-inspect or regulate in defense of corporate fraud in part because self-regulation is so costly and time consuming. The corporation may rationalize that the likelihood of someone committing fraud in the firm is slim, and as a last resort, the company can reorganize under Chapter 11. With Chapter 11 as a support, corporations find it less necessary to regulate themselves in order to deter corporate misconduct.

8 English, “Former Executive Faces Charges over WorldCom.”
11 Ibid.
12 Online Law Dictionary, “Bankruptcy.”
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Because self-regulation programs are absent, the primary regulation of fraud is conducted by the U.S. government. With an army of organizations, agencies, and programs, the U.S. government wages a war against corporate fraud. There are roughly 14,000 companies overseen by a governmental agency called the Securities Exchange Commission (SEC). However, with the recent increase in corporate fraud and the budget constraints of the SEC, some argue that the government is not able to adequately deter corporate fraud.

As the government faces constraints and as self-regulation decreases, the chance of corporate scandals greatly increases. A wise saying explains that it is better to have a fence at the top of a cliff than an ambulance at the bottom. In this comparison Chapter 11 bankruptcy is the ambulance and corporate self-regulation and self-inspection are the fences. Though prevention and regulation seem less painful, trends indicate that more corporations are falling over the cliff of fraud and getting into the Chapter 11 ambulance. Offering Chapter 11 bankruptcy to corporations involved in fraud decreases the amount of self-regulation and self-inspection of other corporations and increases the amount of corporate fraud because of enhanced confidence in government bailouts in the face of trouble.

Some would argue that Chapter 11 has no bearing on self-regulation because corporations will regulate themselves regardless of what bankruptcy is offered by the courts. They claim that it is too detrimental to allow a firm to bankrupt itself because of criminal activity, even if the government allows reorganization. Since Chapter 11 is not foolproof and because its outcomes are not always favorable, some argue that corporations are not willing to take the risk of filing for Chapter 11 bankruptcy; therefore, corporations would self-regulate even with the current laws.

Many believe bankruptcy is “just about the most serious and drastic financial measure that a business debtor could undertake” and that Chapter 11 bankruptcy is risky and costly. According to this argument, corporations have sufficient incentives to effectively self-regulate. However, the popularity of the law among corporate America weakens this approach. In the sixteen years since the effective date of this bankruptcy code, nearly 300,000 cases have been filed under Chapter 11. That is an average of 18,750 Chapter 11 bankruptcy filings per year. The fact that there are a large number of bankruptcy filings each year and the increasing frequency at which they occur, indicates that although there might be high risks or costs involved, Chapter 11 bankruptcy provides debtors with some remarkable benefits.

**Solution**

In order to increase incentives for corporations to self-regulate and self-inspect against corporate crime, Chapter 11 bankruptcy should be withheld from corporations involved in criminal activity. This solution embodies the criminologist “idea of punishing a group because it will turn its anger [regulation] on the wrongdoers in the midst.” Offering Chapter 11 bankruptcy laws to corporations guilty of misconduct impedes the development of more beneficial self-regulation programs. Consequently, Chapter 11 bankruptcy availability to incriminated companies, perpetuates corporate fraud.

As this research has indicated, a possible solution is to withhold all Chapter 11 bankruptcy benefits from corporations meeting financial disaster as a result of corporate fraud. And yet, the implications of this solution are far reaching and seemingly harsh. This solution would create short-term economic difficulty for those most directly linked to the failed firm. Those possibly affected by such a collapse may include shareholders, investors, creditors, pension plan holders, employees, and the economy. However, this short-term difficulty will lead to the deterrence of corporate fraud, and these groups will benefit more substantially in the long-run. Under this system, monetary consequences will be enforced, self-regulation plans will be entitled, long-run damages from fraud would be minimized, and society would benefit immensely as a whole.

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Corporate misconduct can forcefully be addressed by selectively withholding Chapter 11 bankruptcy rights. As incriminated corporations lose protection, this will allow monetary repercussions and induced growth of self-regulation programs to deter fraud. In this way, selectively withholding Chapter 11 bankruptcy will decrease incentives and remove opportunities for firms and individuals to become involved in corporate fraud.

As this discussion has demonstrated, there is no reason to accept billion-dollar corporate scandals as a part of everyday life. Deceit is something Americans do not have to live with. There is no justification for allowing corporate fraud to damage our lives, our economy, or our nation. There are solutions to the problems of corporate America; they need only be implemented. The best way to prevent fraud is to stop it before it starts. The best time to reorganize a corporation is before it has been devastated by misconduct. Corporate America has reached a juncture where fences are needed instead of ambulances. Until these fences are soundly implanted, American business cannot be trusted.