

Chapter 11 Protection: Who Are We Protecting?

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During the past few years, an array of well-publicized scandals have rocked the business world. This Note focuses on the interplay of the bankruptcy process and a debtor's perpetration of fraudulent activity. It utilizes the recent bankruptcy of telecommunications giant WorldCom to illustrate many of the unique problems created for a debtor's competitors when a firm that operates in a capital-intensive industry raises money through fraudulent means and subsequently files for Chapter 11 protection. This Note analyzes different ways in which the mechanisms of Chapter 11 could adversely affect a bankrupt firm's competitors. This Note ultimately argues that, in limited circumstances, a debtor's competitors should be granted a claim in the bankruptcy proceedings. Competitors would be compensated for the losses suffered because of the combination of a debtor's fraudulent activities and the generous provisions of the Bankruptcy Code. Because the definition of claim under current bankruptcy law is not broad enough to encompass such a claim, this Note proposes a legislative solution that remedies the problem while minimizing the perverse incentives that may arise by allowing competitors a claim.

I. INTRODUCTION

Over the past several years, issues of corporate governance and responsibility have dominated politics, the popular news, and academia.¹ The focus has largely revolved around preventing

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1. See, e.g., John M. Holcomb, *Corporate Governance: Sarbanes-Oxley Act, Related Legal Issues, and Global Comparisons*, 32 DENV. J. INT'L L. & POL'Y 175 (2004); David James, *The Governance Myth*, BUS. REV. WKLY., July 15, 2004, at 98; Robert Weisman, *Harvard Raises its Hand on Ethics: 1st-Year MBA Students Must Take New Course*, BOSTON GLOBE, Dec. 30, 2003, at C1.

future abuses — devising laws and institutions that deter corporate executives from engaging in the same types of scandals that have rocked the foundations of the business world and the financial markets over the past several years. While the recent attempts to improve compliance and avoid future problems are critical, it seems doubtful that any system could serve as a fool-proof mechanism to prevent future frauds. Unfortunately, these reforms have largely ignored the ability of the system to minimize the negative effects of future frauds once they have occurred.² Neither the academic literature nor recent legislation recognizes the inability of current and proposed controls to adequately address the issues brought about when companies fail because of fraudulent activities.

The Bankruptcy Code does not incorporate special rules to deal with cases where fraud is a central issue. This Note considers the unique problems that occur when a company has procured capital through fraudulent means, particularly when that company operates in a capital-intensive industry. These companies benefit greatly from Chapter 11 if they rely heavily on debt financing and thus save enormous amounts of money in reduced interest payments. The case of MCI WorldCom (“WorldCom”) highlights these problems and demonstrates the market distortions caused by current Chapter 11 mechanisms. This Note analyzes the advantages bestowed upon companies upon filing a Chapter 11 petition. It then asks whether these advantages outweigh the disadvantages of the bankruptcy process and whether, in turn, the losses caused give a competitive advantage to the company that caused them. Next, this Note analyzes the ability of the current provisions of the Bankruptcy Code to address these potential losses. Ultimately, this Note recommends that under certain circumstances, a bankrupt firm’s competitors should receive a claim in the bankruptcy proceedings. This claim would allow the courts to consider any damages suffered by competitors, not a result of Chapter 11 itself, but a result of the fraud that the competitor has perpetrated on the market.

2. For an overview of recent changes brought about in response to corporate malfeasance, focusing specifically on Sarbanes-Oxley, see John L. Latham, *The Legislative and Judicial Response to Recent Corporate Governance Failures — Will it be Effective?*, 5 *TRANSACTIONS: TENN. J. BUS. L.* 73 (2003).

II. THE WORLDCOM PARADIGM

This section examines the circumstances surrounding WorldCom's bankruptcy filing. It then examines the complaints of WorldCom's competitors and the basis for these complaints. In order to better understand the complaints, this section examines the manner in which the automatic stay, executory contract, and Chapter 11 provisions of the Bankruptcy Code may provide undue benefits to certain debtors. The experience of WorldCom does not necessarily represent the experience of a typical debtor. However, WorldCom operates in the extremely capital-intensive telecommunications industry and finances its acquisitions by taking on debt. Furthermore, the scope of its fraud was enormous. Any potential problems resulting from the confluence of a bankruptcy filing with fraud will be particularly acute in the case of WorldCom because of the size of both the company and the nature of the telecommunications industry.

A. WORLDCOM BACKGROUND

WorldCom filed for bankruptcy on July 21, 2002, becoming the largest bankruptcy filing in the history of the United States.³ At the time of its filing, WorldCom was the nation's second largest long-distance carrier, boasting 20 million consumers including thousands of corporate customers.⁴ When it filed, WorldCom had accumulated approximately \$41 billion in debt.⁵ At one point, the company had a market capitalization of \$180 billion.⁶ Upon emerging from bankruptcy, the company had approximately \$5.8 billion of debt,⁷ decreasing its debtload by over \$35 billion.⁸ The former shareholders received no share in the reorganized company.⁹

3. See Shawn Young et al., *WorldCom Files for Bankruptcy: Debt, Scandal Overwhelm; Operations Set to Continue*, WALL ST. J., July 22, 2002, at A3.

4. Almar Latour & Shawn Young, *MCI Clears Hurdle Towards Emerging from Bankruptcy*, WALL ST. J., Sept. 10, 2003, at A3.

5. Shawn Young & Dennis K. Berman, *MCI's Emergence Portends Tougher Telecom Competition*, WALL ST. J., Nov. 3, 2003, at B4.

6. Latour & Young, *supra* note 4.

7. *Out of Chapter 11, WorldCom is Again MCI*, N.Y. TIMES, Apr. 21, 2004, at C13.

8. Latour & Young, *supra* note 4.

9. *Id.* Shareholders are eligible to receive a share of a \$750 million settlement that WorldCom paid to the SEC. Shawn Young, *MCI Boosts Payout to Shareholders: A Record*

The sheer magnitude of the losses is not the most alarming aspect of the WorldCom saga. WorldCom was able to raise an enormous amount of capital largely because of its fraudulent financial reporting and fraudulent statements to the press. One major aspect of the fraud involved the transfer of certain expense line items into the company's capital accounts.¹⁰ By capitalizing certain expenses instead of expensing them as recognized accounting standards require, the company artificially inflated its income (turning the losses from 2001 and the first quarter of 2002 into a profit) and masked the true state of its operations.¹¹ According to one estimate, WorldCom misstated earnings by as much as \$11 billion.¹²

The other aspect of the fraud involved the gross misstatement of the growth in Internet traffic. WorldCom claimed that Internet traffic was doubling every 100 days.¹³ Because up to 50% of Internet traffic traveled along WorldCom's Internet backbone,¹⁴ regulators, investors, and competitors relied upon these estimates in their decision-making processes.¹⁵ The overly optimistic picture of Internet growth directly benefited WorldCom by enabling it both to raise substantial sums through the capital markets and kept its stock price buoyant. In reality, the growth of

\$750 Million to Cover Investors' Losses Would Settle SEC Charges, WALL ST. J., July 3, 2003, at A3.

10. See Jared Sandberg et al., *Disconnected: Inside WorldCom's Unearthing of a Vast Accounting Scandal*, WALL ST. J., June 27, 2002, at A1.

11. *Id.*

12. Although the fraud principally involved the mischaracterization of certain expenses, the company also routinely misrecognized revenue. For an account of WorldCom's accounting policies and missteps, see Kay E. Zekany et al., *Behind Closed Doors at WorldCom: 2001*, 19 ISSUES ACCT. EDUC. 101 (2004).

13. See Yochi J. Dreazen, *Behind the Fiber Glut: Telecom Carriers Were Driven by Wildly Optimistic Data on Internet's Growth Rate*, WALL ST. J., Sept. 26, 2002, at B1.

14. See Jared Sandberg et al., *WorldCom to File Chapter 11, As Cash Reserves Dwindle Fast*, WALL ST. J., July 19, 2002, at A1.

15. Regulators have attested to the fact that WorldCom was the only source they used in claiming that the Internet traffic doubled every 100 days. The gross exaggeration in growth resulted from WorldCom's counting the increase in fiber capacity as an increase in traffic. The deception of regulators was not the purpose of WorldCom's false claims but was a noteworthy consequence of WorldCom's deceptive attempts to raise additional capital and maintain and grow its share price. See Dreazen, *supra* note 13.

Internet traffic was significantly less than the estimates reported by WorldCom, actually doubling every year.¹⁶

B. COMPLAINTS OF COMPETITORS

The complaints of WorldCom's competitors are quite simple in theory and are not unique to telecommunications companies. Competitors such as AT&T and the regional Bells have argued that the Bankruptcy Code allowed Worldcom to profit from its fraud by allowing it to remove its debt from the books and remain a viable business entity.¹⁷ WorldCom's competitors claim that its fraudulent statements allowed the company to acquire capital, by doubling its debt over a three-year period, which it subsequently used to pursue an acquisition spree and to build out the company's expansive telecommunications network.¹⁸ Competitors contend that WorldCom would not have been able to raise the capital if it had accurately reported its financial condition.¹⁹ William Barr, the general counsel of Verizon Communications, Inc., proclaimed that "[b]ankruptcy is not a mechanism for laundering stolen goods. It doesn't provide a safe harbor for proceeds of [a] crime."²⁰ Thus, WorldCom's competitors argue that the company would not have been able to acquire its assets in the absence of fraud and therefore essentially stole the assets that it currently owns.²¹

C. CHAPTER 11 RELIEF

To comprehend fully the competitors' contention of theft, it is necessary to understand the Chapter 11 mechanism and the effects of a Chapter 11 plan of reorganization. Upon filing for Chapter 11, all claims against a debtor are stayed either for the

16. J. Gregory Sidak, *The Failure of Good Intentions: The Worldcom Fraud and the Collapse of American Telecommunications after Deregulation*, 20 YALE J. ON REG. 207, 230 (2003).

17. Almar Latour & Shawn Young, *MCI Appears to have a Deal with Creditors: If Pact Holds, Phone Firm Would Have a Clear Path to Emerge From Chapter 11*, WALL ST. J., Sept. 9, 2003, at A3.

18. See Rebecca Blumentstein & Almar Latour, *Chapter 11: Laundering Fraud*, WALL ST. J., May 15, 2003, at B1.

19. *Id.*

20. *Id.*

21. *Id.*

duration of the case or until the stay is lifted.²² With certain exceptions, all assets become property of the estate and creditors may not collect upon their claims or file lawsuits against the debtor.²³ The debtor may operate under Chapter 11 (as a debtor in possession) without making payments on its debt load (including both interest and principle).²⁴ Thus, all else being equal, a debtor's operating expenses are greatly reduced while it operates in Chapter 11.

A debtor emerges from Chapter 11 when its creditors approve its plan of reorganization, which must be filed with the court.²⁵ A reorganization plan need not pay all creditors in full. In fact, because most companies entering Chapter 11 are insolvent, creditors rarely receive full dollar value.²⁶ Moreover, the rights of shareholders are typically eliminated or reduced to a small fraction of their original value. In the WorldCom case, for example, most creditors will receive approximately 36 cents on the dollar, while the shareholders will receive nothing.²⁷ Enron creditors, in comparison, can expect to receive approximately 16.6 cents on the dollar.²⁸ Therefore, WorldCom will emerge from bankruptcy with a substantially reduced debt load. In the absence of Chapter 11 protection, a company such as WorldCom would be unable to survive. Creditors who had been defrauded would most likely sue the defrauding company until judgments had been entered against all of its assets.²⁹ Eventually, all of these assets would be sold at auction and the company would be unable to operate.³⁰

22. See 11 U.S.C. § 362 (2000).

23. See 11 U.S.C. § 365 (2000); see also § 362.

24. There are some exceptions to this principle where a creditor is oversecured, 11 U.S.C. § 506 (2000), or where, in the case of single-asset real estate, a creditor is secured by an interest in the real estate, 11 U.S.C. § 362(d)(3) (2000).

25. The requirements of a plan of reorganization are defined by 11 U.S.C. § 1129 (2000).

26. One study found that unsecured creditors, on average, recover less than 32% of the value of their claims in reorganization cases. Michelle J. White, *Bankruptcy Costs and the New Bankruptcy Code*, 38 J. Fin. 477, 483 (1983).

27. Latour & Young, *supra* note 4.

28. *Enron Corp: Creditors' Target Recovery Rate Rises in Reorganization Plan*, WALL ST. J., Sept. 19, 2003, at B4.

29. For a discussion of the collective action problem that bankruptcy seeks to avoid, see Donald P. Board, *Retooling "A Bankruptcy Machine that Would Go of Itself,"* 72 B.U. L. REV. 243, 247-51 (1992).

30. *Id.*

When the debtor operates in a capital-intensive business dependent largely upon debt financing, the advantages that the debtor receives over its competitors are magnified. In such businesses, interest payments are a substantial portion of operating expenses. A company that can reduce the amount of its debts and corresponding interest payments, *while maintaining the assets financed by issuing the debt and equity*, can provide the same services as its competitors at lower prices. While all firms may benefit from such a phenomenon, the benefit is substantially magnified when a firm operates in a capital-intensive industry.

For example, suppose a law firm received a loan by overstating the qualifications of its attorneys or overstating its results from the previous year. It may use some of the funds to improve the firm's facilities and technology. If the firm eventually files for Chapter 11 and (although unlikely) emerges from bankruptcy protection, it would be difficult to argue that it had a major competitive advantage over its competitors. A law firm's competitive advantage does not lie in its supply, and quality, of tangible assets. The paradigm markedly shifts, however, where an industry is made up of firms whose primary assets are tangible assets that must be financed through the utilization of external capital. The law firm must continue to pay for its primary asset, its people, at market price whereas a telecommunications company has effectively already paid for its primary asset at a substantially reduced cost.

D. UNIQUENESS OF CERTAIN BANKRUPTCIES

A logical question is why WorldCom's case is different from any other Chapter 11 filing. Should all companies emerging from Chapter 11 be considered thieves? One may argue that Chapter 11, by design, allows companies to emerge with their assets intact and a reduced debt load.³¹ WorldCom's competitors make the distinction, however, that the WorldCom case differs from the typical Chapter 11 case because WorldCom would not have been able to raise the requisite capital to purchase its assets in the absence of fraud.³² Taken to its logical conclusion, the argument contends

31. See *supra* note 25.

32. See Blumenstein & Latour, *supra* note 18.

that WorldCom's strategy of employing fraud to raise money to finance its expansion is rational. If WorldCom is permitted to exit from bankruptcy unscathed, then the federal government would be essentially aiding and abetting the fraud and would encourage other companies to act in the same unscrupulous manner in the future.³³

The remainder of the Note attempts to determine whether competitors are indeed hurt by situations similar to WorldCom, whether there is a systematic incentive for decision makers to engage in fraudulent activities and, finally, how the system should be changed, if at all.

III. ARE COMPETITORS' COMPLAINTS JUSTIFIED?

This section analyzes whether the impact on WorldCom's competitors (and other similarly situated entities) raises cause for concern. It begins by assessing the potential advantages and disadvantages gained by the debtor upon filing for Chapter 11 and assesses whether the disadvantages systematically outweigh the advantages. Next, this section summarizes several studies that attempt to quantify the effects that a bankruptcy filing has on a debtor's competitors, primarily by viewing the effects of filings on the stock prices of competitors. The Note explores possible explanations for the potential negative effects that a bankruptcy filing has on the stock prices of a debtor's competitors. Finally, this section explores the reactions of WorldCom's competitors as possible evidence of the consequences of a filing upon competition.

A. ASSESSMENT OF THE POSITIVES AND NEGATIVES OF A FILING

Initially, it is necessary to assess whether a debtor may receive an unfair advantage because of the Chapter 11 provisions. If the pitfalls of Chapter 11 outweigh any of the purported benefits, then the complaints of WorldCom's competitors should be dismissed without further examination. From a theoretical standpoint, many have argued that the negatives associated with

33. Because external checks on managers do exist, there is little reason to believe that rational managers will act fraudulently. See discussion *infra* Part IV.A.

a Chapter 11 filing significantly outweigh any of the advantages provided by Chapter 11 protection.³⁴ The disadvantages include the fall in consumer confidence resulting from the announcement of the filing, the need to pay ongoing operating expenses in cash (as opposed to financing such expenses using credit), the costliness (in terms of money, time, and other resources) of Chapter 11 proceedings, the difficulty in retaining employees, and difficulties contracting with third parties.³⁵

Of course, the relative importance of the aforementioned disadvantages varies with the industry and business model of a particular debtor. The large percentage of firms that enter Chapter 11 without ever emerging³⁶ lends some credence to the belief that Chapter 11 is not a panacea.³⁷ Further anecdotal evidence lies in the dearth of companies that voluntarily file for Chapter 11. Even where a company does file voluntarily, it typically waits until the midnight hour to do so. Neither of the above observations, however, is dispositive. A cursory glance may permit the attribution of the failure of many companies to emerge from Chapter 11 to the pitfalls of the bankruptcy process itself. However, one should be cautious in assigning a causal relationship between filing for bankruptcy and business failure. Companies file for Chapter 11 for a myriad of reasons. Some companies may produce an obsolete product, employ an inefficient operating process, or have a faulty business model. These companies would fail regardless of the advantages or pitfalls inherent in the bankruptcy process. Moreover, many of the negative symptoms mentioned above are emblematic of poorly operating companies, gen-

34. See Tonny K. Ho, *Telecom Bankruptcies*, Practising Law Institute, PLI Order No. B0-014Z, Aug. 13–14, 2001, 571, 586–87 (discussing the intangible disadvantages of bankruptcy); see also Susan Jensen-Conklin, *Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law*, 97 COM. L.J. 297, 328 (1992) (discussing the disadvantages noted by firms who had been through Chapter 11).

35. *Id.*

36. The court may convert a Chapter 11 case to a Chapter 7 case for a number of reasons including: inability to effectuate a plan, continuing losses to the estate without reasonable likelihood of rehabilitation or unreasonable delay by debtor which is prejudicial to the creditors. 11 U.S.C. § 1112 (2000). If a case is converted to Chapter 7, the assets of the debtor will be liquidated, although, in the case of a corporation (or any debtor that is not an individual), no discharge will occur. 11 U.S.C. §§ 726–727 (2000).

37. One 1989 study found that only 10–12% of firms that file for Chapter 11 emerge out of the proceeding as a continuing entity. Edward Flynn, *Statistical Analysis of Chapter 11*, Administrative Office of the U.S. Courts Statistical Analysis and Reports Division, Bankruptcy Division (Oct. 1989) (unpublished report).

erally.³⁸ While the informational effect of a bankruptcy filing (informing customers, employees, and third-party contractors that the company is in trouble) may be relevant concerns for smaller private companies, it should not pose major problems for large public companies, which must disclose their financial condition to the public on a regular basis.

The dearth of truly voluntary filings is also somewhat ambiguous as an indicator of the disadvantages incurred by a company in bankruptcy. The trend may reflect perceptions regarding bankruptcy's disadvantages or it may reflect the rational behavior of insiders who have a significant equity stake in a company or depend upon the company for work and, therefore, have an incentive to engage in protecting their own self-interests. These insiders would rather increase the risk of the enterprise at the expense of the overall value of the corporation.³⁹ As equity in an insolvent company is similar to an option, the value of such equity increases with the risk of the company's operations. Insiders in an insolvent company have every reason to allow the company to exhaust its final hopes, even if those hopes have an infinitesimally small chance of realization, because they will often receive nothing in the event of a bankruptcy filing.

An alternative explanation for the hesitancy of many companies to file for bankruptcy may relate to the stigma associated with bankruptcy.⁴⁰ Since bankruptcy has often been associated with failure and because the officers responsible for the filing decision are often those responsible for the failure, there may be an irrational aversion to bankruptcy. This aversion has nothing to

38. The problems discussed are examples of economic distress. Economic distress results from problems in a company's operations without reference to its capital structure. Conversely, financial distress occurs when a company's financial structure (its level of debt) causes a company to be unprofitable. Although either type of distress may cause a company to enter bankruptcy, the bankruptcy process is primarily designed to alleviate financial distress. For further discussion, see Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 580-83 (1998).

39. For a general discussion of the potential for excessive risk-taking by managers, see Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty Upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813, 1821-22 (2002).

40. For a discussion of the possible effects of stigma on the bankruptcy process, see generally Margaret Howard, *Bankruptcy Empericism: Lighthouse Still No Good*, 17 BANKR. DEV. J. 425 (2001) (reviewing THERESA A. SULLIVAN ET AL., *THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT*, ELIZABETH WARREN & JAY LAWRENCE (2000)).

do with the tangible benefits or drawbacks of the bankruptcy mechanism.⁴¹

B. STUDIES OF EFFECTS ON THE STOCK PRICE OF COMPETITORS

Some studies have attempted to quantify the effect that the filing of one competitor has on the stock prices of other competitors.⁴² These event studies tracked the abnormal returns to the stocks of the debtors' competitors upon filing for bankruptcy. The Lawless study analyzed different time horizons surrounding the bankruptcy announcement.⁴³ The study controlled for the stock market returns during the relevant periods to determine any abnormal returns for companies in the debtor's industry.⁴⁴ The Lawless study, like an event study conducted by Lang and Stulz, was generally inconclusive. In the aggregate, Lawless found that the stock prices of the competitor firms decreased by 0.39%, but the decrease was statistically insignificant.⁴⁵ For capital-intensive industries, however, the study found that the filing of one company had a statistically significant 0.57% negative effect on the stock price of other companies within the industry.⁴⁶ This result is consistent with the observation that negative cumulative abnormal returns for AT&T and Sprint stock surrounding the WorldCom fraud announcement were \$2.5 billion.⁴⁷ Moreover, telecommunications manufacturers sustained negative cumulative abnormal returns of \$5.3 billion in conjunction with the WorldCom fraud announcement.⁴⁸ Although the fraud announcement was distinct from the bankruptcy filing announcement, market investors must have realized the strong possibility

41. One commentator notes, "The U.S. did away with the word 'bankrupt' in the 1978 Code, replacing it with the more general 'debtor,' exactly because 'bankrupt' carried such a negative stigma." Nathalie Martin, *Common Law Bankruptcy Systems: Similarities and Differences*, 11 AM. BANKR. INST. L. REV. 367, 374 n.38 (2003).

42. See Robert M. Lawless et al., *Industry-wide Effects of Corporate Bankruptcy Announcements*, 12 BANKR. DEV. J. 293 (1996); see also Larry H.P. Lang & René M. Stulz, *Contagion and Competitive Intra-Industry Effects of Bankruptcy Announcements: An Empirical Analysis*, 32 J. FIN. ECON. 45 (1992).

43. See Lawless, *supra* note 42, at 304–05.

44. *Id.*

45. *Id.* at 303.

46. *Id.* at 305.

47. Sidak, *supra* note 16, at 235.

48. *Id.*

of a subsequent filing that arguably accounted for some of the fall in the stock prices of competitors.

1. *Explanation 1: Contagion Effect Hypothesis*

Although (as the above studies indicate) there is no consensus regarding the universality of bankruptcy's negative effect in capital-intensive industries, there has been sufficient evidence of such an effect to produce multiple hypotheses as to its cause. Not surprisingly, however, experts disagree regarding the meaning of this correlation (where it exists). Some argue for the contagion effect hypothesis.⁴⁹ Under this hypothesis, the negative effect on competitors' stock prices relates to the fact that investors generally lack perfect information about the companies in which they invest. The public bankruptcy filing, therefore, may reflect new information regarding the health of an industry and the value of the assets employed by such industry.⁵⁰ This information may be more reliable than other information disseminated to the public. Thus, to the extent that a bankruptcy filing alerts investors to troubles in an industry, all stock prices in that industry will suffer. The contagion effect is unrelated to the advantages gained by the debtor relative to its competitors through the mechanisms of the bankruptcy process itself.⁵¹ The fall in stock price is caused by the dissemination of new information about the debtor's competitors. The contagion effect does not reflect any advantages or disadvantages attributable to the debtor because of the bankruptcy process.

2. *Explanation 2: Advantages Inherent in Chapter 11 Protection*

The other explanation for the decrease in stock price is the comparative advantage of a debtor resulting from the benefits of bankruptcy protection. These advantages include the automatic stay, the reduction in debt load, the ability to cancel or restructure unfavorable contracts, as well as the factors discussed in Part II.C. The presence of this negative effect has been argued

49. See Lawless et al., *supra* note 42, at 298–99; see also Lang & Stulz, *supra* note 42, at 47–48.

50. See Lawless et al., *supra* note 42, at 298–99.

51. *Id.* at 299.

for by Robert Crandall,⁵² as well as other economists.⁵³ The contagion effect and “Crandall” effect are not mutually exclusive, and there is a strong possibility that each effect has some bearing on any stock movement. What seems clear from the evidence, however, is that the filing of a bankruptcy petition by the debtor does not represent as great a windfall to competitors as popular sentiment often suggests.⁵⁴

The negative correlation between bankruptcies and stock prices of competitors in capital-intensive industries is consistent with either a Crandall effect (the type of advantages that many of WorldCom’s competitors were worried about), a contagion effect, or both. Companies in capital-intensive industries often require a significant amount of debt financing for their investments. Therefore, these companies will be hurt the most when a competitor does not have to service its debt, as debt service represents a significant portion of total expenses. While the negative effect is small and there may be other explanations, the data certainly indicates that bankruptcy may have negative effects on the debtor’s competitors in certain instances.⁵⁵ The evidence does not suggest that the filing of bankruptcy by a debtor benefits its competitors, refuting those who claim that bankruptcy adversely affects the ability of a debtor to compete and bolstering the contentions of WorldCom’s competitors.

C. VIRULENT REACTION OF COMPETITORS

Regardless of the quantitative evidence, the negative effect that WorldCom’s emergence from bankruptcy will have on its competitors is evidenced anecdotally by the intensity of competi-

52. See Doug Carroll, *Competitors Angry About TWA Fares*, USA TODAY, Feb. 13, 1992, at 1B.

53. See Kenneth Labich, *Why Air Fares Are Sure to Go Up*, FORTUNE, May 18, 1992, at 12. For an argument that the bankruptcy process actually serves as a positive alternative to other types of government regulation because of its ability to keep ailing airlines afloat, see Jeffrey S. Heuer & Musette H. Vogel, *Airlines in the Wake of Deregulation: Bankruptcy as an Alternative to Economic Reregulation*, 19 TRANSP. L.J. 247 (1991). The very argument supports the idea that in certain instances, bankruptcy can have a net positive effect on firms in certain industries.

54. “The financial press tends to assume that when a firm declares bankruptcy, its rivals are likely to benefit.” Lawless, *supra* note 42, at 297–98.

55. See Sidak, *supra* note 16; Lawless, *supra* 42.

tors' opposition to WorldCom's emergence.⁵⁶ Competitors like AT&T, SBC, and Verizon have spent enormous resources in order to derail WorldCom's emergence from bankruptcy.⁵⁷ The move against WorldCom was unusual in the expense and trouble the company's adversaries expended.⁵⁸ The principal strategy employed by these companies has focused on accusations of WorldCom's fraudulent attempts to avoid paying access fees to its competitors.⁵⁹ Assuming that these competitors are rational actors in the marketplace, the threat posed by a reorganized WorldCom is likely both real and substantial. One may view the outlay of the resources in making their case to both the press and the government as an investment. If the bankruptcy weakened WorldCom to the point that it could no longer survive as a viable competitor, then the costs of the investment would most likely outweigh any potential benefits.

It is telling that the accusations might have arisen even without the bankruptcy process.⁶⁰ The fraudulent avoidance of access fees had purportedly occurred since 1994.⁶¹ The bankruptcy process did not afford WorldCom's competitors with a unique opportunity to discover the presence of the fraud. The discovery of the fraud, to the extent that it existed, was enabled by the stepped-up efforts to discredit WorldCom in any way possible. The timing of the charge suggests that WorldCom's competitors recognized that the stakes had greatly increased with WorldCom's pending exit from bankruptcy. The perception of WorldCom's competitors that the newly reorganized company would be gaining an advantage is a powerful indicator that WorldCom will receive some very substantial benefits stemming from its reorganization.

56. An article in *The Wall Street Journal* stated that "[t]he campaign against MCI amounts to an extraordinary effort by three competitors . . . to drive a rival out of business through federal action." The competitors steered informants to the U.S. Attorney's Office, paid for informants' attorneys, lobbied legislators, financed advertising campaigns, etc. Almar Latour et al., *Getting Through: How Rivals' Long Campaign Against MCI Gained Traction*, WALL ST. J., Aug. 1, 2003, at A1.

57. *Id.*

58. *Id.*

59. *Id.*

60. Competitors accused WorldCom of making it seem as though calls were coming from Canada to avoid fees for access to the local phone lines. These fees can become substantial over the long run. *Id.*

61. *Id.*

Of course, one could view the antics of WorldCom's competitors as an attempt to "kick the company while it's down." While the timing of the accusations certainly reflects some component of opportunistic behavior, the costliness and intensity of the campaign seem to reflect a real concern regarding the cost advantages of a reorganized WorldCom. Otherwise, WorldCom's competitors could have made many of the same complaints long before WorldCom filed for bankruptcy and argued for the imposition of sanctions. The timing of the attacks was inconspicuously tied to WorldCom's expected emergence from bankruptcy. Though eliminating a competitor will always bring benefits, if WorldCom's competitors did not view the emerging company as a strong and viable competitor, they would not have gone to such great lengths to destroy the company's credibility.

IV. SHOULD WE BE CONCERNED ABOUT THE POTENTIAL BENEFITS AFFORDED BY CHAPTER 11?

Assuming that there are instances in which a company involved in fraudulent activities receives benefits from a Chapter 11 filing, this section considers whether this kind of problem needs to be rectified. This section considers two possible grounds for remediation. First, the section explores whether actors can systematically commit fraud to their own advantage. Second, the section considers whether, regardless of a systematic incentive to commit fraud, the current system advantages parties who, for other distributive reasons, should not be given such advantages. The section ultimately answers the first question in the negative and the second question in the affirmative.

A. IDENTITIES OF THE INDIVIDUAL WINNERS (AND LOSERS)

The evidence suggests that, at least in some situations, a company will be able to emerge from bankruptcy in a strong competitive position. If people who committed the fraudulent activities were able to take advantage of the competitive position, then it would be necessary to devise a bankruptcy mechanism that did not allow fraud perpetrators to benefit systematically from the fraud — a mechanism that would ensure that committing fraud is not rational. However, it is not clear that a company in the ex ante position would have the incentive to perpetrate a fraud upon

the investing community and its competitors (as some competitors have claimed). This doubt results from the asymmetrical identities of those in a position to perpetrate the fraud and the ultimate beneficiaries of the Chapter 11 advantages. As a general model going forward, this Note assumes that top-level management of the corporations typically are responsible for frauds executed at large companies that result in a bankruptcy filing. In an ideal world, punishments should be narrowly tailored to culpable parties in order to protect the innocent to the maximum extent feasible. There are reasons to believe that the punishment of a post-petition firm may result in the inequitable punishment of the innocent.⁶²

As previously noted, the top-level managers (who also may be stockholders) may generally be responsible for the perpetuation of the fraud. The fraud may be perpetrated through affirmative acts by these parties or through the failure to exercise the duty of oversight over a company's operations.⁶³ It is not clear, however, that these people will generally be able reap the benefits associated with the reorganization process. Officers, managers, or anyone else who has perpetrated a fraud will generally not remain in control of the company. Assuming that the managers of the pre-petition company will be unable to retain their control, the danger that they will have any incentive to commit fraud, in order to benefit from the unfair profits of a reorganized firm, is minimal.⁶⁴ Although these actors may have a significant equity stake in their corporations, the typical bankruptcy completely eliminates these equity stakes. While top executives generally receive equity stakes in reorganized corporations,⁶⁵ where fraud is appar-

62. Arthur Anderson and its employees made a similar argument in an attempt to avoid criminal indictment, claiming that prosecution would represent a "gross abuse of governmental power." Kathleen F. Brickey, *Anderson's Fall from Grace*, 81 WASH. U. L.Q. 917, 919 (2003).

63. For a general discussion of some aspects of the duties of officers and directors and the motivations for breakdowns in these relationships, see Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187 (2003).

64. See *infra* note 67 (examining the negative consequences facing managers involved in fraudulent activities).

65. One recent study has shown that companies filing for Chapter 11 overwhelmingly offer their employees some type of severance or retention package in order to create incentives for employees to remain with the corporation. See A. Mechele Dickerson, *Approving Employee Retention and Severance Programs: Judicial Discretion Run Amuck?* 11 AM. BANKR. INST. L. REV. 93 (2003).

ent, a new management team, comprising people who were not instrumental in devising the fraud in the first place, will receive the equity. The loss of corporate control, coupled with the loss of equity, means that those making the decisions to engage in fraud would be unable to reap the fruits of their deception.⁶⁶ Of course, this paradigm breaks down to the extent that officers and directors are permitted to maintain control after reorganization.

1. *Will Most Fraud Perpetrators Be Caught?*

It is unlikely, however, that fear of such a breakdown is warranted. First, as the anecdotal evidence relating to the bankruptcies of Enron, Adelphia, and WorldCom (among others) suggests,⁶⁷ a fraudulent firm's leaders typically lose their posts following the uncovering of any malfeasance. Although the widespread utilization of retention plans underscores the importance that creditors place on keeping management teams intact through the bankruptcy process,⁶⁸ distrust, the possibility of criminal sanctions, retribution, and other factors have contributed to the dismissal of the major players at firms perpetuating major fraud.⁶⁹ Moreover, fears that the responsible actors go un-

66. Although the officers would not benefit from the generous provisions of the Bankruptcy Code, they may benefit from their ability to sell stock at artificially inflated prices. This problem, however, would exist regardless of whether the Bankruptcy Code took into account the malfeasance of a company when approving a plan of reorganization. Breakdowns in the incentive structure for officers and directors of a pre-petition firm, to the extent they systematically exist, are best dealt with through the securities laws and other forms of liability, not through the Bankruptcy Code. Further discussion on this topic, however, is outside the scope of this Note.

67. For a summary of the executives' problems following the Enron and WorldCom scandals, see *Can't Tell the Scandals Without a Scorecard: From Kozlowski to Quattrone, Former Corporate Highfliers Parade Through U.S. Courtrooms*, WALL ST. J. EUR., Oct. 3, 2003, at A5. For an account of the Adelphia situation, see Christine Nuzum, *Executives on Trial: Broker Testifies Rigas Margin Call Yielded Big Sum*, WALL ST. J., Apr. 7, 2004, at C5.

68. See *supra* note 65.

69. A study of 111 publicly traded firms that either filed for bankruptcy under Chapter 11 or privately restructured found that over half of the CEOs and directors of the firms lost their jobs during the restructuring period. Stuart C. Gilson, *Bankruptcy, Boards, Banks and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default*, 27 J. FIN. ECON. 355, 369-71 (1990). Another study found that the CEO was replaced at least once in over 90% of the cases during the period beginning 18 months before the filing and ending six months after confirmation. Lynn M. LoPucki and William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 723 (1993).

punished also are largely unfounded. In most of the major fraud-related bankruptcies, the most prominent leaders of the companies have lost their jobs. Many of these executives have faced criminal prosecutions and the prospect of incarceration.⁷⁰

Another possible breakdown stems from the potential that certain frauds will remain undetected. If recent history is any indication, however, the possibility of non-detection does not seem to be a major concern once a firm has failed. The investigative measures invoked by creditors to reveal the reasons for the failure and future prospects of the firm make the possibility of non-detection extremely unlikely. Non-detection may be a problem to be addressed by legislators for a firm prior to bankruptcy,⁷¹ but once a firm's failure necessitates a bankruptcy filing, creditors, the courts, and other stakeholders generally have the incentives and the tools to uncover the true nature of the firm's operations.⁷²

All of the above factors strongly suggest that it may be unnecessary to worry about the incentives provided by Chapter 11 for a company to commit fraud. A company, as a dynamic and constantly changing entity, does not have one unitary personality. In the WorldCom bankruptcy, for instance, most of the top managers have been forced to leave subsequent to the discovery of the fraud and the company's bankruptcy filing.⁷³ Furthermore, the old equity holders no longer exist and the creditors are set to become the equity holders in the new, reorganized company.

70. See *supra* note 67.

71. These concerns would be addressed best by law enforcement agencies or securities regulators.

72. A further impediment to a fraudulent director or officer being permitted to retain his position in the reorganized firm is the requirement that the court ensure that the appointment of any director or officer "is consistent with the interests of the creditors and equity security holders and with *public policy*." 11 U.S.C. § 1129(a)(5)(A)(ii) (2000) (emphasis added). For a discussion claiming that the clause is underutilized by the courts, see Ali M. Mojdehi, *Appraising Postconfirmation Leaders: The Underutilized Confirmation Requirement*, 77 AM. BANKR. L.J. 199 (2003).

73. The extent of the purging of management should not be overstated. In WorldCom, the court approved a retention plan of up to \$25 million to pay bonuses ranging from \$20,000 to \$125,000 to 329 of the company's key employees. Rebecca Blumenstein, *WorldCom Judge Approves Plan to Keep Employees*, WALL ST. J., Oct. 30, 2002, at B3.

B. DISTRIBUTIVE CONSIDERATIONS

It is possible to accept the proposition that bankruptcy law does not provide systemic incentives for corporations and corporate actors to commit fraud, while still insisting that interests of competitors should be taken into account where fraud is involved. The question still remains regarding whether the bankruptcy court, or any other court or agency of the US government, is under a duty to take a firm's fraudulent activities into account when approving a plan of reorganization. After all, it could be argued that, between creditors, stockholders, and employees, who have voluntarily entered into a relationship with a company, and competitors and their investors, who have no voluntary relationship with the bankrupt firm, issues of equity mitigate in favor of allowing the losses to lie with the investors and other voluntary stakeholders in the bankrupt firm. At the very least, competitors should have some voice in the bankruptcy process where fraud was involved. Why should stockholders who have been defrauded be permitted to participate in the bankruptcy proceedings in the capacity of both stockholders and tort claimants (through derivative securities suits),⁷⁴ whereas competitors who will suffer the adverse consequences of the fraudulent activities are completely shut out? Investors also receive compensation through a provision of the Sarbanes-Oxley Act that allows the SEC to reimburse investors who have lost money because of fraudulent activities.⁷⁵ The program has amassed \$2.6 billion in the two years leading up to September 2004.⁷⁶ Moreover, investors may often collect large sums of money from professionals and others who have worked with the fraudulent company.⁷⁷ One of the principal purposes of Chapter 11 is to provide a forum where all interested parties may

74. WorldCom agreed to settle its investor fraud suits with the SEC for \$750 million, representing the largest such settlement in history. Moreover, these shareholders still may press claims against WorldCom's leaders and against the firms that underwrote WorldCom's securities. See Shawn Young, *MCI Boosts Payout to Shareholders: A Record \$750 Million to Cover Investors' Losses Would Settle SEC Charges*, WALL ST. J., July 3, 2003, at A3.

75. 15 U.S.C. § 7246 (2002).

76. Jonathan Peterson, *Fair Funds' Give Investors Recourse*, L.A. TIMES, Sept. 27, 2004, at C1.

77. For example, Citigroup recently settled a class-action suit brought by WorldCom investors for \$2.6 billion, *Citigroup Settlement of WorldCom Suit OK'd*, L.A. TIMES, Nov. 6, 2004, at C3.

adjudicate their claims and where the debtor may thereafter receive closure through its ability to address all claims upon its assets.⁷⁸ Allowing competitors to be heard seems to be consistent with these twin goals.

V. POTENTIAL SOLUTIONS

This section explores potential solutions to the problems previously outlined. It first entertains the possibility of leaving oversight to regulatory agencies, as at least one scholar has suggested. It next explores the possibility of utilizing current provisions of the Bankruptcy Code to attain the goal. Finally, this section proposes that the optimal solution would allow bankruptcy judges to consider claims of competitors in the bankruptcy process, but proposes that this solution necessitates changes to the Bankruptcy Code are necessary to implement this power.

A. REGULATORY AGENCY OVERSIGHT

Noted scholar J. Gregory Sidak argues that the FCC should revoke WorldCom's licenses, thus essentially forcing the company into a Chapter 7 liquidation.⁷⁹ In a Chapter 7 liquidation, all of WorldCom's assets would be sold and the company would no longer exist in its current form. Sidak does not believe that the bankruptcy court should be responsible for monitoring the anti-competitive consequences that result from allowing firms such as WorldCom to reorganize under Chapter 11.⁸⁰ Sidak further states that "[t]he bankruptcy court's mandate is the fair and efficient administration of the Bankruptcy Code with respect to the conflicting interests of the debtor and its creditors. Consumers and the competitive process are not within the bankruptcy court's

78. The Bankruptcy Code broadly defines a claim as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." 11 U.S.C. § 101(5)(A) (2000). The Code further allows any right to an equitable remedy to be considered a claim. 11 U.S.C. § 101(5)(B) (2000). Congressional history explains that "by this broadest possible definition and by the use of the term throughout the title 11 . . . the bill contemplates that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case. It permits the broadest possible relief in the bankruptcy court." H.R. No. 95-595, 95th Cong., 2d Sess 309 (1978).

79. Sidak, *supra* note 16, at 255.

80. *Id.* at 254.

purview.”⁸¹ He further concludes that “[t]he duty to guard the welfare of consumers and preserve competition among producers of telecommunications services falls squarely on the FCC. Plainly, neither the SEC nor the bankruptcy court has the responsibility and expertise to investigate the competitive ramifications of WorldCom’s fraud and bankruptcy.”⁸² Sidak appreciates the huge negative implications that a reorganized WorldCom will have on its competitors. If WorldCom is not censured for its conduct, then the government will have effectively aided and abetted the scandal.⁸³ Sidak also recognizes the potentially greater effect that government acquiescence would have on financial markets generally.⁸⁴ While this Note agrees with his assessment of the grave danger of allowing companies like WorldCom to emerge from bankruptcy with a favorable capital structure, it argues that the bankruptcy courts should be involved in the process of determining the appropriate compensation for damaged competitors.

The largest flaw in Mr. Sidak’s ultimate assessment is the potentially incongruous manner by which consideration of competitor interests would be applied across industries. Presumably, the anticompetitive potential of a bankruptcy filing with the corresponding inequity of “rewarding” a firm who has committed fraud will be present any time a company in a capital-intensive industry has committed fraud leading to its insolvency. In the interests of fairness and consistency, all such companies should be subject to the same treatment in bankruptcy. If agencies conduct oversight on an industry-by-industry basis, however, a company in WorldCom’s circumstances, in an industry not directly regulated by a federal agency, could potentially emerge without any sanctions. Although most companies in capital-intensive industries are regulated by at least one federal agency,⁸⁵ these agencies

81. *Id.*

82. *Id.* at 253–54.

83. *Id.* at 259–60. Learned Hand, in a formulation that was later embraced by the Supreme Court, stated that in order to aid or abet another in a crime, the defendant must “in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed.” *United States v. Peoni*, 100 F.2d 401, 402 (2d Cir. 1938), *quoted in* *Nye & Nissen v. United States*, 336 U.S. 613, 619 (1949).

84. Sidak, *supra* note 16, at 255.

85. Examples include airlines and broadcasters, regulated by the Federal Aviation Administration and the Federal Communications Commission respectively.

have vastly different mandates and operate in vastly different political climates and industries. It would be nearly impossible for a consistent and coherent strategy to be developed with regard to the issues brought up by the filing of a bankruptcy petition in the face of fraud. While it may be argued that the very fact that the industries operate in significantly differing climates mitigates in favor of allowing federal agencies to control the decision-making process, most agencies are not experts in the bankruptcy process and its goals.

B. BANKRUPTCY COURT SOLUTIONS UNDER PRESENT LAW

Bankruptcy courts, however, are adept at balancing the interests of different constituencies including different groups of creditors, shareholders, employees, and communities.⁸⁶ Certainly, bankruptcy courts are not experts in the industries in which they adjudicate, nor are bankruptcy courts experts in the financial instruments and agreements with which they must routinely deal. Despite some of these shortcomings, Congress has entrusted the bankruptcy courts with the adjudication of complex issues.⁸⁷ It would be anomalous to argue that the court has the expertise to balance the interests of these groups but would be overwhelmed when factoring in the interests of competitors under limited circumstances.

Can the bankruptcy courts utilize current law to account for the interests of competitors? Judges would have to stretch current law severely in order to bring competitors under its jurisdiction in a bankruptcy case. As previously noted, the Bankruptcy Code purposely utilizes a broad definition of "claim."⁸⁸ However, even given the broad definition, courts have placed limits on its application.⁸⁹ Neither the common law nor any statutory provi-

86. Although the Bankruptcy Court is constrained by the goals and policies of the Chapter 11 reorganization process, the Supreme Court has noted that "[t]he Bankruptcy Court is a court of equity, and . . . is in a very real sense balancing the equities." *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 527 (1984).

87. See *Cal. Pub. Employees' Ret. Sys. v. WorldCom, Inc.*, 368 F.3d 86, 96–97 (2d Cir. 2004) (discussing the broad grant of jurisdiction to the bankruptcy courts to "dispose of controversies that arise in bankruptcy cases or under the bankruptcy code").

88. See *supra* note 78.

89. In *In re Piper Aircraft*, 162 B.R. 619, 629 (Bankr. S.D. Fla. 1994), the court stated that "Congress may have intended the broadest possible definition of claim, but that definition still has limits."

sions currently give a competitor a cause of action based on fraud perpetrated by another competitor upon its own investors which, when combined with the generous provisions of the Bankruptcy Code, puts those competitors at a disadvantage. Though the current statutory definition of claim is broad, it would not be prudent to allow judges to expand its reach infinitely.

One may argue that current provisions are sufficient to allow claims of competitors. The Bankruptcy Code allows judges significant discretion in adjudicating cases. This section of the Code gives judges the power to issue broad equitable relief.⁹⁰ Section 105, however, has been interpreted by the courts to be a procedural provision. Courts generally may not utilize the provision to create substantive law.⁹¹ In fact, a recent Seventh Circuit decision calls into question the doctrine of necessity, one of the more established usages of section 105 whereby the court permits “critical vendors” to receive payment before other creditors of similar priority are paid.⁹² The decision may suggest a renewed reluctance on the part of courts to construe section 105 liberally. Although the courts have, at times, arguably used section 105 to broaden the definition of claim,⁹³ utilizing section 105 as a catch-all provision is probably not in the long-term best interests of the Bankruptcy Code.

The bankruptcy court also has the ability to convert a case in Chapter 11 to a Chapter 7 liquidation or to dismiss the case altogether pursuant to section 1112.⁹⁴ The statutory authority to

90. The section, in part, states, “[T]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” 11 U.S.C. § 105(a) (2000).

91. *In re Chicago, Milwaukee, St. Paul & Pac. R.R.*, 791 F.2d 524, 528 (7th Cir. 1986). (“The fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightening those views may be.”); *In re Yancey*, 301 B.R. 861, 868 (Bankr. W.D. Tenn. 2003) (“A private cause of action is a substantive right, not a procedural one, and . . . § 105(a) cannot, standing alone, create a private right of action.”).

92. *In re Kmart Corp.*, 359 F.3d 866, 871 (7th Cir. 2004). The court went on to state that “[e]very circuit that has considered the question has held that this statute does not allow a bankruptcy judge to authorize full payment of any unsecured debt, unless all unsecured creditors in the class are paid in full.” *Id.*

93. In the *Johns-Manville* bankruptcy proceeding the courts used section 105 as the rationale for allowing a plan of reorganization that bound all future claimants who may have been exposed to asbestos. See *In re Johns-Manville*, 97 B.R. 174 (Bankr. S.D.N.Y. 1989).

94. 11 U.S.C. § 1112 (2000).

convert or dismiss a case, however, is only available in limited situations.⁹⁵ Moreover, the court must take the interests of the creditors into account in its decision regarding whether to convert or dismiss a case.⁹⁶ Because the interests of creditors and competitors are typically incompatible, rarely will the consideration of competitors' interests justify the utilization of section 1112. Even if the court could dismiss cases where fraud was present under this section, it would probably not be the optimal course for the courts to take. The dismissal of a bankruptcy case or forced liquidation of a debtor is a blunt means of affording consideration to the rights and interests of competitors. While there may be some instances where this tool would be appropriate (e.g., where a widespread fraud is ongoing throughout the bankruptcy process), it certainly cannot be the only tool at the court's disposal in accounting for these interests.

C. BANKRUPTCY COURT SOLUTIONS UTILIZING PROPOSED CHANGES IN LAW

The following sections outline the specific changes proposed by this Note to the current bankruptcy laws.

1. *Outline of Law*

Ultimately, the solution must not come from a strained reading of current bankruptcy law, but from amendments to the law through legislative action. Congress should explicitly allow competitors to hold claims and participate in the bankruptcy process *only in cases in which fraud is involved* and where debt service payments represent a sizable portion of an industry's expenses or revenues. Congress should decide whether to mandate a minimum average industry percentage of debt/revenues, debt/assets, or some other ratio under which competitor interests cannot be considered or whether to leave such decisions up to the courts. The judge would have to make an initial determination that the prerequisites of fraud and capital intensity existed before entertaining competitors' claims. Congress has already de-

95. *Id.*

96. *Id.*

termined that the interests of creditors come first and foremost in the typical bankruptcy case and the markets and bankruptcy system have survived for many years based upon that assumption. However, there are extraordinary cases in which the system must take into account these unprotected and significant interests.

2. *Protection Against Frivolous Claims*

In order to protect against claims of competitors who may opportunistically use the system to gain an unfair advantage over the debtor, the standard of proof for such claims must be high. First, competitors would have the burden of proof relating to all aspects of their claim. The standard by which competitors would have to prove these claims should resemble a “substantial evidence” or “reasonable doubt” standard. The high standard of proof would have two goals. First, it would prevent frivolous claims and close calls. Second, it would encourage claims by competitors only when there have been substantial losses. Given the significant legal expenses involved in proving such claims, competitors will press such claims only when the fraud and corresponding losses have been substantial. Finally, the judge should have the power to impose heavy sanctions on parties bringing frivolous claims.⁹⁷ This power is necessary to deter opportunistic strike suits intended to derail the Chapter 11 proceedings.

The system would not permit competitors to collect for *any* losses they had suffered. Competitors would also have to demonstrate that their past and future losses are directly linked to the fraud perpetrated by the debtor and that these losses would not have existed but for the fraudulent behavior of the debtor. It is important that courts distinguish those claims that would result from Chapter 11 generally — e.g., a claim by one of the debtors’ vendors — from those claims that linked to the fraudulent activities of a firm.

97. Courts currently may impose sanctions upon attorneys, law firms, or parties pursuant to the Federal Rules of Civil Procedure. FED. R. CIV. P. 11.

3. *Priority of Claims*

Once competitors have proven their claim, the issue arises of the priority that their claims should have and their level of participation in the bankruptcy process. One obvious approach is to give damaged competitors rights similar to those of tort victims. Both classes have become creditors to the corporation against their will. Furthermore, both claims involve improper conduct by the debtor. The similarity, however, between tort victims and a debtor's competitors ends there.

Tort victims are creditors because of the debtor's prepetition activities. As a rule, future tort claimants whose injuries result from the activities of the reorganized debtor, may bring such claims as they arise, unaffected by the bankruptcy proceedings. In contrast, the principal damages that will be borne by the competitors will arise from the bankrupt firm's *future* conduct.⁹⁸ Thus, these claims are more analogous to administrative expenses. Generally, administrative expenses are payments to the professionals who administer the estate and to third parties that provide products or services to a firm while it is in Chapter 11.⁹⁹ Administrative expenses receive priority over other claims in order to induce entities to deal with the debtor throughout the bankruptcy period.¹⁰⁰ Similarly, society (as represented by a corporation's competitors) should be induced to deal with bankrupt firms by having a claim of its own. The injury to competitors (if there is one) occurs every day that the reorganized debtor is able to perform its business utilizing the provisions of the Bankruptcy Code. These administrative expenses would only be payable in cash, as is required by the Code for other administrative expenses.¹⁰¹ Conflicts of interest would preclude the competitor claimants from receiving any equity in the reorganized firm.

98. One might argue that the situation is analogous to a tort victim who is injured by the pre-petition conduct of the debtor, but whose injury does not manifest until after a confirmation plan is confirmed. Here, the conduct giving rise to the claim is both the fraudulent activity and the ability of the debtor to take advantage of bankruptcy's generous provisions. Whether the confluence of these two events causes an injury to the competitor is a separate inquiry.

99. See 11 U.S.C. § 503 (2000).

100. 11 U.S.C. § 507(a) (2000). Section 507 dictates a detailed list of the priority afforded to each class of claim. Administrative claims receive first priority in the scheme.

101. 11 U.S.C. §§ 507(a)(1), 1129(a)(9)(A).

VI. POTENTIAL CRITICISMS AND/OR PROBLEMS OF PROPOSED SOLUTION

The following section addresses some of the potential criticism to this Note's proposed solution. First, it examines the anti-competitive effects of giving competitors a claim in bankruptcy. Next, it examines the potential conflict between the solution and current antitrust law. This section further explores the argument that Chapter 11 is a valuable vehicle to promote competition. Finally, this section evaluates the possible harmful effects the solution may have upon those parties whom the fraud harmed.

A. POTENTIAL OF CLAIMS TO ELIMINATE DEBTORS

This Note recognizes that the losses of competitors could be quite substantial. These claims may be sufficient to eliminate the prospect of a successful reorganization. Under such circumstances, the bankrupt must liquidate. This possibility would be appropriate. In a liquidation, the claims of the competitors would disappear. Their claims exist only insofar as the fraudulent firm's reorganization will cause losses to be borne by competitors, and no reason exists for the innocent investors in competitors, specifically, or for society, generally, to have to bear the costs of the fraudulent activities of certain debtors.¹⁰²

The result may be more efficient because creditors and stockholders will know that in circumstances of fraud, they may not be able to benefit from the generous Chapter 11 provisions of the Bankruptcy Code. Although these groups always face losses in the event of reorganization, their losses will be even greater, and may potentially be catastrophic, where fraud is involved. They will have the incentive to develop contracts that enable them to better monitor the companies in which they invest. The solution would thus let the losses lie with the parties that are in the best position to prevent the fraudulent activities in the first place.

102. The same argument could probably be made regarding pre-petition tort claimants. Without commenting on the justness of the rule relating to tort claimants, one major difference between the constituencies is that torts in the business sense need not arise through willful misconduct of a company and its agents.

B. APPARENT CONTRARINESS TO ANTITRUST LAW

Bankruptcy protection allows for the survival of many firms that would fail in the absence of bankruptcy protection. Firms that would have otherwise exited the marketplace are can continue providing products and services to consumers. Some may find it troubling that, by allowing competitors to have a stake in the reorganization process, there may be instances where competition decreases. The decrease in competition could in turn hurt consumers who generally benefit from increased competition. The law would thus be incongruent with antitrust laws, the uncontroverted purpose of which is the protection of consumers. The Supreme Court has clearly stated that “antitrust laws . . . were enacted for ‘the protection of competition, not competitors.’”¹⁰³ Courts have further stated that “[a] plaintiff who wants something, such as less competition or higher prices, that would injure consumers, does not suffer antitrust injury.”¹⁰⁴ Although the remedies might be different and the effects of giving competitors a claim may stifle competition in certain instances, both causes of action have the same goals. They are both concerned with the long-term healthy functioning of the market. For instance, predatory pricing may result in short-term gains for consumers, but would ultimately result in long-term systemic losses. Likewise, although consumers may suffer particularized losses under this proposal, they will gain in the long-term because capital will flow to its most efficient usage.

To illustrate this point further, most would agree that consumers are not helped, and are probably hurt, when capital is appropriated to a source because of fraudulent information disseminated by that source. By giving competitors a claim, this proposal does nothing more than ensure that capital is redistributed to its most efficient users.¹⁰⁵ These efficient operators are

103. *Brown Shoe Co. v. United States*, 370 U.S. 294, 320 (1962).

104. *U.S. Gypsum Co. v. Indiana Gas Co.*, 350 F.3d 623, 627 (7th Cir. 2003).

105. A powerful argument could recognize that Chapter 11 is a mechanism by which less efficient users of capital are permitted to continue operating in the face of their inefficiency. The financial system in the U.S., however, implicitly assumes a well-functioning market where investors make investment choices based on that information. When this paradigm breaks down because of the presence of fraud, it is important that the system reassures the market that the fraud will not be tolerated and that all incentives to commit such fraud, however minimal they may be, will be extinguished. As a result of this vigi-

the parties most likely to provide cheapest cost services to consumers. Furthermore, because claims are only allowable to the extent that they were caused by the fraudulent activities, competitors of companies that operate in competitive industries will often not have judicially cognizable claims. Often times, debtors will be able to show that they were able to raise money notwithstanding the fraud. Because competitors only will have claims where they have suffered due to some fraudulent activity (as opposed to suffering from the advantages inherent in Chapter 11 itself), there will be no claim unless the fraud caused damages.

The possibility exists that a debtor operates in an industry where there is a natural monopoly.¹⁰⁶ In these cases, elimination of a competitor may result in a monopoly for another industry participant. This result, however, would be proper. David Skeel disagrees, arguing that there is an “antitrust benefit” associated with Chapter 11.¹⁰⁷ He notes, “[I]f the industry is already relatively concentrated, the disappearance of a major company might leave a small number of companies that have significant market share.”¹⁰⁸

There are several views regarding the optimal solution to problems of monopolistic competition. One of these solutions, however, is not to allow companies to distort the true nature of an industry by fraudulently raising money and then to permit the company to continue operating through the generous provisions of Chapter 11. If industry dynamics are such that only one firm is capable of surviving (which may be the case in capital-intensive industries), then federal regulation may be warranted.

lance, investors will know that while there are external, operational, and corporate governance risks (at the companies in which they are invested) that must be taken into account, these risks need not be exasperated by the risk that the malfeasance of other companies will negatively affect their investments.

106. A natural monopoly was historically defined as a market in which the unit costs of firms within the market decrease as output increases. John Cirace, *An Economic Analysis of Antitrust Law's Natural Monopoly Cases*, 88 W. VA. L. REV. 677, 684 (1986). Because this was hard to measure in the real world, a market is said to be a natural monopoly when it will only support one firm. *Id.* at 685. Although, by definition, multiple firms will not typically operate where a natural monopoly is involved, the presence of fraud has the potential to distort the market to allow multiple firms to operate in the short run. Antitrust regulations also create environments in which multiple firms can operate despite an industry structure conducive to natural monopoly.

107. David A. Skeel, *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 938 (2003).

108. *Id.*

Problems related to monopoly and competition are not solvable, however, by protecting the perpetuation of misleading information and fraudulent practices.

C. CHAPTER 11'S ROLE IN PROMOTING COMPETITION

Recognized bankruptcy scholar Douglas Baird believes that bankruptcy promotes competition. He likens any punishment to the assets of a firm, even one whose managers engaged in fraud or other malfeasance, to punishing a car that was driven by someone committing a crime.¹⁰⁹ Baird views the victims as those parties (the creditors, tort victims, contractors, employees) who have been directly affected by the fraud.¹¹⁰ Because section 959 of the Bankruptcy Code requires that the estate be operated "according to the requirements of the valid laws of the state in which property is situated,"¹¹¹ Chapter 11, in Baird's view, "does not give firms a competitive advantage over others in their industry."¹¹² Baird further argues that the existence of viable firms tends to foster competition.¹¹³

A firm's need to abide by substantive non-bankruptcy laws while in Chapter 11 merely takes away one potential competitive advantage. Because a firm cannot thwart regulatory and criminal statutes does not mean that the content of the Code itself, which does alter the underlying substantive law, does not offer a competitive advantage over other firms. Moreover, Baird does not explain why those dealing directly with the firm are the only victims of the fraud. This Note's solution does not argue that tort victims, creditors, or investors are not victims and do not deserve a claim. It merely argues for a more robust definition of the victims and claimants. Furthermore, while the automobile analogy may have some merits, it does not comply with current corporate

109. *The WorldCom Case: Looking at Bankruptcy and Competition Issues; Hearing on Senate Judiciary Committee* (statement of Douglas G. Baird, Vice Chair National Bankruptcy Conference), available at http://www.nationalbankruptcyconference.org/documents/NBC_testimony7_03.pdf (last visited January 11, 2004).

110. *Id.*

111. 11 U.S.C. § 959 (2000).

112. See Baird, *supra* note 109.

113. *Id.*

law. If a criminal prosecution lies against a corporation,¹¹⁴ it follows that the corporation is liable for harms that it perpetrated on competitors. In a criminal prosecution, it is the employees who acted wrongly yet it is all the stakeholders, not just the wrongdoers, who will be punished. This dispersion of punishment should exist even where control of the corporation has shifted since the perpetuation of the illegal acts or where, as in the case of bankruptcy, the entity is ostensibly a new corporation.

Finally, Baird is correct in stating that more choice generally enhances competition and consumers are probably better off because Greyhound and Dow Corning survived.¹¹⁵ However, the desire to promote competition by coddling the development of firms is not without limits. Regulations limiting the practice of law to those who have passed the bar and/or have law degrees necessarily limits competition. The same holds true for limitations on the practice of physicians or limitations on securities practices. The above examples represent just a fraction of the instances where Congress has decided that the desire to promote competition is outweighed by other considerations. It is not enough to contend that it is desirable to allow viable firms to survive. One must show that the costs of allowing these firms to survive do not outweigh the potential benefits.

D. THE PUNISHMENT OF THOSE WHO ARE ALREADY VICTIMS

Perhaps the most damning indictment of this Note's proposal is that by giving competitors a claim, fewer assets will be available to creditors, equity investors, tort victims, and contractors. While some of these constituencies will receive a share in the reorganized company, it is difficult to imagine that these parties consider themselves fortunate to have a stake in the reorganized enterprise, even though the enterprise will be able to take advantages of the provisions of Chapter 11. Billions of dollars of value was lost in the WorldCom fraud. To most parties involved with the firm, it is probably small consolation that they may take advantage of certain Chapter 11 provisions. By affording competi-

114. For a discussion concerning the indictment of Arthur Anderson, see *supra* note 62.

115. *Id.*

tors a stake, the proposal only works to further dilute the minimal value these parties may maintain.

Several factors militate in favor of affording competitors a claim, notwithstanding the negative effects it will have on already downtrodden stakeholders. First, investors have other vehicles, such as 10b-5 suits and S.E.C. funds, through which they can recover value. Competitors, however, do not have any vehicles through which to state their claims.¹¹⁶ Second, although the majority of passive investors are not to blame for the fraudulent activities of a firm, these investors are in a better position to monitor the activities of a firm than are competitors. Investors may implement and enforce tighter controls on management teams, and these investors determine for themselves whether the cost of the additional controls is justified given the potential losses that may occur. Finally, while many may be able to justify greater losses falling upon sophisticated creditors or investors, it is more difficult to justify the losses that would fall upon employees of companies such as WorldCom who have presumably already experienced significant losses. To the extent, however, that any gain to WorldCom's employees represents a loss to the employees of one of its competitors, then this argument is greatly diminished.¹¹⁷ The choice then becomes a choice between two equally innocent classes. Allowing the losses upon employees of the fraud perpetrating company may, however, give all employees added incentives to ferret out fraud in the future.

VII. CONCLUSION

Bankruptcy systems necessarily involve difficult choices. Many of the problems of our current bankruptcy system stem from large groups of stakeholders with significant claims against a debtor attempting to divide a finite amount of assets among themselves. Some of the problems inherent in the system reflect a conscious choice by Congress regarding the most efficient method to divide the finite pie to maximize efficiency, both *ex ante* and *ex post*. In a situation where more claims than assets

116. Even if a competitor discovers the fraud prior to a firm's filing for bankruptcy, there is no means for the competitor to pursue its claims.

117. Because of the novelty of this Note's approach, it is difficult to assess what percentage of the competitor's claim is visited directly upon employees of that company.

exist to satisfy those claims, there will always be winners and losers; attempting to devise a system where all parties win would be impossible and a waste of time.

Competitors represent a group that systematically loses when they operate in capital-intensive industries. Typically, the filing of a bankruptcy petition by one firm in a capital-intensive industry is followed by subsequent filings by other firms in the industry. This pattern was seen in the railroad industry in the 19th and early 20th century,¹¹⁸ in the airline industry in the 1980's and early 1990's¹¹⁹ and again in the telecommunications industry over the past few years.¹²⁰ Congress has decided, probably correctly, that such patterns are part of the typical business cycle and serve to ensure the competitiveness of American industry.

The same indifference towards competitors, however, should not prevail when fraud is involved. One must be careful not to exaggerate the problem or the level of perverse incentives involved, as many of WorldCom's competitors have done over the past several months. Typically, those perpetuating the fraud will not be the beneficiaries of the bankruptcy process. Thus, any fear of a widespread push towards raising money through fraudulent means is probably unfounded.

Although the aforementioned perverse incentives may not be great, they still exist at some levels. More importantly, notions of distributive justice and economic efficiency suggest that the Bankruptcy Code should change in order to confront fraud in a capital-intensive industry. The debate heretofore has primarily focused on whether it is an appropriate duty of industry-regulating agencies to discipline their members. The dogmatic assumption that the bankruptcy courts are simply unable to handle such concerns, however, is without support. The bankruptcy

118. Approximately half of all railroads in the U.S. entered an equity receivership between 1890 and the United States' entry into World War I. Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. 1420, 1420 (2004).

119. More than 120 airlines have gone bankrupt since the Airline Deregulation Act of 1978. Mark C. Mathiesen, *Bankruptcy of Airlines: Causes, Complaints and Changes*, 61 J. AIR L. & COM. 1017, 1020 (1996).

120. "Over 100 telecommunications companies have filed for bankruptcy protection, and an equal number . . . have 'shut shop,' . . . [over the past several years]." Arun S. Subramanian, Note, *Assessing the Rights of IRU Holders in Uncertain Times*, 103 COLUM. L. REV. 2094, 2094 (2003) (quoting) Om Malik, *Broadbandits: Inside the \$750 Million Billion Telecom Heist*, at ix (2003).

courts can and should catalyze a reassessment of the appropriate participants in the Chapter 11 process.