When the Going Gets Tough, the Tough Go Bankrupt
The Questionable Use of Chapter 11 as a Strategy

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The 1978 Bankruptcy Reform Act was intended to make reorganization easier and more successful. However, the law may have removed so much of the risk from bankruptcy that filing is now considered an effective management strategy. Yet there are several practical, logical, public policy, legal, managerial, and definitional problems with the strategic use of bankruptcy. This article discusses these problems and argues that decision makers should not think of bankruptcy as a viable strategy but should rather concentrate on ways to prevent it.

The 1978 Bankruptcy Reform Act and its amendments were intended to make corporate reorganization easier and more likely to succeed (Cifelli, 1983). The idea was that it would be easier for a declining corporation to recover if it filed for reorganization before it lost its value, ran down its physical plant, and saw most of its quality staff leave. However, because the law no longer required that a company be insolvent before filing for reorganization, managers found that they had great leeway in determining the proper circumstances and timing of such a filing (Martin, 1983). Thus the bankruptcy law provided managers with a device that would allow their organization, almost at will, to escape from most any undesirable financial obligations.

The discretionary nature of the 1978 bankruptcy law prompted many to think of bankruptcy as a strategy (Slaughter & Worton, 1991). Before the law was 4 years old, one author (Cifelli, 1983) claimed that reorganization under Chapter 11 of the Bankruptcy Code was “an effective management strategy” (p. 69). A more recent example in the business press (Farrell, Carson, & Schiller, 1988) stated, “Bankruptcy is now a business strategy, a way to solve a problem” (p. 85). Strategy theorists have also made similar claims. For example, a recent article by Flynn and Farid (1991) called Chapter 11 “a viable strategic option” and suggested guidelines as to when might be the most strategically advantageous time to file for bankruptcy. Although it may seem unlikely that going bankrupt

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could be advantageous at any time, this is not necessarily the case. Research has suggested that under some circumstances bankruptcy may be effectively used as a strategic tool for helping to create value for the shareholder (Sirower, 1991).

In a great many cases, bankruptcy is no longer seen as failure but a strategy that can be employed to give the firm a fresh start. In other words, bankruptcy is now viewed as a way of turning an old, flabby, tired, and docile firm into a new, lean, mean fighting machine. It’s almost as though Chapter 11 were a fitness center and some huckster were singing the praises of the companies that have “emerged from the bankruptcy spa with great new figures.” One could imagine an endorsement from Texaco: “We were able to shed the extra weight we gained in the liabilities area after we gobbled up Getty and had a bout with Pennzoil.” There are probably many other cases of clients at what one might cynically call the “Federal Bankruptcy Weight Loss Clinic” who could also speak of their ability to shed hundreds (of millions) in excess fat gained from of overindulgence at the diversification and expansion banquets.

Is this reduction racket what the lawmakers intended? Possibly. However, as will be discussed, it is doubtful that Congress had in mind the extensive use of this law to allow firms to be relieved from almost any unwanted financial commitment. Managers can indeed employ Chapter 11 to “lose fat” from their organizations, and I will look at the various ways reorganization can help businesses complete such an endeavor. However, I will also contend that due to some important practical, logical, legal, and public policy problems Chapter 11 is not a “strategy” or even a realistically viable management tactic. Before getting to that, a brief review of the bankruptcy law would be best. After the review, I will look at the advantages and disadvantages of the use of Chapter 11 as a strategy. Finally, I will conclude with some recommendations on what might be a more appropriate way to view Chapter 11.

**THE BANKRUPTCY LAW**

The original U.S. Bankruptcy Act of 1898 addressed only business liquidation and not reorganization (Altman, 1971). Bankruptcy Act revisions in the 1930s formally brought the idea of corporate reorganization into the bankruptcy law (Altman, 1971). In the late 1970s Congress amended the law to allow businesses greater flexibility to reorganize. This change in the law was predicated (in part) on the perception that firms that may have been viable if reorganized were often forced to liquidate because of the legal requirement that they be insolvent (liabilities exceeding assets) before they could file for reorganization (Engel, 1984; Lubove, 1991). The 1978 law removed this insolvency restriction so that declining firms could file before they went too far downhill. There was also an additional incentive for managers who might be reluctant to file for bankruptcy. Unless there were findings of dishonesty or incompetence, the law allowed managers to stay in charge of their company while planning how to reorganize rather than having the court appoint a trustee (Schwandt, 1981). Thus managers could keep their jobs, the company could be saved, and, therefore, the economy would benefit because jobs and productive assets would be preserved (Sherman, 1991).

An additional problem with the new bankruptcy law was that it allowed reorganizing companies to unilaterally reject labor contracts. Because companies no longer had to be insolvent to enter Chapter 11, it became tempting for firms to go bankrupt simply to avoid overly burdensome labor contracts. When companies like Bildisco (who set the legal precedent in 1982) and Continental Airlines used this tactic to break their union contracts, there were howls of public protest (e.g., see Dentzer, McAlevey, Shapiro, & Weathers, 1983). In 1984, the law was therefore altered again to compel debtors to bargain with its unions in good faith or get court approval before being able to modify the contract (Pulliam, 1985). Because of these legal changes, the tactic that allowed Frank Lorenzo to successfully break the union at Continental Airlines in the early 1980s failed to break the union at Eastern Airlines several years later.

The current law, however, still has some great advantages for those managers who choose to file for Chapter 11. The law can allow companies to file Chapter 11 to fight lawsuits, break many types of contracts, and even resist the Internal Revenue Service (IRS; Cifelli, 1983). The law is a pretty popular one, too. Over 60,000 filings and a total of $82.7 billion in assets went into the bankruptcy courts in 1990 (Duncan, 1991; Sherman, 1991).

**EMPLOYING CHAPTER 11 TO AID THE FIRM**

What does the current bankruptcy law do for an organization? Can it really be advantageous to go
bankrupt? If a company’s debts are high and its funds are low, if its creditors are pounding at the door, if its attorneys’ offices are being swamped with lawsuits, if its assets are being seized by the IRS, or its legal agreements are simply disadvantageous, can Chapter 11 help the firm? Yes! Not only can bankruptcy help the firm, but under some circumstances it can be handled expeditiously and at apparently low cost. In addition, under Chapter 11, organizations can continue to grow, corporate officers can keep their jobs, and managers can create value for the shareholders. If you are in doubt, simply read on.

Bankruptcy can certainly help in cases where the firm has expanded too quickly with too much debt financing. Argenti (1976) lists this reason as one of the primary causes of business failure. Thus, if debts are high, funds are low, and creditors are pounding at the door, bankruptcy can stop the racket immediately. In all cases, the law allows for an automatic stay of the creditors’ claims for 120 days during which time the debtor has the exclusive right to file a plan of reorganization (Schwab, 1981). Frequently this “period of exclusivity” can be extended, as has been done for LTV for the last 5 years (Lubove, 1991).

If lawsuits are piling up in the corporate attorneys’ offices, follow the lead of Manville and A. H. Robins. It’s difficult to deal with a confusing array of claims for injury and pain and suffering from a massive number of plaintiffs. It would be easier, not to mention cheaper, to simply handle them all at once. Instead of fighting 16,000 separate lawsuits which, in total, would likely empty company coffers (and then some), Manville, in one swift Chapter 11 filing, hailed them all into bankruptcy court simultaneously to force a settlement (Cifelli, 1983). To remove the crushing weight of its legal burden, A. H. Robins entered into bankruptcy in 1985. At the time of filing Robins had already paid about $500 million in claims to over 15,000 former Dalkon Shield users (“Also in the Chapter 11 Club,” 1986). At the same time, Robins had 5,100 lawsuits pending and 400 new ones arriving each month (Steiner & Steiner, 1988). Through the help of Chapter 11 reorganization, Robins stayed in business. However, Chapter 11 cannot solve all ills. A. H. Robins’s head, E. Clairborne Robins, Jr., lost his job when the company was sold to American Home Products (AHP) 4 years after the bankruptcy filing (Baldo, 1990). The jobless Mr. Robins, however, may be comforted by the $140 to $180 million of AHP stock he will split with his father as a result of the sale of the company (Baldo, 1990; Shereff, 1989).

One need not have lawsuits piling up to go bankrupt, however. Chapter 11 can help if you simply have one big lawsuit weighing your firm down. Texaco was able to shed $7.5 billion of the $10.5 billion it owed to Pennzoil because of Texaco’s interference in Pennzoil’s attempt to buy Getty Oil (“American Bankruptcy,” 1989).

There are several types of disadvantageous contracts that Chapter 11 can help businesses avoid. As was mentioned previously, labor contracts can be voided with court approval. Also, under Chapter 11 failing retailers can be let out of unprofitable leases. This clause helped HRT Industries shut down 55 of its 192 retail outlets and regain profitability (Cifelli, 1983).

If the IRS is seizing the firm’s assets, the company only needs to follow the lead of Whiting Pools of Fairport, New York. In 1981, a day after the IRS seized most of its assets, Whiting went into Chapter 11. A district judge ruled that the IRS had to return the property and stand in their designated place in the line of creditors (Cifelli, 1983). This is not to say that one can prevent the IRS from getting the taxes owed but simply that the IRS must wait until the claims of other unsecured creditors with priority (bankruptcy administrators, normal business expenses, certain wages and benefits, and claims from consumers) are satisfied before receiving what is due to it (Anderson, Fox, & Twomey, 1980).

Surely a company can’t continue to grow when it’s bankrupt. Don’t tell this to the folks at Eagle Clothes. While in Chapter 11, Eagle (a company losing $3 million on sales of $6 million) took over profitable retailer April-Marcus. Like the mythical phoenix, this company rose from the ashes. One year after Eagle took over April-Marcus the combined company had a profit of $5 million on sales of $94 million (Cifelli, 1983).

Managers who might otherwise fear job loss will be allowed to stay in control of the firm that they drove into the ground. Unless the court determines that there is gross mismanagement, fraud, or dishonesty, management will be given the time to develop a reorganization plan and execute that plan (Schwab, 1981). Witness Frank Lorenzo’s ride into, through, and out of the Continental Airlines bankruptcy in the early 1980s (“American Bankruptcy,” 1989).

Additionally, Chapter 11 need not be overly burdensome. By using the newest twist in the bankruptcy game, a “repackaged” bankruptcy, managers can save their company considerable effort, time, and money. By negotiating with creditors before filing a bankruptcy petition, the firm can reemerge from bank-
rupty in months or even weeks, instead of the years of a standard Chapter 11 (Sherman, 1991). Southland Corporation, owners of the 7-11 convenience chain, were in and out of bankruptcy in just 4 months (Light, Woolley, & Forest, 1991).

Even without a “prepack,” a firm may not find Chapter 11 overly burdensome. An organization may find that bankruptcy can even create value for the shareholders (Sirower, 1991). It seems oxymoronic that bankruptcy can be a strategic tool to create value for the shareholder. However, Sirower (1991) tells us that “seeking Chapter 11 protection from creditors serves as a strategic planning tool for increasing shareholder value in large (i.e., Fortune 1000) troubled companies” (p. 46). He further explains the decline process as a “value destruction strategy.” In a process similar to Hambrick and D’Aveni’s (1988) “downward spiral,” troubled companies invest in projects that yield returns that are much lower than the cost of funds; any cash flows generated are basically plowed back into these “value destructive investments,” and the end result is that, in the long run, the value of the company is nearly destroyed. However, Chapter 11 can save the day.

Sirower (1991) tells us that “it is possible to view Chapter 11 as a major component of a value creation strategy” (p. 47). He reminds us that since Chapter 11 gives the firm the ability to reject certain contracts, firms can begin to rid themselves of contracts that were the main components of their value destructive investments. Additionally, the company is allowed to defer interest and dividend payments. These deferrals mean that the company now has the money to invest in value creation activities that were previously unapproachable. Sirower goes on to state that “a Chapter 11 decision should be viewed as a positive strategic action toward reversing decline and creating value in a severely troubled company facing possible liquidation” (p. 48).

The proof of these contentions is fairly convincing. Sirower (1991) found “a dramatic reversal of the negative shareholder returns that prevailed prior to a Chapter 11 filing in large troubled firms. Significant positive returns begin to accrue to shareholders of these firms immediately following the day of the Chapter 11 announcement” (p. 49). Even more convincing was that in the year following the Chapter 11 announcement, shareholders earned a risk-adjusted excess return of over 90%! After years of shareholders losing on their investment, Chapter 11 seems magical.

Sirower is not alone in his observation that investors can make a good return from bankrupt corporations. Altman (1969) found higher than average returns on investments in common shares of bankrupt companies. Platt (1985) found similar results regarding investors in bonds of bankrupt companies. There are even guidebooks to help you to invest in bankrupt firms (e.g., Ramaswami & Moeller, 1990). If we needed further proof of the value of Chapter 11, we need simply ask Wall Street. In 1988, around $500 million was raised for the purchase of securities in firms that had filed Chapter 11 (“American Bankruptcy,” 1989).

In conclusion, there is great support for using Chapter 11 as a strategy to aid the long-term survival of the organization. Cielli’s (1983) early contention that Chapter 11 was “becoming an effective management strategy” (p. 69) seems to now be well supported. This contention is supported by Flynn and Farid’s (1991) theory that, “In the context of strategic planning, Chapter XI can be regarded as a viable strategic option for long-term survival” (p. 72). The argument is further supported by Sirower’s (1991) conclusion that “the evidence clearly supports the notion of Chapter 11 as a strategic planning tool for large severely troubled firms that . . . has been used successfully for value creation and the avoidance of organizational demise” (p. 50).

Thus Chapter 11 appears as the manager’s manna—it mysterically appears from heaven to support and sustain the enterprise. You may say nothing could be so perfect. There must be some drawbacks to Chapter 11—if there weren’t, everyone would employ this strategy. Well, my skeptical friend, there may be a few problems with the strategic use of bankruptcy.

THE DRAWBACKS TO CHAPTER 11

Now that you’ve read some of the promotional literature for Chapter 11, it might be tempting to sign your company up for what I have cynically called the Federal Bankruptcy Weight Loss Program. Before you do, however, maybe you should read the fine print. What the fine print will tell you, in general, is that there are several definitional, practical, logical, public policy, legal, and managerial problems with the strategic use of bankruptcy. Your attorney could best explain many of the details, but some of them are worth discussing here.

Definitional Problems With Using Chapter 11 as a Strategy

Mintzberg (1991) gives five definitions of strategy: a plan, a ploy, a pattern, a position, and a perspective.
These are not mutually exclusive definitions, so more than one may apply to defining bankruptcy as a strategy. Yet maybe none of them apply to “strategic” bankruptcy.

The first definition that Mintzberg (1991) gives for strategy is that it can be considered a plan. In general this means that the firm is undertaking a “consciously intended course of action, a guideline (or set of guidelines) to deal with a situation” (p. 12). As a plan, Chapter 11 could be considered a guideline to deal with a situation. Yet if we define a plan as an intended course of action, then it is doubtful that Chapter 11 could qualify as a strategy (except, as will be discussed later, in cases of fraud—in which case we would have to wonder whether it is a legitimate strategy).

Mintzberg (1991) also tells us that strategy may also be viewed as a ploy. What this means is that the firm is attempting some kind of “specific ‘maneuver’ intended to outwit an opponent or competitor” (p. 13). However, as a ploy, a Chapter 11 does not “outwit an opponent or competitor” but rather robs allies and breaks strategic alliances that have supported the organization in the past (e.g., those who have extended the firm credit, suppliers, and so on).

A third way that one can view strategy is as a pattern of fairly consistent actions rather than a set of intended ones. Again, Chapter 11 can hardly be considered strategic because it is a single (and rather drastic) decision and not a pattern of any kind.

Strategy, per Mintzberg’s fourth definition, is seen as a position. Under this definition, strategy reflects placing the organization in a particular environment (i.e., a market niche) that puts the organization at a competitive advantage and allows it to produce a greater than normal rate of return. Chapter 11 does not really aid in placing the firm in a particular market niche. Chapter 11 may in some ways help the firm compete by restructuring its finances (in other words, Chapter 11 may create an organization that is, in general, more capable of competing, but this does not insure that the chosen niche is any more likely to support the firm).

Last, according to Mintzberg (1991, p. 16), strategy reflects a perspective or the organization’s “ingrained way of perceiving the world” (i.e., there’s the right way, the wrong way, and the way we do it here). For Chapter 11 to become an “ingrained way of perceiving the world,” one would logically expect the firm to regularly go bankrupt. It is hardly likely that any organization could sustain such a level of (non)perfor-

mance for long—after the third or fourth filing no one would extend the firm credit (in any case, the phrase, “there’s the right way, the wrong way, and the bankruptcy way” has a decidedly ominous ring to it).

Thus, in almost all respects, Chapter 11 does not qualify as something that we can really call a strategy. Although Chapter 11 may, by definition, fail as a strategy, it also has some truly practical problems. If you went into Chapter 11, you would probably find out about them sooner or later. In this case, sooner might be a great deal better than later.

Practical Problems With Using Chapter 11 as a Strategy

Bankruptcy is not advantageous for everyone. Much of the research that has been done on the subject has been done on large corporations. Because 80% of the asset value of Chapter 11 filings in 1990 could be attributed to 10 companies (Sherman, 1991) the emphasis on studying large bankruptcies makes sense from a public policy standpoint. However, there are tens of thousands of smaller companies for whom the research, and the happy outcome of Chapter 11, may not apply. Other research shows that there is a definite “liability of smallness” (Singh & Lumsden, 1990) when it comes to corporate survival. Moulton (1988) has shown that size is the only significant measure of whether a company will make it through Chapter 11 and be anything more than a shadow of its former self.

Bankruptcy is expensive. Although Chapter 11 may cause payouts on lawsuits to be halted, the lawyers must certainly be paid. In the 6 years that Manville was in Chapter 11, they spent over $100 million in lawyers’ fees—approximately 10% of their net worth (Sherman, 1991). In addition to the expense of lawyers’ fees, there are some other costs associated with bankruptcy. There is likely to be the loss of some market share (Sherman, 1991) because consumers may confuse reorganization under Chapter 11 of the bankruptcy code with closure and liquidation under Chapter 7 (Cifelli, 1983). Such confusion means that consumers are less likely to deal with the business because they do not realize it is still a going concern (e.g., shoppers stay away from retailers because they think they are closed even though they are still open, and manufacturers cannot sell their products because consumers may think that guarantees will not be honored). Addition-
ally, interest on loans granted while in bankruptcy will entail extra costs because they command higher interest rates (Sherman, 1991).

A prepackaged bankruptcy may reduce the lawyers fees involved in a Chapter 11, however, there are two things to remember. First, the prepack is not as straightforward as it may seem. Extensive planning and negotiation with sufficient numbers of amicable creditors of each class are needed, as is the bankruptcy court judge’s approval (Light et al., 1991; Sherman, 1991). The second thing is that if the prepack is rushed through the court it may not help the company. JPS Textile Group was in and out of bankruptcy in about a month with their prepack. Yet the company’s debt restructuring was not extensive and its long-term prospects therefore do not look encouraging (Light et al., 1991).

The argument that one can create value for the shareholders by entering into Chapter 11 may be empirically supported. However, such contentions are logically inconsistent.

Logical Problems With Using Chapter 11 as a Strategy

Ex post facto justification versus an intended outcome. This problem (what one might call the “I meant to do that” syndrome) is one difficulty with looking at bankruptcy as a way to improve the firm’s condition. For example, if one were to ask the chief executive officer (CEO) of a newly bankrupt corporation why the firm went into Chapter 11, the CEO might say that it was to preserve the assets of the company, insure its long-term survival, and eventually create value for the shareholders. On the other hand, if we were to ask corporate heads how to preserve the assets of the company, insure its long-term survival, or create value for the shareholders, they are not likely to immediately say, “Go bankrupt, of course.” Thus the strategy of going bankrupt is not so much the intended or desired outcome of a “strategic” plan but rather an after-the-fact rationalization of the action.

The problem of ceteris paribus. This is another difficulty with the idea that Chapter 11 improves the condition of the corporation. In a narrow sense, all other things being equal, the firm may benefit from a Chapter 11 filing. From the time that it files, conditions at the firm may well improve. However, all other things are not equal. We are not getting the full picture. We are ignoring the more vital problem of how to stop the firm from reaching such dire straits that it needs to file a petition for bankruptcy in the first place. In other words, the important question is not whether the firm’s condition improves from the point of filing but why they needed to file in the first place.

An analogy would best highlight this problem. Imagine the ailing firm as someone in a high-stress job who is a chain smoker, never exercises, is 40% overweight, and has a cholesterol count of 350. We would expect a heart attack and a long hospital stay. The hospital stay would give our friend the chance to rest, to possibly quit smoking, to lose weight, to lower the cholesterol count, and maybe learn how to take life a bit slower. This is not much different from the firm with poor financial controls that is overburdened with debt and is in a highly competitive industry. We expect it to go into Chapter 11. The bankruptcy, like a hospital stay, gives the firm a chance to get fixed up, recover, and, we hope, learn new habits that it can use to go on to lead a productive life.

To suggest going to the hospital when having a heart attack is obvious. To suggest that leading a lifestyle that increases the chance of a heart attack so that one needs to go to the hospital is ridiculous. Wouldn’t it be better if you could prevent the illness in the first place? The same holds true for sick organizations: It is better to concentrate on preventing the illness rather than looking at the positive aspects of ending up in the bankruptcy ward.

In addition to the practical problems and logical inconsistencies of a firm’s strategically going bankrupt, there may be some significant difficulties regarding whether the 1978 law is actually doing what was intended. This has an impact on all of us who use credit. In addition, it may be of great importance to lawmakers who may change the statutes in the future.

Public Policy Problems With Using Chapter 11 as a Strategy

As was stated above, part of the logic behind Congress’s making bankruptcy easier was that the economy would benefit from reorganizations—as opposed to liquidations—if corporations filed before they completely collapsed. Such reorganizations, it was thought, would preserve jobs and productive assets (Sherman, 1991).

Bankruptcy may not preserve jobs or productive assets. Filing companies often make drastic payroll cuts; for
example, Drexel Burnham’s work force went from 11,000 in 1986 to 200 in 1991 (Sherman, 1991). As for preserving productive assets, one would assume that the market would find buyers who would put such assets to good use.

The ease of Chapter 11 may also lead to distortions in the credit market. It has been argued (Sherman, 1991) that the new bankruptcy law effectively lowered the cost of failure and thus encouraged an unreasonable degree of risk taking (e.g., the junk bond frenzy of the 1980s). These high-risk debts are now beginning to go bad. These debt defaults mean that creditors are now more reluctant to extend credit (Meehan, Farrell, & McNamee, 1991).

If bankrupt companies have helped create some kind of “credit crunch” they may also be its beneficiaries. Because of the structure of the law, “Lenders love bankruptcy loans because they command premium interest rates plus a top-ranked claim on assets” (Sherman, 1991, p. 128). Thus brand-new bankrupts are more likely to get credit. Under such a system, it makes sense to declare bankruptcy to receive credit. If one looks closely at the Allied/Federated Stores (Campeau) collapse, one can see that the suppliers pushed for the Chapter 11 so that the merchandise shipped after the filing could have a priority claim.

Thus the public policy problem is that if we all realize that it makes more sense to escape our debts than to pay them (as it seems some major corporations have realized), then lenders restrict credit, the economy slows, assets stand idle, and people are thrown out of work. Therefore, the bankruptcy law may aid the very thing it hoped to prevent: loss of jobs and productive assets.

Government cannot long support a law that encourages debtors to avoid their debts and thus so chips away at the ability of business people to engage in commerce that the economy may be threatened. What public policy question could be more important than economic collapse? Remember E. Clairborne Robins, Jr. discussed above? Although the $140 to $180 million in stock he splits with his father after driving A. H. Robins into bankruptcy may seem criminal, it is hardly the real crime in this case. The Dalkon Shield, the product that brought about the company’s collapse, lead to the deaths of at least 20 women and injuries to possibly 200,000 others (Barrett, 1988). The majority of these deaths and injuries can be traced to actions that the firm’s executives (including E. Clairborne Robins, Jr.) had knowingly undertaken (Steiner & Steiner, 1988).

If Chapter 11 serves to aid the financial well-being of those who, intentionally or through their negligence, killed and maimed others, it is not right, ethical, or in the public’s best interest. If the law is not in the public interest, it is likely to be changed or interpreted in a different manner. Neither Congress nor the courts are likely to support a law that may promote unemployment, that may sicken the credit market, and that helps reward those who injure people. When pressured to change the bankruptcy law, Congress has acted (e.g., in response to the Continental Airlines bankruptcy and labor contract avoidance). Even if Congress does not change the law, the courts may interpret it in such a way that top managers and the board may be forced to suffer some of the same negative consequences as creditors (e.g., loss of income or valuables). The legal details of how the courts might do this are discussed later.

Legal and Managerial Problems With Using Chapter 11 as a Strategy

Can the courts hold management or the board responsible for a firm’s bankruptcy? Surely, uncontrollable factors (e.g., hard economic times or bad luck) caused the firm’s collapse. Possibly, but according to Tamari (1990, p. 786), “Empirical research has shown clearly that bankruptcy is not the result of unforeseen circumstances or unavoidable actions but rather it is the consequence of poor management or incorrect economic decisions.”

Argenti (1976) has argued there are clear indications as far as 10 years in advance, that an organization may be predisposed to failure. Management-related defects such as an autocratic leader, centralized power, and poor corporate financial controls may mean that the organization is likely to make mistakes that a well-managed company will not make. Mistakes such as expanding faster than the capital base allows and betting the firm’s entire future on one project lead to deterioration in the firm’s financial ratios, and in due course to bankruptcy. One would assume that competent managements and boards would be aware of the factors that predispose a firm to making the mistakes that could bring about its demise and would thus take precautions against them. To the extent that top cor-
porate officials did not take these precautions, and in not doing so brought about the collapse of the firm, they must not have been competent.

Under the current law, courts have the responsibility to remove incompetent top management teams and install a trustee. For example, a competent board would thus set up decentralized power systems that could keep an autocratic leader in check and institute adequate financial controls. By instituting and maintaining such systems, the people in charge of the firm should be able to keep it healthy in the long run. If such systems are not in place and the firm goes bankrupt, we have no choice but to reach the conclusion that those running the company were incompetent and should be removed. The court, acting responsibly to protect creditors' interests would have a responsibility to do so. Such unpleasant treatment makes Chapter 11 far less attractive to managers who may wish to apply this law strategically.

The loss of a job is not trivial, but if the manager is also a director, the job loss could be only the beginning. If the firm fails because the directors obviously knew that proper control systems were not in place, then directors might find themselves on the losing end of a shareholder derivative suit (a suit where a shareholder sues on behalf of the corporation). For example, directors may be liable to the firm if the board received management letters from the auditors that cited significant problems with the internal control system, and substantial changes were recommended but not implemented.

The directors could be held liable to the shareholders for not exercising due diligence in the performance of their duties. For example, the mere fact that a CEO is allowed to stay in charge of the corporation as it fails could be sufficient evidence of negligence on the part of the directors. A bit extreme? Not really. Even the most cursory reading of the turnaround literature (e.g., Slatter, 1984) tells you that one of the first steps to recovery for a declining company is to bring in a new chief. This is why Lee Iacocca was originally brought into Chrysler. Because directors must act "with the care which an ordinarily prudent person in a like position would exercise" (Hoebler, Retzel, Lyden, Roberts, & Severance, 1986, p. 1003)" a court could rule that (a) an ordinarily prudent person holding the directorship in a declining corporation would take care to give some attention to literature on the efforts involved in turning a declining organization around; (b) after doing the research it would have been obvious that a new CEO should have been installed; (c) the fact that the old CEO was not expeditiously removed and replaced by a new CEO means that the directors were negligent in fulfilling their duties and; (d) such negligent directors are at least partially liable for the damage that was inflicted on shareholders because of such negligence. Finally, there is the potential criminal case that could arise from using bankruptcy as part of a strategic plan.

To the extent that you have strategically planned to go bankrupt you may have committed an act of fraud. The example that comes to mind is hypothetical yet interesting. Suppose you highly leveraged a company to make substantial improvements in its physical plant. Because of knowledge about the industry and years of experience, you were able to convince creditors that such improvements would save the company, make it profitable, and allow the firm to pay the loan's interest and principal. However, you know that when the improvements are completed, it is extremely unlikely that you can make a profit given the interest burden. Knowing the wonders of Chapter 11 you plan accordingly: You complete the improvements, for appearance sake lose some money for a month or two, and then go into Chapter 11.

By taking these actions you have given the company a new plant, a firm foundation for the future, and eliminated the onerous debt service burdens. You have also committed an act of fraud. (Actually, the extreme version of this scenario was played out in the plot of the 1968 Mel Brooks [1968] film The Producers.) To the extent that you made a false representation of a material fact and knew it (that the firm would be able and willing to repay the loan), that you induced another to act (they gave you the loan), that they justifiably relied on your representation (your knowledge and experience convinced them), and that they are injured from relying on your representations (you aren't paying them), you have committed an act of fraud. At least that's what the tort law says (Hoebler et al., 1986, p. 62).

What then does it mean to say that we are "using bankruptcy strategically?" Are we referring to a way to defraud creditors or cheat those who have won (or are likely to win) lawsuits against the company? Is it therefore legitimate to say that there is a strategic use for Chapter 11? Again, it depends on how one defines strategy, and this has been discussed previously. Nowhere in those definitions of strategy was the word
fraud mentioned. If we are now stretching the definition of strategy to include fraud, how legitimate then is the concept of strategy?

CONCLUSION

It was the intention of those who wrote the Bankruptcy Reform Act of 1978 to make corporate reorganization easier and more likely to succeed. Declining firms would no longer need to die but could instead be nursed back to health and again made into productive citizens of the business community. As Congress intended, managers and employees would keep their jobs, productive assets would be maintained, companies would be saved, and the economy would benefit. Although Chapter 11 may have accomplished these goals, there have been some unexpected twists. Instead of saving firms in trouble and who require the special gifts that Chapter 11 can provide, bankruptcy, in many cases, has become a trite device to remove any unwanted financial commitments into which the firm may have entered.

Early in this article I spoke of great services the Federal Bankruptcy Weight Loss Clinic could render. Yet entering a bankruptcy proceeding is not like joining Weight Watchers™, it is a legal proceeding in which almost every stakeholder associated with the event has lost something. Shareholders and creditors have lost money, workers have lost wages, communities have lost jobs, and plaintiffs have lost their health and maybe their lives. It does not make us good business people, smart managers, or clever strategists if we can extract some illusory benefit from the filing of a Chapter 11 petition. The argument that Chapter 11 can create some apparent value for shareholders in a narrow sense ignores the larger picture. An enormous degree of value destruction can occur prior to the filing. The obvious issue on which to concentrate is how can we learn more about the vital problem of stopping the firm from sliding downhill into bankruptcy and not how Chapter 11 can help the firm after the damage has been done.

A great many of the adverse aspects that make bankruptcy a nonviable strategy have been cited in this article. As important, however, is the contention made here that Chapter 11, by definition, is not a strategy at all. What is Chapter 11? From a cynical perspective, Chapter 11 is a cheap device to cheat those who have claims against the company from collecting their due; it allows decision makers, for the time being, to evade responsibility and liability, and it may even, as we have seen, enrich those who have harmed others. From an optimistic perspective, Chapter 11 is a panacea that can cure all the ills of an ailing company and benefit the economy by preserving jobs and productive assets. Realistically, Chapter 11 is a messy and expensive process that managers should be better able to avoid. If researchers and management experts concentrate on finding ways to avoid Chapter 11 rather than discovering ways in which it can be used, then maybe we could reach a decidedly positive goal of seeing fewer firms going this unpleasant route.

Although Chapter 11 may be a way to save potentially endangered companies, the costs are high and there should be a better way. One way might be to make directors and professional managers more knowledgeable about the preconditions that may imperil a firm and then make decisions more responsibly. Such an interpretation may go a great way toward correcting some of the more serious abuses of the present sorry system.

REFERENCES

Also in the chapter 11 club. (1986, July 21). Fortune, p. 94.


