A Short History of 'Chapter 11': Model for a Bankrupt Economy

by Edward Spannaus

As the U.S. economy and the global financial system careen deeper into collapse, it is an appropriate time to examine the background and history of what we call bankruptcy reorganization, or "Chapter 11" for short.

For many years, Lyndon LaRouche has warned that the U.S. economy—and indeed, the entire global financial system—must be put through the equivalent of a Chapter 11 bankruptcy reorganization. This requires that debts and paper financial titles are put to one side, while the essential functions of the economy are maintained. "The general rule," LaRouche wrote in 1999, "is that useful production and distribution of needed physical goods, must be uninterrupted, and that essential institutions remain standing and functional, even if they might be judged insolubly bankrupt. Keep things which must function, functioning, and sort out the financial accounts at leisure."

LaRouche spelled out the principles involved on Oct. 3, 2001, in a video-conference presentation to the Peruvian Society of Economist Engineers.[1]

"We're in the final, breakdown phase of the existing world monetary and financial system," LaRouche warned. "The system is, essentially, finished, and can not be preserved in its present form, with its present institutions."

LaRouche said that we must have a reform of the international financial and monetary system immediately, and that governments and the entire world financial system must be put through the equivalent of bankruptcy reorganization. "The principles are not much different than they are for the bankruptcy of an important firm, in a nation," LaRouche explained. "There are certain firms you do not want to have collapse at any cost, because they're too important to the country. And therefore, somehow, you will arrange that these firms continue to function because they perform an essential function for the nation. When you're dealing with the bankruptcy of a nation, the authority of this principle is even stronger. *You can not bankrupt a nation. You can not foreclose on a nation.* That would be mass-murder."

LaRouche emphasized that it is necessary to keep the essential institutions of a nation functioning, to keep the levels of employment high, and to have a program for recovery. The same principles apply when dealing with an international financial and monetary crisis, LaRouche stressed. *"You can not liquidate countries;* you can not decide which country is going to survive or not; *all nations must survive.* And they must survive together."

But, the reader might ask, what exactly *is* bankruptcy reorganization? Is it possible to allow a firm—or a nation—to keep operating, even if it can't meet its financial obligations, or pay its debts? What happens to all the contracts, solemnly negotiated, which bind a firm to pay its creditors, and which allow its creditors to collect the debts, even to the point of seizing assets or shutting down a company?

It is to provide answers to these and other questions, that we present this brief report concerning the development and the operation of current U.S. bankruptcy law, with an emphasis on its provisions for corporate reorganization, or Chapter 11. For what this does, is exactly what LaRouche prescribes for the entire economy: It subordinates debt payments and strict fulfillment of contracts, to the U.S. Constitutional principle of the general welfare, by putting a priority on keeping a company in business and operating, over and above the payment of back debts.

And we will see, how corporate reorganization—which once stood in opposition to bankruptcy—came to be incorporated as an essential feature of U.S. bankruptcy law, through the efforts of Franklin Delano Roosevelt, and his collaboration with his outgoing predecessor, President Herbert Hoover, in 1932-33. This story, which remains untold in the history textbooks, is vital for us today, as we face an even more devastating economic and financial collapse.

The Uniqueness of U.S. Bankruptcy Law

It is important to note at the outset, that U.S. bankruptcy law is unique in the world today, for its equitable treatment of debtors. Indeed, a current legal treatise on bankruptcy law states:

"In many respects the U.S. Bankruptcy Code is perhaps the most liberal debtor relief bankruptcy system to come into existence since the Jubilee Year of the Old Testament."[2] Under the Jubilee provisions (Leviticus 25:10), every 50 years,

1. "LaRouche Discusses World Crisis With Peruvian Engineers," *EIR,* Oct. 19, 2001.

2. David L. Buchbinder *Fundamentals of Bankruptcy* (Boston: Little Brown, 1991).

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National Guardsmen control a crowd protesting a farm foreclosure in Iowa in 1933. After Franklin D. Roosevelt's election victory in November 1932, he and incumbent President Herbert Hoover collaborated to reform U.S. bankruptcy laws, in the interest of the general welfare.

all debts were discharged and all indentured servants and slaves were freed. During the intervening years, it was possible to redeem property or persons given in payment of a debt. The purpose of the Jubilee was to provide the opportunity for a "fresh start"—which is an essential feature of U.S. bankruptcy law.

Even more significant than the ability of individual debtors to discharge their debts and to have the opportunity for a "fresh start," are the provisions which apply these principles to corporations. What is today known as "Chapter 11"—corporate reorganization—is even more unusual: This allows a debt-strapped corporation to set its debts to one side, and continue in business, rather than shutting down, throwing its workers on the unemployment lines, and depriving the economy as a whole of its products and (what should be) its contribution to the common good.

Under the traditional Anglo-American "rule of law"—modelled on Roman law—contracts are considered sacrosanct, and debts must be repaid at all costs, in former times often at the cost of the life or liberty of the debtor. Thus, to be bankrupt was considered a crime to be punished.

But, there is another tradition—falling within the sphere of jurisprudence—known as "equity," in contrast to "law." This tradition stems from the Judeo-Christian concept of the Jubilee's debt forgiveness and redemption, and was expressed historically in the usually subordinate republican tradition in English law, as that tradition was carried forward into those American colonies which were committed to building a republican nation-state in the New World. This stands in contrast to the rigid, oligarchic notions of law of a John Locke or Thomas Hobbes, for example.

The classic exposition of the principle of equity is, of course, Shakespeare's *The Merchant of Venice,* wherein Portia's famous speech on the subject of mercy and true justice, is framed by Shylock's protestations: "I stand for law," and, "I crave the law," as, sharpened knife in hand, he sought his pound of flesh.

The Principle of Equity

Going beyond Shylock's view took a long time, and began under the republican tradition in Europe.

The first provision in English law which allowed the discharge of a debtor from his debts, was introduced in 1705 under Queen Anne. (It was under Anne, and with her support, that the nation-building project in the New World was launched by republican circles in England and on the Continent.)[3]

In the United States, it was within the sphere of equity (in contrast to "law") that the most important developments relative to bankruptcy took place, including the emergence of provisions for corporate reorganizations.

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3. On Queen Anne, her ties to the republican Leibniz networks, and her importance for the transatlantic republic conspiracy which produced the United States of America, see H. Graham Lowry, *How the Nation Was Won: America's Untold Story* (Washington: Executive Intelligence Review, 1987).

Equity dealt with correcting and mitigating the law, when strict compliance with the law (a contract, for example) would cause a hardship or an injustice. Whereas a court of law would attempt to enforce a contract, a court of equity could mitigate a contract on grounds of mistake, fraud, accident, or hardship.

The great 17th-Century German philosopher Gottfried Wilhelm Leibniz defined equity (or distributive justice) as a higher level of natural justice than strict right (or commutative justice); but the highest level, said Leibniz, is piety, or universal justice. Leibniz compared equity to the Golden Rule: to treat others as you yourself would wish to be treated.

It was from courts of equity (often called Chancery Courts) that provisions for relief of debt could be sought. In former times, equity was that branch of the judicial system which dealt with justice, termed "natural justice" by Joseph Story, the preeminent 19th-Century legal and Constitutional commentator (and Supreme Court Justice), and other commentators. (The Federal courts eliminated the distinction between law and equity in the 1930s.)

The U.S. Constitution foresaw the importance of having uniform, national laws on bankruptcy, with the provision in Article I, Section 8, Clause 4, giving the Congress the power to establish "uniform Laws on the subject of Bankruptcies thoughout the United States." Bankruptcy and insolvency laws were, otherwise, matters of state, not Federal law; this provision provided for national uniformity, but more importantly, ensured that such laws would be subordinate to the principles of the Federal Constitution.

Story discussed this provision in his 1833 *Commentaries on the Constitution.* He wrote that one of the purposes of bankruptcy and insolvency laws was "to relieve unfortunate and honest debtors from perpetual bondage to their creditors."

To keep a debtor in perpetual bondage until a debt is fully paid, either through imprisonment, or through "an absolute right to appropriate and monopolize all their future earnings," Story explained, takes away all encouragement to industry and enterprise, and it takes away all just rewards of his labor. To imprison a person on account of his debts, Story declared, is "incompatible with the first precepts of Christianity."

One of the first duties of legislation, Story said, should be "to relieve the unfortunate and meritorious debtor from a slavery of mind and body, which cuts him off from a fair enjoyment of the common benefits of society, and robs his family of the fruits of his labor, and the benefits of paternal superintendence." Any national government which did not have this power of legislation, Story declared, "would be little worthy of the exalted functions of guarding the happiness, and supporting the rights, of a free people."

For the first century of our republic's existence, there were only a few periods of time in which there were uniform national bankruptcy laws. These were passed in periods of economic distress, or immediately following a panic—1800, 1841, 1867—but were repealed after a few years, usually under pressure from the creditor class. The effect of these short-lived national bankruptcy laws, was to eliminate the punitive character of state bankruptcy laws, and to permit debtors to voluntarily petition for relief from debt. By mid-19th Century, all states had eliminated imprisonment for debt.

Finally, in the wake of the Panic of 1893, the Bankruptcy Act of 1898 was passed, which has remained in force, with major amendments and revisions, ever since.

The U.S. Supreme Court's 1935 review of the history of U.S. bankruptcy laws in its decision upholding the constitutionality of the 1934 railroad reorganization bill, underscored the divergence of U.S. bankruptcy law from the "rule of law" tradition.[4] English law, at the time of the adoption of the U.S. Constitution, "was conceived wholly in the interest of the creditor and proceeded upon the assumption that the debtor was necessarily to be dealt with as an offender," the court said, adding that anything like voluntary bankruptcy was unknown to the English system. But the court was emphatic that the framers of the Constitution had *not* intended to limit the power of Congress to then-existing English law and practice.

The first U.S. bankruptcy law, in 1800, still operated exclusively in the interest of the creditor, the court said, but "the act of 1841 took what then must have been regarded as a radical step forward by conferring upon the debtor the right to surrender his property, with some exceptions, and relieve himself of all future liability in respect of past debts." While English law and the U.S. 1800 law assumed that the bankrupt debtor was dishonest, "the act of 1841 and later acts proceeded on the assumption that he might be honest but unfortunate."

Then, in the short-lived 1874 amendments to the 1867 bankruptcy law, for the first time a debtor was permitted "to propose terms of composition [reorganization] to his creditors to become binding upon their acceptance by a designated majority and confirmation by the judge."

The Public Good

We now turn to the extension of this principle of equity into U.S. bankruptcy law, particularly as applied to corporations.

Until the 1930s, "bankruptcy" generally meant liquidation, and bankruptcy courts dealt primarily with liquidation of a firm's assets for the benefit of creditors. Courts of equity, on the other hand, provided for reorganizations, for the benefit of both debtor and creditor, and more importantly, for the public good. Until 1933-34, what is now known as Chapter 11 reorganization, was known as "Federal equity receivership," and it operated outside of—and in contrast to—bankruptcy.

The practice of equity receivership first developed around insolvent railroads, beginning in the 1840s. Why railroads? Well, for one thing, it was clearly impractical to dismember a railroad for the benefit of creditors. The only way to ensure that creditors could get some benefit, was to keep the railroad operating under a financial reorganization.

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4. *Continental Illinois Bank v. Rock Island Railway,* 294 U.S. 648 (1935).

LaRouche: Why We Need Bankruptcy Reorganization

On Oct. 9, 2001, Lyndon LaRouche was interviewed by radio talk show host Jack Stockwell of KTKK radio in Salt Lake City, Utah, in a follow-up of LaRouche's historic Sept. 11 interview on the same show. In the course of the two-hour interview, Stockwell raised the question of the rising number of bankruptcies, and he suggested that perhaps "we need to consider a reorganization on a much higher scale, a much broader spectrum, than just the local business down the end of the street" (*EIR,* Oct. 26, 2001).

Stockwell said that this idea is catching on around the world, and among certain governments, which are "beginning to recognize that we didn't just hit the iceberg, we hit it some months, some years ago, and that if something isn't done *quickly,* and move in the sense of nation-building, rather than nation-bombing, we may have the 14th-, 13th-, 12th-Century lifestyle foisted upon us again, whether we like it or not."

LaRouche's response included the following:

"Well, it's true. You know, the fellow today who may be very useful to his or her neighbor, is the businessman who, sometime ago, went through a successful reorganization and bankruptcy, and what he would probably tell that neighbor, if he actually did pull successfully out of a bankruptcy reorganization, he would have said: 'Well, first of all, I didn't want to do it. I didn't want to accept the fact that my business had gone bankrupt. But then I realized I had to bite the bullet, I had to face that reality, and boy, am I glad I did.' Because this was the way in which he *saved* that business, which may have been significant to that community.

"I think we can apply the lesson which such people can tell us, to the more general situation.

"We have a bankrupt U.S. and world economy. Right now, it's hopelessly bankrupt. There's no way this is going to bounce back. You know, people who went to jail in bankruptcy, did so because they kept issuing, or taking credit, when they were already bankrupt. And the United States government, especially this Federal Reserve chairman, is doing exactly that! We are hocking everything in sight, against assets which really do not exist, promissory notes which will never be paid; they never could be. We should have a reorganization of this economy now, in order to keep the businesses, the banks, and so forth, which are essential, going; to prevent employment from collapsing; to maintain pensions and essential services, and keep the economy going; and keep things growing. The same way that you would take a corporation, a company, that was essentially a sound company, but had gotten into financial bankruptcy—and take that company, put it through reorganization, save it, and bring it back as a viable part of the community. We're going to have to think in those terms."

But more significantly, railroads were seen as imbued with the public interest, and as having a quasi-public character. Indeed, in the 19th Century, their charters generally stated that their corporate status was granted in exchange for providing a public service. As the Supreme Court put it in the *Rock Island* case: "A railway is a unit; it can not be divided up and disposed of piecemeal like a stock of goods. It must be sold, if sold at all, as a unit and as a going concern. Its activities can not be halted because its continuous, uninterrupted operation is necessary in the public interest."

The old railroad receivership system was, however, riddled with abuses, and it worked to the effect of increasing the concentration of railroad holdings on Wall Street. Nevertheless, this is where the principle of corporate reorganization, rather than liquidation, first came into play. There was an effort to incorporate something like this, as we have noted, in an 1874 amendment to the 1867 Bankruptcy Act, but the law was repealed four years later. Throughout the 19th Century, courts denied to other corporations the right to reorganize their finances in the same manner as railroads, saying that railroads were a special case because of their service to the public.

Hoover Presses for Reform

The crash of 1929-31—with its widespread liquidations and massive resulting unemployment—spurred new efforts to reform the bankruptcy laws. The number of bankruptcies had already been rising throughout the 1920s, reaching a peak in 1932. The disastrous consequences of this, convinced even the conservative Republican President Herbert Hoover to consider a new approach.

On July 29, 1930, Hoover authorized a comprehensive investigation into bankruptcy law and practice, to determine if changes in the laws were needed. The investigation was headed by Solicitor General Thomas Day Thacher, a former Federal judge, who had previously participated in an investigation of bankruptcy in New York City. The Solicitor General's investigation was to be aided by the Department of Commerce, which had just conducted its own study of commercial bankruptcies. New York attorney Lloyd K. Garrison was designated to conduct the investigation under Thacher's supervision.

One of the reasons for Hoover's concern, was obviously that losses in bankruptcy over the previous five years were more than $3 billion, and were averaging $750 million per

year. Thacher said that creditors were only recovering an average of about 8%.

And it was getting worse. On Aug. 14, 1930, the Justice Department reported that the amount of liabilities involved in bankruptcy cases during the last fiscal year (1929-30) had risen to $948 million, from $883 million a year earlier. The amount of assets realized from the cases was only $118 million. These figures include farmers, wage-earners, and businesses, with the largest number being wage-earners.

Initially, the thrust of the investigation, according to Thacher, was that a bankrupt was discharged too easily, without examination into the causes of his distress, and that he was given a slap on the back and told to "go do it again." In an address to the American Bar Association on Aug. 21, 1930, Thacher actually endorsed the British view, saying that the present system encourages dishonesty and recklessness. He said that English and Canadian law, which made it a public duty to investigate the causes of each bankruptcy, was better than the way American law operated, which left it to the creditors alone to be concerned with the administration of a bankrupt's assets and his discharge.

Thacher's remarks only pertained to liquidations—which were the only form of bankruptcy at the time. However, in New York, the Federal Court had also appointed a committee in June, in coordination with the local Bar Associations, to examine the rules of practice of equity receiverships. Robert P. Swaine of the law firm Cravath Swaine & Moore was one of the leaders of the equity committee.

In February 1931, Thacher gave a speech to a banking conference, in which he again called for reform of the bankruptcy laws, saying that when nearly $1 billion a year is taken out of trade and industry because of the inability of bankrupts to pay their debts, and less than 10% is returned to creditors, there is something wrong with the system.

At the conclusion of his study, Thacher submitted his report to Congress in 1931; the report included proposals for a section on corporate reorganizations—in contrast to liquidations—to be added to the Bankruptcy Act, and also a provision allowing other debtors to make adjustments or extensions of their debts.

Hoover sent a message to Congress on Feb. 29, 1932, urging revision of the bankruptcy laws. Hoover's proposals included a provision for debt reorganization by individuals and corporations, so that debtors could have the protection of the courts while adjusting or reorganizing their debts, without being adjudged bankrupt. But Hoover's proposals apparently did not go anywhere, until after the November elections.

The Hoover-Roosevelt Collaboration

Two days after his victory in the November 1932 elections, Franklin Delano Roosevelt took up the issue of bankruptcy—which led to a surprising collaboration. FDR first carried on discussions with his "Brains Trust," particularly A.A. Berle and Raymond Moley, about revising the receivership laws, as well as ideas for centralized industrial planning. FDR directed Berle to work with Republican New York Congressman Fiorello LaGuardia, both on a farm relief bill, and on draft revisions to the 1898 Bankruptcy Act, including provisions for railroad reorganizations.

In mid-January 1933, with the country sinking deeper into depression, President Hoover had issued a special message to Congress, asking for emergency action in the form of immediate revision of the bankruptcy laws. Hoover wanted the law changed, so that individuals, corporations, and railroads could obtain the protection of the courts, and voluntarily adjust their debts, and so that they could avoid "the process of forced liquidation through foreclosure and bankruptcy sale" of their assets, which he called "utterly destructive of the interests of debtors and creditors alike."

Hoover urged immediate consideration of his proposal, saying the "effective legislation would have most helpful economic and social results in the welfare and recovery of the nation." He pointed out that forced liquidation and foreclosure simply immiserated debtors, without any substantial benefit to creditors. "In the great majority of cases, such liquidation under present conditions is so futile and destructive that voluntary readjustments through the extension of composition of individual debts and the reorganization of corporations must be desirable to a large majority of the creditors."

For debtors to seek the protection of the courts, for readjusting their debts, should not carry the "stigma" of bankruptcy, Hoover said. Rather, the protection of the court should be extended to the debtor and his property, while the debtor and his creditors are given the opportunity "to arrange an equitable settlement of his affairs."

"Under such process it should be possible to avoid destructive liquidation through the composition and extension of individual indebtedness and the reorganization of corporations, with the full protection of the court extended to the rights and interests of creditors and debtors alike," Hoover declared. He added that while the individual and corporate debtors are under the protection of the court, all creditors would be prevented from enforcing their debts.

Hoover said that members of Congress and his administration were collaborating on the proposed measures, and he urged immediate consideration and passage of his legislation "as an emergency action." Within hours of his address, Senator Hastings, and Representatives McKeown of Oklahoma and LaGuardia, who all had proposed bills along these lines, met with Solicitor General Thacher; they arranged to consolidate the McKeown and LaGuardia bills, and to submit them to the House Judiciary Committee on Jan. 13.

Over the next week, work proceeded in committee on the consolidation of the different bills, and a provision was added to include farmers. On Jan. 24, the bill was reported out of committee to the full House, and it was reported that the House would suspend its rules, to expedite consideration of the bill.

President Roosevelt (right) on Inauguration Day, March 4, 1933, with outgoing President Hoover. The day before, Hoover signed the new bankruptcy reform bill into law, with financial reorganization becoming a permanent part of U.S. law.

But opposition to the bill then surfaced. Mayor John O'Brien of New York City said that the bill would have the effect of reducing the value of tax liens on real estate. LaGuardia told him that his opposition was based on a misunderstanding of the bill. On Jan. 30, the Federal Bar Associations of New York, New Jersey, and Connecticut announced their opposition to the provisions of the bill for corporate reorganizations, saying this would bring back a multitude of bankruptcies and strengthen the grip of Wall Street on bankruptcies; they cited the "Irving Trust Monopoly" (Irving Trust Co. having a monopoly on trusteeships in the Southern District of New York). But the Bar Association also protested that the proposed bill would constitute "reckless interference with sacred contractual rights."

Nevertheless, on Jan. 30 the bill passed the House, and it went to the Senate, where the Hastings bill was already pending. On Feb. 5, the *New York Times* reported that the bills were stalled, and would probably have to wait for a special session of Congress to be called by FDR after his inauguration. The *Times* reported on strenuous opposition to the bills by bankers, who said the proposed bills would "destroy all credit." There were also warnings (or perhaps hopes) that the Supreme Court would likely find the proposed bills unconstitutional, on the grounds that they violated the sanctity of contracts.

Senator Hastings submitted a new draft of the bill on Feb. 10, containing a section on railroads, which had the approval of FDR, to the Senate Judiciary Committee. However, the *Times* reported the next day again that, despite FDR's approval, passage of the bill seemed unlikely at this session. Hastings described how the bill, including both corporate and railroad reorganizations, was the product of consultations with representatives of both Hoover and Roosevelt, plus with the Interstate Commerce Commission (ICC) and railroad executives. He also said that, at the insistence of Senator Robinson (D-Ark.), the Democratic floor leader, he had added a section on farm relief.

But on Feb. 13, the Senate Judiciary Committee reported out a stripped-down version of the bill, with the provisions for corporate and railroad reorganizations taken out.

With only ten days left in the session, Hoover sent another special message to Congress on Feb. 20, asking for immediate action on various matters, including bankruptcy reforms, the ratification of the St. Lawrence Seaway Treaty so construction could begin, the Glass banking bill, and increased lending authority for the Recontruction Finance Corporation (RFC) for states and municipalities.

Passage of the bankruptcy bill was the first item in Hoover's list; he said that obtaining cooperation between debtors and creditors for the orderly adjustment of debts "will preserve the integrity and continuous operation of business, save the values of goodwill and the continuation of people in their occupations."

The bill, allowing individuals, farmers, and railroads to readjust their debts, but without the section on corporate reorganization, passed the Senate on Feb. 27.

On March 1, the *New York Times* reported that, under the impetus of FDR's influence, the bankruptcy bill was certain to pass the House before Saturday, adding that Roosevelt had made it clear that he wanted the bankruptcy act amended to provide protection to railroads and corporations before he entered into his duties as President. The Senate version was

passed by the House that day, with only two days left in the session. Representative Summers, chairman of the House Judiciary Committee, said that President-elect Roosevelt regarded the railroad situation as very serious, and that he was in agreement with Hoover that the bankruptcy revision bill should be passed.

Hoover signed the bill on March 3, his last full day in office, marking a major transformation of U.S. bankruptcy law, with financial reorganization (although limited in scope) becoming a permanent part of the bankruptcy code.

'Corporate Reorganization' Enacted

In the new Congress, the McKeown bill for corporate reorganizations was reintroduced, and was then passed by the House in June 1933, along with provisions for municipal bankruptcy. In his third Fireside Chat, on June 24, 1933, Roosevelt cited the problems of individual credit, and people losing their homes and farms, as reasons for reform of the bankruptcy laws, as well as for passage of the Home Loan Act and the Farm Loan Act.

Meanwhile, in the Senate, an investigation of bankruptcy and equity receiverships was under way, with a report being issued in February 1934. But the corporate and municipal reorganization bills did not pass the Senate until May 1, 1934. The *New York Times* reported that this represented a renewal of the movement for bankruptcy reform which had been started in the 72nd Congress by LaGuardia, and was then extended into the Roosevelt Administration.

After negotiation in the House-Senate conference committee, the bill was signed by President Roosevelt on June 7, 1934. Thus, finally, corporate financial reorganization was part of the bankruptcy code.

The statement of purpose of the Corporate Reorganizations Act, noted that, although the bill was designed to deal with current economic conditions, its value would be permanent, in permitting the operation of indebted companies for the public good:

"While this bill was framed with a due regard for the present and immediate prospective economic conditions, it is believed that an expansion of the opportunity for amicable adjustment by debtor and creditors, under the supervision and protection of the bankruptcy courts, and for holding the property of the debtor intact with its operation disturbed as little as practicable such as is provided for by this bill, will prove itself to be of permanent helpful assistance both to distressed corporations and in line with the public interest."

The June 8 *New York Times* described the passage of the bankruptcy bill as "a major achievement of the present Congressional session," and as the result of long investigation and intensive study. It said that "long-drawn-out and expensive receiverships will be obviated and monopolies by professional receivers will be barred." And, with corporations now

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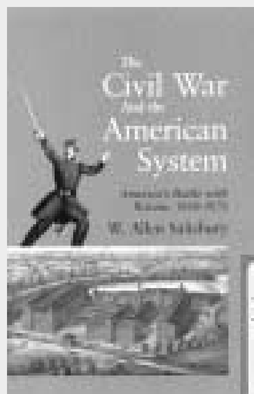

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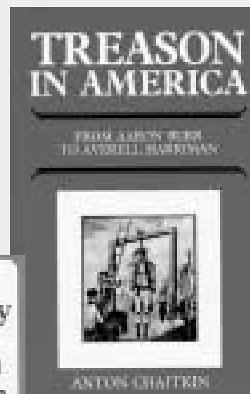

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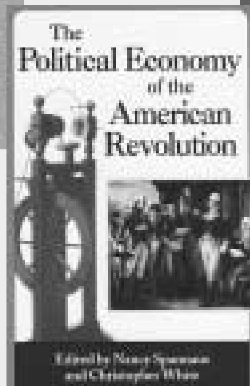

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able to file voluntary petitions for reorganization of their affairs, "the stigma of 'bankruptcy' may to all intents be removed."

The bill also prohibited any interference, by a court, trustee, or the management of a company under court protection, with the right of employees to join a labor organization of their choice; and it prohibited the use of company funds to maintain company unions when a company was under court protection.

The next day, June 9, the *Times* headline read: "Bankrupt Act Held Spur to Recovery: Sponsors Expect It To Help Troubled Concerns Get on Paying Basis."

And indeed, within minutes of FDR's signing of the bill, a number of large corporations, which were already involved in bankruptcies or receiverships, filed voluntary petitions for reorganizations, and it was anticipated that thousands more would do so soon.

The Question of Constitutionality

Why were the provisions for corporate reorganization incorporated into the bankruptcy law, despite their rather distinct histories, in which bankruptcy generally meant liquidation? One reason often given, is that its proponents felt that it otherwise might be declared unconstitutional as an impairment of contracts—not an unwarranted concern, given the reactionary character of the Supreme Court in the early days of the New Deal.

But by making reorganization (which clearly "impairs" contracts) part of the national bankruptcy laws, the law came under the protection of Article I, Section 8 of the U.S. Constitution. And indeed, when a challenge soon came before the Supreme Court in the *Rock Island* case, the constitutionality of the new provisions was upheld, in a 1935 opinion which affirmed that the bankruptcy power granted to Congress in the Constitution, can override contract law. When a "composition," or reorganization, of debt is made binding on non-assenting creditors, the court ruled, this is not a deprivation of property without due process of law; rather, such laws and regulations "simply require each individual to conduct himself for the general good as not unnecessarily to injure another."

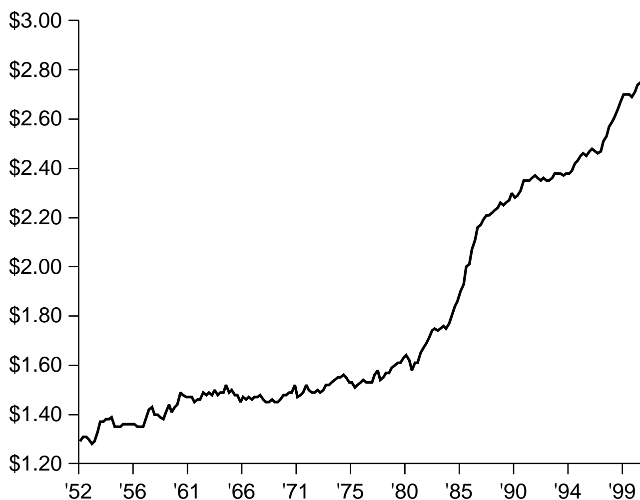
The Corporate Reorganizations Act was passed the day after one of the keystone New Deal legislative enactments, the Securities Exchange Act, which, *inter alia,* directed the newly created Securities and Exchange Commission (SEC) to conduct a study of corporate reorganizations and to submit a report to Congress. The SEC study was headed by Yale Law School Prof. William O. Douglas, and its recommendations resulted in the 1938 amendments to the Bankruptcy Act known as the Chandler Act. (Douglas was appointed by FDR to the U.S. Supreme Court in 1939, where he served until 1975.)

The New Dealers wanted direct government oversight of the reorganization process while that process was under way, rather than only allowing a plan to be reviewed by a court after it had been adopted. One of the most important changes made by the Chandler Act was that it provided for the appointment of a trustee to replace the existing managers in reorganization cases involving large, publicly held corporations. The effect, was to sharply reduce the influence of Wall Street investment banks and the powerful Wall Street law firms, such as Cravath Swaine & Moore, which had controlled major corporate reorganizations, especially those involving railroads.

However, over time, the SEC's role was diminished. Although the intention was to give the SEC an oversight role in the reorganization of publicly held companies (i.e., those whose stocks were sold and traded to the public), the SEC's role was confined to what was then known as Chapter 10 of the Bankruptcy Act; a "loophole" in the law allowed large public-stock companies to avoid the trustee requirement by filing under Chapter 11.

Chapter 11, under the 1938 amendments, had been intended for use by smaller corporations, and it allowed a company's management to retain control during a reorganization. By the 1970s, the use of Chapter 10 had been sharply reduced, and in 1978, the new comprehensive bankruptcy reform law combined the two chapters into a new, single Chapter 11.[5]

FIGURE 1
Dollars Of Debt Per Dollar Of GDP



Sources: Federal Reserve, *EIR*

The course of today's entire U.S. economy toward bankruptcy: It takes issuance of twice as much indebtedness to produce one dollar of GDP, as it did only 20 years ago.

5. David A. Skeel, Jr., *The Rise and Fall of the SEC in Bankruptcy* (University of Pennsylvania Law School, Institute for Law and Economics, 1999).

What Chapter 11 Does

By allowing the reorganization and reduction of debts, Chapter 11 proceedings violate every "common sense" notion of the free market and contract law. The public interest in maintaining an entity as a going concern, trumps all other narrower legal "rights."

How does it work? The first thing that happens upon the filing of a petition for bankruptcy, is that all other legal proceeding involving debts of the corporation are frozen. This is what is now called the "automatic stay," and it brings to an immediate halt all collection efforts, harassment of a debtor, and all court proceedings, including to seize bank accounts or other property. It also means that a utility cannot cut off power or other services to a business (or an individual, for that matter) because of non-payment of back debt.

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In most cases, the current management of the company is allowed to continue to operate the business; in some cases, where fraud, for example, is suspected, a trustee can be appointed by the court to operate the business.

More importantly, the company can obtain *new* credit necessary for ongoing operations, and the repayment of this new credit takes priority over the old debt; it is as if it is a new company, starting with a clean slate, for credit purposes.

The official purpose of this, as stated in the legislative history of the law, is so that the company can continue to operate, provide jobs for its employees, and, over time, pay its creditors and provide a return for its stockholders. It is also recognized, that the assets of a company are far more valuable if they are used in the production of goods or services, than if they are sold off for scrap or otherwise, in a liquidation.

As the business continues to operate, the company and its creditors can work out a plan for partial payment of back debts over time, so that it does not impair the ongoing operations of the firm.

In the case of a public utility, the customers of the utility are also a party-in-interest, whose right to have the utility continue to provide electicity, for example, under contractual arrangments, must be taken into account by the supervising court.

It can thus be seen, from this review, why Chapter 11 bankruptcy is not only a vital feature of our Federal constitutional and legal system, but how it provides a model of the principles which must be applied to the economy as a whole under conditions of economic collapse: Keep corporations and businesses operating so as to maintain necessary functions, keep employees working, and provide new sources of credit, while freezing all debt-collection and back debt, which is to be sorted out over time.

Of course, when dealing with the economy as a whole, economic recovery cannot be accomplished by financial reorganization alone; what is vital is that the Federal government 1) exercise sovereign powers over credit and currency, to ensure a steady flow of low-interest credit into productive enterprise, and 2) promote large-scale infrastructure projects—transportation, energy, water, as well as such "soft" infrastructure, such as schools and hospitals—upon which the revived health of any economy depends. But, without wiping out the massive amount of accumulated, speculative debt now strangling our economy, no other measures could be successful.

And if anybody starts screaming about "the sancity of contracts" and the solemn obligation to pay all debts, just point them in the direction of the United States Constitution and United States bankruptcy laws, to help them rise above their ideology-bound ignorance.

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