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## PRE-BANKRUPTCY CRIMES AND ENTREPRENEURIAL BEHAVIOR. SOME INSIGHTS FROM AMERICAN AND ITALIAN BANKRUPTCY LAWS

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The word “bankruptcy” derives from the Italian word *bancarotta* (= broken bench) that during the Middle Ages was used to indicate the typical sanction applied to bankrupt tradesmen or bankers – the bench breaking, i.e. the breaking of the tradesman/banker’s money table. At its origin, thus, the word bankruptcy had a punitive meaning that has been preserved in continental Europe (for instance the words *bancarotta*, *Bankrott* and *banqueroute* still designate the criminal consequences of failure in Italy, Germany and France respectively), but it has been lost in the Anglo-American world, where bankruptcy presently indicates the default as such. This study focuses on criminal liability of directors and entrepreneurs for misconduct committed prior to bankruptcy in the US and Italy and tries to understand how the different regulation is likely to affect the economic agents’ behavior. We show that the boundary between a firm’s legal and illegal management appears more clear-cut in the US than in Italy, with positive effects on the economic behavior of entrepreneurs and managers.

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***PRE-BANKRUPTCY CRIMES AND ENTREPRENEURIAL BEHAVIOR.***  
***SOME INSIGHTS FROM AMERICAN AND ITALIAN BANKRUPTCY LAWS***

Maurizio PONTANI\*

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Keywords: *Bankruptcy law, Criminal liability, Judicial discretion, Optimal risk taking*

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## 1. Introduction.

The word bankruptcy derives from the Italian word *bancarotta* (= broken bench) that during the medieval times was used to indicate the typical sanction applied to bankrupt tradesmen or bankers – the bench breaking, i.e. the breaking of the tradesman/banker's money table. Since its origin, thus, the word bankruptcy has had a punitive meaning that Italian law still preserves until today: *bancarotta*, indeed, is the noun used to define some crimes that can be committed by the bankrupt (either the sole proprietor of the firm or the firm managers), whereas the bankruptcy itself is called *fallimento*. The same happens in France and Germany, where *banqueroute* and *Bankrott* designate the penal consequences of bankruptcy that, by contrast, is named *faillite* and *Konkurs* respectively.

In the Anglo-American world, instead, the punitive meaning of the term bankruptcy has been lost since the XIX century. Starting from this period, in fact, bankruptcy law became more and more "debtor friendly" at least with good faith's creditors, differentiating in that way from continental bankruptcy law. Nevertheless some criminal sanctions for the bankrupt still survive in American law, even if they are hardly considered by scholars.

This paper aims to describe the differences between the American and Italian law systems as for criminal liability of directors and sole entrepreneurs in cases of insolvency. Thus the attention will thus be focused on the so-called pre-bankruptcy crimes – i.e. the crimes targeting the conduct carried out prior to insolvency – and on trying to understand the economic consequences arising from the two different approaches.

The study is organized as follows. Firstly it describes the change in perspective that characterized the historical evolution of bankruptcy laws: from an early punitive approach against all the defaulted debtors to a regulation much more oriented towards distinguishing between good faith bankrupts (defaulted because of misfortune) and

fraudulent bankrupts (defaulted because of patrimonial mishandlings). Only the latter are indeed still punished by criminal sanctions. Successively, the paper discusses the economic goals of a bankruptcy procedure, focusing on the possible role of pre-bankruptcy crimes in implementing the *ex-ante* efficiency of the firm. The economic analysis highlights that some trade-offs can arise from the use of criminal liability. In fact, too harsh sanctions, as well as too broad criminalization of pre-bankruptcy conduct are likely to weaken optimal risk taking and economic initiative at large. Thereafter, we analyze the present US pre-bankruptcy crimes (*1. Concealment or transfer in contemplation of bankruptcy; 2. Falsification or alteration of records; 3. Bankruptcy Fraud; 4. Destruction, alteration, or falsification of records in Federal investigations and bankruptcy*), and compare them with the Italian ones. The comparison reveals that the US bankruptcy crimes are better defined, especially with regard to the intent: they require indeed ‘intent to defraud’ with a strong mental nexus between the conduct and the bankruptcy petition. Moreover, as for the material element, American bankruptcy crimes target only conduct of ‘transfer and concealment’ of assets, or of fraudulent abuse of the bankruptcy procedure, besides the alteration or falsification of material information. In this way the judicial discretion in reviewing business judgments is limited.

## **2. The era of Bankruptcy Law as criminal Law.**

Not only has the word “bankruptcy” Italian origins, but also the insolvency legislation which derived in its early period from the bankruptcy law adopted by the statutes of the Italian medieval city-states. Although in a broad sense the earliest bankruptcy laws were Roman,<sup>1</sup> something closer to modern bankruptcy law arose in Italy during the 13th century, as trade was developing and consequently the need of having recourse to credit was growing, giving rise to more chances of default. For instance, Siena and Vercelli, during the 1220s and 1240s respectively, already had bankruptcy laws

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<sup>1</sup> See ALFREDO ROCCO (1917), *Il fallimento. Teoria generale e origine storica*, Torino, at 48ff.

providing for a collective recovery of debts directed by public officials<sup>2</sup> and having a criminal nature, since they aimed to punish insolvent debtors. During the early Medieval Era bankruptcy was seen more as a misdeed that was to be punished than as a misfortune deserving sympathy<sup>3</sup>. The most common sanctions were harshest, such as banishment or even the death penalty.<sup>4</sup>

During that period, in England, common law remedies against the debtor's default (such as the execution writs of *feri facias*, *elegit*, and *levari facias*)<sup>5</sup> were individual and

"did not address the distinct problems presented by a debtor's multiple defaults. As commerce expanded, the need for a collective procedure to collect debts became evident. Creditors needed protection from defaulting debtors and from each other".<sup>6</sup>

According to the most followed opinion, the first English bankruptcy law adopted in 1543 under the reign of Henry VIII was influenced by the aforementioned Italian laws<sup>7</sup> at least because, as Lord Coke pointed out, Italian merchants from Lombardy also

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<sup>2</sup> See UMBERTO SANTARELLI (1964), *Per la storia del fallimento nelle legislazioni italiane dell'età intermedia*, Padova, at 28 and 41. See also A. ROCCO, *supra* (note 1), at 179 and 194.

<sup>3</sup> UMBERTO SANTARELLI (1990), *Fallimento (storia del)*, *Digesto Italiano discipline privatistiche, sezione commerciale*, Torino, Vol. 5, at 368.

<sup>4</sup> ANTONIO PERTILE (1902), *Storia del diritto italiano*, Torino, 2<sup>nd</sup> ed., Vol. 5, at 658 and Vol. 6, 2<sup>nd</sup> part, at 386.

<sup>5</sup> According to BLACK'S LAW DICTIONARY (1999) 7<sup>th</sup> ed., a writ of *feri facias* "directs a marshal or sheriff to seize and sell a defendant's property to satisfy a money judgment", whereas a writ of *elegit* is a "writ of execution either upon a judgment for a debt or damages or upon the forfeiture of a recognizance taken in the king's court". Lastly, a writ of *levari facias* orders "a sheriff to seize a judgment debtor's goods and income from lands until the judgment debt is satisfied".

<sup>6</sup> CHARLES TABB (1995), *The History of bankruptcy laws in the United States*, 3 *AM. BANKR. INST. L. REV.* 5, at 7.

<sup>7</sup> GUIDO ROSSI (1956), *Il fallimento nel diritto americano*, Padova, at 12; PAOLO SANTELLA, *Le droit des faillites d'un point de vue historique*, *Mimeo*, at 6 and 8. But see SIR WILLIAM BLACKSTONE, *Commentaries on the Laws of England*, Oxford 1766, II p. 473, according to whom the English Bankruptcy law derived directly from Roman law: "[o]ur legislature seems to have attended to the example of the Roman law [...] I mean the law of *cession*, introduced by the christian emperors [...]".

exported the bad habit of not paying their debts.<sup>8</sup> Not surprisingly this law had a strong criminal character. It was indeed entitled "*An act against such persons as do make bankrupts*" and considered defaulted debtors (called "*offenders*") as criminals.

"At that time, the bankruptcy laws were viewed as a necessary concomitant to the exigencies of commerce, but no more. Credit generally was viewed as immoral and almost fraudulent; as Blackstone noted: [T]he law holds it to be an unjustifiable practice, for any person but a trader to encumber himself with debts of any considerable value. If a gentleman, or one in a liberal profession, at the time of contracting his debts, has a sufficient fund to pay them, the delay of payment is a species of dishonesty, and a temporary injustice to his creditor: and if, at such time, he has no sufficient fund, the dishonesty and injustice is the greater".<sup>9</sup>

Defaulted debtors were therefore defendants accused of having committed "*Acts of Bankruptcy*", without which bankruptcy law could not apply. Acts of Bankruptcy were, for instance: keeping to one's home, absconding without paying debts or even yielding oneself to prison. Being real crimes, these required the *mens rea* as well, i.e. "*the intent or purpose to defraud or hinder any of his or her creditors*".<sup>10</sup> Thus, during the first two centuries of the Bankruptcy laws

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<sup>8</sup> SIR EDWARD COKE, *Institutes of the Laws of England*, London 1797, 4<sup>th</sup> part, at 276†: "In former times as the name of a bankrupt, so was the offence it self (as hath been said) a stranger to an Englishman, who of all other nations was freest of bankruptcy. And the first statute that we find against this crime, was indeed made against strangers, viz. against Lombards, who, after they had made obligations to their creditors, suddenly escaped out of the realm without any agreement made with their debtors". According to G. ROSSI, *supra* (note 7), at 12, the reception of the Italian and continental bankruptcy laws is due to the fact that, as trade expanded, England developed the so-called *law merchant*, a sort of international trade law deputed to rule the exchanges between English and foreign tradesmen. Obviously the *law merchant* (due to its international character) was influenced by the continental legal tradition.

<sup>9</sup> C. TABB, *supra* (note 6), at 9.

<sup>10</sup> See JOE POMYKALA (2000), *Bankruptcy origins in debtor perpetrated crimes*, at 1, 2, available online at [www.ssrn.com](http://www.ssrn.com).

"Parliament and the courts tried to refine the Acts of Bankruptcy provisions to make the law more morally sensitive to the fraudulent behaviour it was trying to identify".<sup>11</sup>

Successively, even though the 1705 Statute of Queen Anne provided for the death penalty for the most serious Acts of Bankruptcy, the same Act inaugurated another trend in bankruptcy, introducing for the first time the *discharge of debts* (i.e. the debtor's relief from any further liability, after the bankruptcy proceeding end) for debtors cooperating in the bankruptcy proceedings. In doing so, as Daniel Defoe had suggested,<sup>12</sup> the bankruptcy law was attempting to perform one of its most important tasks, i.e. to distinguish between honest yet unfortunate debtors and fraudulent bankrupts. But those discharge provisions notwithstanding, even the Eighteenth century bankruptcy laws were not intended for the debtor's relief, but at most showed a more pragmatic 'carrot and stick approach' conceived in order to give the debtor an incentive to cooperate in recovering of the debts.<sup>13</sup> The contemporary contempt for bankruptcy is indeed well expressed by Adam Smith, according to whom, under the 1732 Statute of George II, several insolvent debtors in England were sentenced to death

“and with great justice...[because]...there is no fraud which is more easily committed without being discovered”<sup>14</sup>

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<sup>11</sup> DAVID WEISBERG (1986), *Commercial Morality, the Merchant Character, and the History of the Voidable preference*, 39 *STAN. L. REV.* 3 at 8.

<sup>12</sup> In his 1697 *Essay upon Projects*; see D. WEISBERG, *supra* (note 11), at 6-7: “Defoe was the most vocal and literate of the commentators on bankruptcy law who wrote at perhaps the pivotal transitional phase in the history of English bankruptcy law. [...] First Defoe divides debtors in two rough categories: ‘For as the Indigent Debtor is a branch of the Commonwealth, which deserves its Care, so the willful Bankrupt is one of the worst sort of Thieves’. The goal of the statute is to identify those debtors who have morally and perhaps physically absconded from civilized society by breaking rules of commercial decency. The law should capture them, seize their goods for their creditors, and then cast them out punitively. But these rouses are to be separated from the honest unfortunate debtors whose business disasters reveal no moral flaw, and whom the law should secure in the bosom of society”.

<sup>13</sup> D. WEISBERG, *supra* (note 11), at 30.

<sup>14</sup> Quoted by FRANCISCO CABRILLO (1986), *Adam Smith on Bankruptcy Law. New Law and economics in the Glasgow Lectures?* 8 *HISTORY OF ECONOMIC SOCIETY BULLETIN*, at 41.

Under the Anne Statute, debtors who did not surrender to bankruptcy commissioners within 30 days of being adjudged bankrupt were deemed felons subject to capital punishment without benefit of clergy, whereas the George II Statute lengthened this period to forty-two days and added to the list of capital offences: making willful omissions of the extent of their former estate, concealing or embezzling property valued at more than £ 20 or books, with the intent to defraud creditors.<sup>15</sup>

The first United States bankruptcy law, enacted in 1800, was strongly influenced by the above-mentioned Statute of George II which was in effect in England at the time. The United States law followed an approach very similar to the English one, by granting a discharge and allowance for a debtor who cooperated and jail for the fraudulent debtor. The death penalty for not surrendering within forty-two days was in fact replaced with the more lenient prison sentence of a minimum of one year, but no more than ten.<sup>16</sup>

The 1800 law passed thirteen years after the ‘Bankruptcy Clause’ – which empowered the Congress to enact “uniform laws on the subject of bankruptcies” – was adopted by the 1787 Philadelphia Constitutional Convention, with the only vote against by Connecticut, motivated by the concern that bankruptcies could be punished by death, as was still in effect in England.<sup>17</sup> All the other delegates voted in favor of the Bankruptcy Clause principally in order to prevent *frauds* where debtors crossed state lines with property to avoid legal proceedings against them under state law.<sup>18</sup> The concerns about the death penalty and the possible frauds clearly indicate that in those times bankruptcy was still viewed as an act deserving punishment. Furthermore, another indication of the purely pro-creditor orientation of the 1800 bankruptcy law derives from the fact that bankruptcy proceedings could be initiated exclusively by creditors, upon

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<sup>15</sup> As J. POMYKALA, *supra* (note 10), at 2, reports.

<sup>16</sup> *Id.* at 6.

<sup>17</sup> As Connecticut’s delegate, Roger Sherman, objected: see C. TABB, *supra* (note 5), at 13.

<sup>18</sup> J. POMYKALA, *supra* (note 10), at 10.

proof of the debtor's commission of an act of bankruptcy,<sup>19</sup> just as it had always been in England.

### **3. Bankruptcy as a (honest) debtor's relief means.**

The need for uniform laws that led to the Bankruptcy Clause adoption must not have been felt as overwhelming: the federal 1800 Act was in effect only for three years, and the following federal bankruptcy law passed in 1841, after the great financial crisis of 1837. Despite its short duration (it was repealed in early 1843), the 1841 Act is one of great importance because it ushered in a new era of bankruptcy, allowing for the first time a debtor's *voluntary petition* and extending the eligibility for (voluntary) bankruptcy to *all debtors*, not only to merchants.<sup>20</sup>

“In the meanwhile, the lengthy era of widespread use of imprisonment for debts was coming to an end. The practice was abolished at the federal level in 1833, and many states followed suit in the 1830s and 1840s. In England general abolition of the practice did not come until 1869. Today, only vestiges of ‘body execution’ remain, usually in cases where the debtor is perceived to be morally culpable, such as debts incurred through fraud [...]”<sup>21</sup>

The successive federal bankruptcy law passed in 1867, after the great financial panic caused by the American Civil War. This law introduced (involuntary) bankruptcy for corporations and subjected any person to the threat of the ‘involuntary petition’.<sup>22</sup> After the repeal of the 1867 law, which occurred in 1878, the Bankruptcy Act of 1898 marked the beginning of the era of permanent federal bankruptcy legislation which would remain in effect for eighty years (even if with numerous amendments, such as the famous

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<sup>19</sup> C. TABB, *supra* (note 6), at 16.

<sup>20</sup> See, for instance, G. ROSSI, *supra* (note 7), at 34.

<sup>21</sup> C. TABB, *supra* (note 6), at 16.

<sup>22</sup> *Id.* at 19.

1938 *Chandler Act*<sup>23</sup>), until the adoption of the presently enforced 1978 Bankruptcy Reform Act. The title of the 1898 Act was “*an Act for the relief of debtors*” and it explains us clearly how the function of bankruptcy regulation changed in less than one hundred years: it was now intended as a relief measure for unfortunate individual debtors. Most of the limits imposed by preceding legislations to the granting of discharge (such as the consent by a certain number of creditors and the payment of a minimum percentage of the debts) were in fact abolished. The discharge extended to the sole entrepreneur the limited liability granted to the corporations, thus providing a second opportunity (*fresh start*) and more incentives to the economic initiative.<sup>24</sup> In any case, it is worth noting that *discharge* and *fresh start* were granted solely to the good faith debtor, while some criminal sanctions for the fraudulent bankrupt remained in effect, especially against those who tried to cheat the system by taking advantage of the newly introduced pro-creditor provisions. In particular, the 1898 Statute was amended in 1926 so as to strengthen the penal rules; some of those have remained in effect until today.

From a historical point of view, it can be said that the explanation of such a change in perspective (from the debtor’s punishment to the honest debtor’s relief) is due to the fact that all the U.S. bankruptcy acts, apart from the 1978 Act, followed serious economic and financial crises that required a legislation capable of facing problems and contingencies related to a modern credit economy.<sup>25</sup>

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<sup>23</sup> 52 Stat. 844 (1938).

<sup>24</sup> See PAOLO SANTELLA (2000), *Considerazioni sul diritto fallimentare in una prospettiva di analisi economica del diritto*, *Mimeo*, at 14.

<sup>25</sup> G. ROSSI, *supra* (note 7), at 32. See also D. WEISBERG, *supra* (note 11) who, in relating the evolution of American bankruptcy law to the evolution of the merchants’ social reputation and of the commercial ideology and rhetoric, explains that: “The argument for the new bankruptcy law is an argument for the historical necessity of expanded capitalism and credit and for recognizing that the merchant, as a crucial participant in this historical progress, merits protection from the risks he takes in its name: Debts of great magnitude must be contracted; and the most honest and prudent man may, by accidents and misfortunes incident to commerce, be deprived of the means of making good his engagements”.

#### **4. The role of bankruptcy law in implementing the ex-ante efficiency of the firm.**

Bankruptcy plays an important role in market economies, being a device through which both the disposal of inefficient firms and the reallocation of the assets of insolvent debtors are made possible.<sup>26</sup> To that extent economic theory prescribes that the *first goal* that a good bankruptcy law should meet is the maximization of the *ex-post* (i.e. after the firm's bankruptcy) value of the firm.<sup>27</sup> Thus, an optimal bankruptcy procedure should be designed in order to induce (1) the firm's reorganization or (2) sale as a going concern, rather than (3) its piecemeal liquidation, depending on which of these options generates the greatest total value for all the entitled claimants.<sup>28</sup>

On the other hand, economic literature has begun to study even the *ex-ante efficiency* properties of bankruptcy procedures, i.e. their effect on the incentives of the involved parties before the firm goes into bankruptcy. This means, for instance, that a bankruptcy procedure protecting creditors' interests in cases of insolvency will make the

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<sup>26</sup> FRANCISCO CABRILLO - BEN W.F. DEPOORTER (1999), *Bankruptcy proceedings*, *Encyclopedia of Law & Economics*, at 261.

<sup>27</sup> See, among others, PHILIPPE AGHION (1998), *Bankruptcy and its Reform*, *The New Palgrave Dictionary of Economics and the Law*, Vol. I, at 145.

<sup>28</sup> OLIVER HART (2000), *Different approaches to Bankruptcy*, *HIER Discussion paper 1093* (available on line at [www.ssrn.com](http://www.ssrn.com)), at 3, 4. But, from another perspective, this goal has been challenged: why should this outcome be better achieved through a bankruptcy procedure than through private contracting? The traditional answer is related to the so-called *common pool problem* that is likely to arise when many creditors are involved in the debtor's default. Creditors have conflicting pretences, so that they have a strong incentive in trying to be the first to obtain their loan repayment by the sale of the firm's assets (either what served as collateral for the secured loans, or – in case of unsecured loans – the residual assets). It follows that, even if the firm were worth more as a whole than as a sum of single assets, a voluntary agreement among creditors in order to sell the firm as a whole would be difficult to reach and, however, difficult to enforce. Moreover, creditors might waste resources that would cancel reciprocally out by trying to anticipate each others. See THOMAS JACKSON (1986), *The Logic and Limits of Bankruptcy*, at 11 and followings. See also O. HART, at 3, according to whom “the empirical evidence – both the fact that firms rarely write such contracts and that almost all countries have at least a primitive state-provided bankruptcy procedure – suggests that we cannot rely on this private solution in practice. In other words, there seems to be a clear case for the government at least to provide an ‘off the shelf’ bankruptcy procedure, i.e., one that the parties can use in the event they did not write their own”.

financiers more inclined to lend money, thus reducing the overall cost of credit.<sup>29</sup> However, it is the incentives of bankruptcy (criminal) regulation on entrepreneurs and directors which are relevant to the purpose of this study. Among bankruptcy scholars, in fact, it is widely held that the *second goal* a good bankruptcy procedure should meet is the penalization of the entrepreneurial and/or managerial conduct that can lead to the firm's bankruptcy, in such a way as to provide adequate *ex-ante* incentives for the entrepreneur and the management to perform well with the firm's assets.<sup>30</sup> The *ex-ante* efficiency goal is related to the so-called 'disciplinary role of debt': by issuing debt, the managers or the sole proprietor commit themselves to paying out future cash flow or, in any case, to acting in the interest of the claim-holders.<sup>31</sup> Exposure to liabilities means exposure to the bankruptcy risk, which serves as an incentive for managers to run the firm more efficiently. Clearly, a bankruptcy procedure that is too soft with the firm's management would fail to give such an incentive any real force.<sup>32</sup> As we have seen, historically, this commitment has been imposed by criminal sanctions for the defaulted debtor. Nevertheless, in modern times imprisonment for debts has disappeared and present bankruptcy crimes aim to target only the worst misconduct related to the default. From an economic perspective this change can be understood by thinking that too harsh sanctions for the default can prevent managers and/or entrepreneurs from engaging in optimal risk level activities or even undermine entrepreneurial initiative. Moreover, in the presence of strong penalties, as the bankruptcy risk increases, the company managers are likely to try and avoid it at any cost, e.g. by gambling with the company's assets.<sup>33</sup> This can be true even for the sole entrepreneur, if he anticipates that in case of bankruptcy he

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<sup>29</sup> On the specific problem of the *ex-ante* incentives for the creditors, see FRANCESCA CORNELLI - LEONARDO FELLI (1996), *Ex ante efficiency of bankruptcy procedures*, available on line at [www.ssrn.com](http://www.ssrn.com).

<sup>30</sup> See FRANK H. EASTERBROOK (1990), *Is Corporate Bankruptcy Efficient?* 27 *JOURNAL OF FINANCIAL ECONOMICS*, at 411-418, and P. AGHION (1998), *supra* (note 27), at 145.

<sup>31</sup> MICHAEL JENSEN (1986), *Agency cost of free cash flow, corporate finance and takeovers*, *American Economic Review Paper and Proceedings*, at 324 and OLIVER HART (1995), *Firms Contracts and Financial Structure*.

<sup>32</sup> O. HART (1995), *supra* (note 31), at 160.

<sup>33</sup> *Ibidem*. See also MAGDA BIANCO - MONICA MARCUCCI (2001), *Procedure fallimentari ed efficienza economica: valutazioni teoriche e riflessioni per l'economia italiana*, *BANCA, IMPRESA E SOCIETÀ XX*, 2001, no. 1, at 23.

is going to save none of his assets. If he succeeds, he will avoid the negative consequences of bankruptcy, whereas if he fails, the residual assets' dissipation will be borne by the creditors. This could at least partially explain the discharge and exempt property provisions for the individual bankrupt.

Therefore, it is evident that bankruptcy crimes can affect both corporate governance issues and economic initiative at large.

### **5. American pre-bankruptcy crimes.**

Despite the scarce attention scholars have devoted to this issue, a few bankruptcy crimes still figure under Chapter 9 of Title 18 of the United States Code. The main purpose of the bankruptcy crimes statutes is to protect the integrity of the bankruptcy system<sup>34</sup> and therefore most of those crimes refer to conduct committed during the bankruptcy proceeding – i.e. once the petition has been filed – such as bribery, false claims presentation, embezzlement and so on. But, for the purposes of this study, it is the managerial and/or entrepreneurial conduct committed prior to bankruptcy which is relevant, because the attention is focused on the role of bankruptcy crimes in protecting creditors' (and to some extent even shareholders') claims prior to failure, i.e. on the *ex-ante efficiency problem*. It follows that only bankruptcy crimes that can target pre-bankruptcy conduct will be considered.

#### **5.a Concealment or transfer in contemplation of bankruptcy.**

Under *Section 152(7)*, a crime is committed by a person who, “in a personal capacity or as an agent or officer of any person or corporation, in contemplation of a case under Title 11, by or against the person or any other person or corporation, or with intent to defeat the provisions of Title 11, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation”.

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<sup>34</sup> *United States v. Grant*, 971 F.2d 799, 805 (1<sup>st</sup> Cir. 1992).

This section can be violated by either pre-petition or post-petition transfers or concealments and, as the Fifth Circuit Court of Appeals held in *United States v. West*,<sup>35</sup> a fraudulent transfer can be made at any time prior to the defendant filing his bankruptcy petition, on condition that it made in contemplation of a case under Title 11. Awareness of the debtor's financial problems and the potential for an eventual bankruptcy have been used by the courts in order to establish the element of “*contemplation of a bankruptcy case*”.<sup>36</sup> Moreover, it is not necessary that the defendant actually causes the bankruptcy filing. In *United States v. Micciche*,<sup>37</sup> in fact, the case was filed by the creditors and the defendants did not file for bankruptcy themselves.

The conduct consists of either *transfer or concealment* of assets.<sup>38</sup> The former has a broad definition under the Bankruptcy Code (11 U.S.C. § 101) – i.e. “every mode direct or indirect, absolute or conditional, voluntary or involuntary of disposing of or parting with property or with an interest in property...” – that applies even to bankruptcy crimes<sup>39</sup>; it follows that simple transfers of possession, without regard to ownership or title, are covered as well. The latter is one of the most dangerous offences against the system, because it prevents the objective evaluation of the bankruptcy estate. As for the word transfer, the term concealment is applied in a broad sense by courts.<sup>40</sup> It includes “secreting, falsifying and mutilating...”<sup>41</sup>, as well as preventing discovery, fraudulently transferring or withholding knowledge or information required by law to be disclosed.<sup>42</sup>

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<sup>35</sup> *United States v. West*, 22 F.3d 586, 589 (5<sup>th</sup> Cir. 1994), *cert. denied*, 513 U.S. 1020 (1994).

<sup>36</sup> STEPHANIE WICKOUSKI (2000), *Bankruptcy Crimes*, at 76.

<sup>37</sup> 525 F.2d 544, 546 (8<sup>th</sup> Cir. 1975), *cert. denied*, 424 U.S. 966 (1976).

<sup>38</sup> See *United States v. Shapiro*, 101 F.2d 375 (7<sup>th</sup> Cir. 1939), *cert. denied* 306 U.S. 657 (1939).

<sup>39</sup> See *Collier on Bankruptcy*, 15<sup>th</sup> ed., revised, 1998, Vol. 1, at 7-73, according to which a systematic analysis of those provisions that incorporate the definition of transfer within the Bankruptcy Code, such as preferences (§ 547) and fraudulent transfers (§ 548), reveals that they are aimed at the same common goal as bankruptcy crimes are: i.e. ensuring an equitable distribution of the firm's assets. It follows that it should be correct to adopt the same definition.

<sup>40</sup> Courts have adopted the same broad construction given to the term concealment under § 152(1). See *United States v. Falcone*, 544 F.2d 607, 610 (2<sup>nd</sup> Cir. 1976), *cert. denied*, 430 U.S. 916 (1977).

<sup>41</sup> According to the old definition of concealment under the now repealed 1898 Bankruptcy Act.

<sup>42</sup> See *United States v. Turner*, 725 F.2d 1154 (8<sup>th</sup> Cir. 1984).

For instance, a transfer to a third party of a legal title to property with retention of secret interest by bankrupt has been considered as concealment.<sup>43</sup>

Section 152(7) prohibits the debtor from transferring or concealing “his property or the property of such other persons or corporations”. The expression “his property” can cover either property of the estate or property of the debtor, prior to, as well as after, the bankruptcy estate formation.<sup>44</sup> Instead, the second part of the sentence refers to property of ‘another entity’ which can alternatively be the defendant’s principal (in this case, the defendant would have to be “an agent or officer of [such other] person or corporation”) or a bankruptcy debtor (the transfer or concealment would then have to be “in contemplation of a case under Title 11 by or against the person or any other person or corporation”).<sup>45</sup>

As for the mental state, Section 152(7) requires that the transfer or concealment be done *knowingly and fraudulently* – as it is for other subsections – i.e. voluntarily and intentionally and with the specific intent to do something forbidden by law.<sup>46</sup> In addition, the present section requires that the guilty conduct or acts be made “in contemplation” of a bankruptcy case (either by or against the defendant, rather than an agent of his); or, alternatively, with the additional intent of defeating provisions of Title 11. The first of the two alternative mental states should be proven through some nexus between the defendant’s action and the bankruptcy filing.<sup>47</sup> The second one “requires the defendant to act in such a way as to intentionally effect a deviation from the distributions anticipated by Title 11 liquidations”.<sup>48</sup>

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<sup>43</sup> *In re Vecchione*, 407 F Supp 609 (E.D.N.Y. 1976).

<sup>44</sup> See *Collier on bankruptcy, supra* (note 39), at 7-75.

<sup>45</sup> *Id.* at 7-75.

<sup>46</sup> EDWARD DEVITT – CHARLES BLACKMAN (1977), *Federal jury practice*, 3<sup>rd</sup> ed., at 48-04, 49-05.

<sup>47</sup> *United States v. Haymes*, 610 F.2d 309, 312 (5<sup>th</sup> Cir 1990). According to *Collier on Bankruptcy, supra* (note 39), at 7-80, this proof may be easier in case of voluntary petition, because of the defendant’s control over the action. “For involuntary cases, the prosecution’s task will be more difficult and will probably have to rely on inferences from both the defendant’s financial situation and creditor activity”.

<sup>48</sup> *Collier on bankruptcy, supra* (note 39), at 7-65. Note that this second alternative mental state is analogous to the one required by sec. 152(5).

### 5.b Falsification or alteration of records.

Under *Section 152(8)*, a crime is committed by a person who, “after the filing of a case under Title 11 or in contemplation thereof, knowingly and fraudulently conceals, destroys, mutilates, falsifies, or makes a false entry in any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor”.

The bankruptcy system is based on full and truthful disclosure of financial information, so that integrity and reliability of the debtor’s books and records is crucial for the bankruptcy estate creation. Thus, this section penalizes both the alteration of truthful information and the fabrication of false entries in a document related with the debtor’s holdings and/or his financial situation, regardless of whether the action occurred before or after the commencement of the case.<sup>49</sup>

The falsification or alteration of documents shall be made knowingly and fraudulently, i.e. – as we have seen above – intentionally and with the will of deceiving or cheating parties holding some interest at stake in the bankruptcy case. Furthermore, in case of a pre-petition conduct, the specific intent of a ‘contemplation of a bankruptcy case’ is required as well.

### 5.c Bankruptcy fraud.

Under *Section 157*, titled bankruptcy fraud, a crime is committed by a person who, “having devised or intending to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice or attempting to do so files a petition under Title 11; files a document in a proceeding under Title 11; or makes a false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under Title 11, at any time before or after the filing of the petition, or in relation to a proceeding falsely asserted to be pending under such title...”.

This section was introduced with the 1994 Amendment as a sort of ‘closing

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<sup>49</sup> *Collier on bankruptcy, supra* (note 39), at 7-83.

clause' aiming to empower prosecutors to hit misconduct that otherwise could not be sanctioned, as well as innovative fraudulent conduct that might be performed in the future.<sup>50</sup> Due to its breadth, this section has recently been challenged under the 'void for vagueness' doctrine (i.e. the requirement for a legislative crime definition to be precise<sup>51</sup>) in *United States v. Daniel*.<sup>52</sup> The defendant claimed that Section 157 was "unconstitutionally vague as applied to him because it did not provide notice that his scheme was illegal". Nevertheless, the court rejected this objection stating that

"the mail fraud statute contains identical language [...] leading [...] to the conclusion that there is nothing inherently vague in the notion of a general antifraud provision".

Section 157 is indeed consciously based upon the federal mail and wire fraud statutes<sup>53</sup> and prohibits "schemes or artifice to defraud" followed by three different types of jurisdictional acts aiming at executing or concealing such a scheme or artifice, or at attempting to do so. The jurisdictional act can be alternatively (1) a bankruptcy petition; (2) a filing of other documents in a bankruptcy procedure; or (3) a false or fraudulent representation, claim or promise concerning or in relation to a proceeding under Title 11, at any time before or after the filing of the petition, or in relation to a proceeding falsely asserted to be pending under such title.

This crime can be distinguished from frauds that can be committed either before or during a bankruptcy case, because it needs the instrumental use of a (present or future)

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<sup>50</sup> See 108 Stat. 4106 (1994), according to which the new provision should "enhance the integrity of the bankruptcy process and give prosecutors new tools to use against those who would abuse the system".

<sup>51</sup> See *Kolender v. Lawson*, 461 U.S. 352, 357 (1983): "the void for vagueness doctrine requires that a penal statute define the criminal offense with sufficient definiteness that ordinary people can understand what conduct is prohibited and in a manner that does not encourage arbitrary and discriminatory enforcement".

<sup>52</sup> 247 F.3d 598 (5<sup>th</sup> Cir. 2001), *cert. denied*, 534 U.S. 928 (2001). It is worth noting that Daniel's is not a first amendment challenge, so the court applied the standard "in the context of the specific facts of the Daniel's case".

<sup>53</sup> See §§ 1341 and 1343 under Title 18 U.S.C.

bankruptcy procedure as a means to perpetrate the fraud.<sup>54</sup> The use of bankruptcy must have aided the fraud scheme in some way. A typical example of bankruptcy fraud is the so-called *rent* or *equity skimming* that frequently occurs in the commercial real estate context.<sup>55</sup> Such a fraudulent scheme is committed by acquiring title to multiple properties with no intention to pay mortgage payments and diversion of the property (often rental) income to another entity controlled by the property holders. Frequently, the fraudulent scheme strategically exploits the ‘automatic stay’<sup>56</sup> imposed by a *voluntary bankruptcy petition* which is filed exclusively in order to stall the foreclosure on the debtor’s properties and to allow the perpetrators to continue their fraud.<sup>57</sup>

As for the *mens rea*, Section 157 requires a specific intent “to defraud” that – as set forth above – implies the defendant’s will to do something unlawful.

All of the three crimes considered before are class D felonies, punishable by up to five years of prison, a fine up to \$ 250,000, or both. They can be perpetrated by the bankrupt (that is the more frequent case) as well as by other persons. Furthermore, conviction of a bankruptcy crime has collateral consequences such as, for instance, precluding the debtor from receiving a discharge of debts (Sections 727, 1141 Bankr. Code). In fact, the conviction will be *res judicata* as to the proof of the type of fraud necessary to exclude a discharge in civil bankruptcy proceedings.<sup>58</sup> This means that even

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<sup>54</sup> See S. WICKOUSKI, *supra* (note 36), at 103.

<sup>55</sup> In the above-mentioned *United States v. Daniel* (*supra*, note 52), for instance, the defendant was convicted for bankruptcy fraud for having offered, to some homeowners who were about to have their houses foreclosed on, his services in stopping the foreclosure. The fraudulent scheme he used consisted of making the homeowners convey a part of the interest in their home to one of the several companies he had formed. The companies then filed for bankruptcy, listing the interest in the house as one of their assets. In such a way the foreclosure on the houses was automatically stayed, and Daniel used various techniques to avoid the scrutiny of bankruptcy officials and ‘flip’ the interest in the house from one company to another.

<sup>56</sup> Under 11 USC § 362(a), “... a petition [commencing a case] ... operates as a stay, applicable to all entities...”. See, e.g., *Maritime Electric co. v. United Jersey Bank*, 959 F.2d 1194, 1204 (3<sup>rd</sup> Cir. 1991): “automatic stay allows debtor breathing spell from creditors and stops collection efforts”.

<sup>57</sup> S. WICKOUSKI, *supra* (note 36), at 103.

<sup>58</sup> See *Collier on bankruptcy, supra* (note 39), at 7 – 19 and, e.g., *In re Chaplin v. Transamerica premier Ins. co.*, 33 C.B.C. 2d 50, (Bankr. E.D. Wis. 1995), that uses the ‘collateral estoppel’ doctrine in order to

contemporary bankruptcy law follows a twofold approach: discharge and allowance are granted only to honest debtors, whereas no relief is available for fraudulent debtors that, on the contrary, risk to be sentenced to prison and harsh fines.

**6. The new pre-bankruptcy crime introduced by the 2002 Sarbanes-Oxley Act of 2002: destruction, alteration, or falsification of records in Federal investigations and bankruptcy.**

Recently, on July 30<sup>th</sup>, 2002, the Sarbanes-Oxley Act was enacted as a reaction against the accounting scandals and managerial misbehavior that had led to the Enron and WorldCom Corporations default. This act has introduced, among other provisions, even a new pre-bankruptcy crime. In particular, Section 1519 of Title 18 USC states that a crime is committed by “whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document or tangible object with the intent to impede, obstruct or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or *any case filed under Title 11, or in relation to or contemplation of any such matter or case*”. This provision aims to be a response to the conduct of the Enron Corporation’s directors and employees that have destroyed lots of documents in order to obstruct the anticipated upcoming government investigations. In fact, as the legislative history underlines, Section 1519 is a

“new general anti-shredding provision [...]. Currently, provisions governing the destruction or fabrication of evidence are a patchwork that have been interpreted

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apply findings made in the criminal proceeding (in this case the conviction for fraudulent transfer and concealment of assets and lying by denying) to the bankruptcy proceeding involving denial of discharge under § 727. Under ‘collateral estoppel’, once a court has decided an issue of fact or law necessary to its judgment, that decision may preclude re-litigation of the issue in a suit on a different cause of action involving a party to the first case.

often very narrowly by federal courts [...]. Section 1519 is meant to apply broadly to any acts to destroy or fabricate physical evidence”.<sup>59</sup>

The new crime targets the destruction, alteration, concealment and falsification of any record, document or tangible object, whereas the required mental state imposes that the prohibited act is done ‘*knowingly*’. Within the bankruptcy crimes context the word *knowingly* is generally used to mean acts executed purposely and not accidentally, mistakenly, or because of other innocent reason.<sup>60</sup>

The same conduct as the one targeted by Section 1519 can also be punished under Section 152(8), even though with a slight difference as for the mental state: the latter Section requires a person to act “*fraudulently*” in addition to *knowingly*, while under the new provision, it is the specific “intent to impede, obstruct, or influence the investigation or proper administration of any case filed under title 11 or in relation to or contemplation of any such a case” which is needed, besides a knowing mental state. Since such an intent does not necessarily imply the will to cheat or deceive others, whereas an act or failure to act is fraudulent (as required by Sec. 152.8) when it is done willfully and with the intent to deceive or cheat any creditor, trustee or bankruptcy judge,<sup>61</sup> one can say that the required *mens rea* has been slightly relaxed.<sup>62</sup> Another little difference is related to the fact that, on the basis of Section 1519, the falsification can affect also tangible objects and not only documents and records, as it happens under Section 152(8). Therefore nothing really new, but the raising of punishment up to 20 years of imprisonment (instead of the 5 provided for by § 152.8), has been introduced by the Sarbanes-Oxley Act, at least in the field of bankruptcy crimes. On the other hand, the largely increased sanction gives rise to a paradox: a slightly minor offence (because of the relaxation of the needed mental state) is punished by a much longer sentence; but this contradiction can be explained by referring to the so called ‘symbolic use of the criminal law’. This is the broad use of the

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<sup>59</sup> 148 Congressional Record S7419 (July 26<sup>th</sup>, 2002).

<sup>60</sup> *Collier on bankruptcy, supra* (note 39), at 7 – 130.4.

<sup>61</sup> See, for instance, *US v. Shaddock*, 112 F.3d 523; 1997 U.S. App.

<sup>62</sup> See *Collier on bankruptcy, supra* (note 39), at 7 – 130.6.

criminal sanction by the government in order to show a big effort in facing a problem felt as particularly urgent by the public opinion.

“Some things are inevitable [...] when scandals erupt or horrific crimes capture public attention, Congressmen want to show that they are doing something about it. There is a long, and sometimes ignominious, history in Congress of [...] addressing public outcry over some recent event through new criminal laws, even in areas in which there appeared to be little need for new federal legislation”.<sup>63</sup>

However, the overuse of the criminal sanction is too easy a remedy: to threaten a harsher sanction is almost costless, whereas raising the probability of being caught, especially in the business crimes context, is much more costly, because it implies deeper investigative efforts. But, as it is well known since the XVIII century,<sup>64</sup> criminal behavior is much more affected by the probability to be punished than by the harshness of the sanction threatened. In fact the criminal’s “expected utility can still be positive even for crimes with severe punishments, if the probability of detection and conviction are low”.<sup>65</sup>

In any case, apart from considerations concerning the new crime appropriateness, it is worth pointing out that the new legislation is mainly meant to prevent accounting frauds. Consequently, the new pre-bankruptcy crime targets exclusively conduct of falsification and or alteration of any physical evidence useful to reconstruct and evaluate the true accounting situation of the firm, whereas managerial and/or entrepreneurial business decisions are by no means affected by the new provisions.

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<sup>63</sup> MICHAEL A. PERINO (2002), *Enron’s Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, at 7. Columbia Law School working paper no. 212. Downloadable at [www.ssrn.com](http://www.ssrn.com).

<sup>64</sup> See CESARE BECCARIA (1764), *Dei delitti e delle pene*, Livorno.

<sup>65</sup> M.A. PERINO (*supra*, note 62), at 6. See also ERLING EIDE (1999), *Economics of Criminal Behavior*, *Encyclopedia of Law & Economics*, at 360: “in some studies the effect of an increase in the severity of punishment is not statistically different from zero and a statistically positive effect has only occasionally been obtained”.

### 7. Comparison with the Italian pre-bankruptcy crimes.

Italian bankruptcy law tries to achieve the above discussed *ex-ante efficiency goal* especially by offering recourse to the heaviest sanction, i.e. criminal sanction: in fact the sixth section of Law n. 267 of March 16<sup>th</sup>, 1942 (thereinafter Law 267/42) provides for several “bankruptcy crimes” that are heavily penalized. In particular, the so-called “pre-bankruptcy crimes” aim to identify misconduct of the entrepreneur (or that of managers in case of corporations) that in the abstract could lead to bankruptcy, or, at the very least, undermine the role of the firm’s assets (or that of the entrepreneur’s private assets, in the case of firms without limited liability) in acting as a creditors’ guarantee.<sup>66</sup>

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<sup>66</sup> The Law 267/42 provides for two main bankruptcy crimes. The first (section 216, paragraph 1, no. 1, Law 267/42) is called “*bancarotta fraudolenta*” (= fraudulent), and targets the conduct of (1) ‘diversion, concealment, dissimulation, destruction or dissipation’ of the entrepreneur’s own assets, as well as (2) either ‘the registration or the recognition’ of non existent liabilities for the purpose of harming creditors (all these samples of misconduct are called “*bancarotta fraudolenta patrimoniale*” = on assets). The ‘fraudulent’ *bancarotta* can also be perpetrated either by removing, destroying or falsifying the accountant books of the firms for the purpose of obtaining an undue profit or of harming creditors, or by keeping the accountant books in such a way that it is impossible to reconstruct the entrepreneur’s assets (so-called “*bancarotta fraudolenta documentale*” = on documents): section 216, paragraph 1, no. 2, Law 267/42). The sanction for this crime goes from three to ten years of imprisonment. Paragraph 3 of the same section adds another type of fraudulent *bancarotta*, so-called “*bancarotta preferenziale*” (= preferential), that forbids violations of preference law – either by paying some of the creditors or by creating fictitious titles of preference – adopted for the purpose of favouring some creditors and of harming others. It provides from one up to five years of prison.

The second pre-bankruptcy crime, so called “*bancarotta semplice*” (=simple), targets: (1) making personal or familiar expenses out of proportion to the actor’s economic conditions; (2) consuming a relevant part of the actor’s estate in purely chancy or manifestly imprudent transactions; (3) having carried out seriously imprudent transactions in order to delay the bankruptcy; (4) having made the insolvency worse, failing to file a voluntary bankruptcy petition; (5) having failed to comply with the obligations arising from a former agreement with creditors (all these kinds of conduct are called “*bancarotta semplice patrimoniale*”: section 217, paragraph 1, Law 267/42). Lastly, the ‘simple’ *bancarotta* can be “*documentale*” (= documental) as well and, in that case, it targets conduct of not having kept the accountant books at all or having kept them incomplete or irregular, during the three years prior to bankruptcy (section 217, paragraph 2, Law 267/42). The sanction for this crime goes from six months up to two years of prison. ‘Fraudulent’, as well as ‘simple’ *bancarotta* can be committed exclusively by the entrepreneur and his agents (section 227, Law 267/42) as well as by all of the partners without limited liability (article 222, Law 267/42), or by the management on the assets and accountant books of the firm, in case of corporations (sections 223 and 224, Law 267/42). As for the mental state, ‘fraudulent’ *bancarotta* requires the fraudulent intent, whereas –

Italian law opts for a case-based incrimination technique<sup>67</sup> formulated according to the description of several cases of patrimonial mishandling that, to some extent, resemble the ‘acts of bankruptcy’ that constituted the condition *sine qua non* for the commencement of a bankruptcy procedure in early English and American bankruptcy regulation.

All of the pre-bankruptcy crimes require the firm to go bankrupt as a condition (for these provisions) to apply. Nonetheless, Italian bankruptcy law does not require the concrete causation of the bankruptcy by the actor in order to intervene with criminal sanctions, and does not restrict the period of time during which the crime could have been committed prior to the actual insolvency itself. When dealing with crimes carried out prior to bankruptcy, it is not necessary to assess any relationship of cause and effect between the guilty conduct and the bankruptcy,<sup>68</sup> nor *mens rea* (culpability), because the bankruptcy is merely considered a so-called “objective condition of punishment”.<sup>69</sup> It follows that even if the bankruptcy arises from factors completely beyond the agent’s control (for instance, a sudden increase in the prices of raw materials or the closure of a foreign market), the judge may determine that the entrepreneur or the management committed some of the misconduct described under the criminal norms. For instance, an entrepreneur who diverts part of the firm’s assets, or – in the case of firms without limited liability – dissipates part of his own assets (e.g. in gambling or even in making

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according to the opinion followed by the courts – ‘simple’ *bancarotta*’ can be committed either intentionally or negligently: see, e.g., *Ragaldi v. Italian State*, Cassazione penale, sez. V, 14<sup>th</sup> April 1999, *RIV. TRIM. DIR. PEN. ECON.* 2000, at 484.

<sup>67</sup> PAOLO PERETOLI, *Considerazioni in tema di prova nel delitto di bancarotta fraudolenta patrimoniale per distrazione*, *DIR. PEN. E PROC.* 2002, at 163.

<sup>68</sup> See, among others, CESARE PEDRAZZI (1984), *Riflessioni sulla lesività della bancarotta*, *Studi in memoria di Giacomo Delitala*, Milano, at 1137 and, as for the case law, *De Benedetti v. Italian State*, Cassazione penale, sez. V, 22<sup>nd</sup> April 1988, *CASS. PEN.* 1999 at 651.

<sup>69</sup> At least by the greatest part of bankruptcy scholars: see FRANCESCO ANTOLISEI (1998), *Manuale di diritto penale, Leggi complementari*, Vol. II, 10<sup>th</sup> ed., Milano, at 31; C. PEDRAZZI (1984), *supra* (note 68), at 1137; CARLO FEDERICO GROSSO (1970), *Osservazioni in tema di struttura, tempo e luogo del commesso reato nella bancarotta prefallimentare*, *RIV. IT. DIR. PROC. PEN.*, at 569.

considerable donations to charity<sup>70</sup>), may be condemned for a pre-bankruptcy crime even if his firm has been declared bankrupt fifteen years later<sup>71</sup> for reasons completely unrelated to such misconduct.

The problem is related to the breadth of these provisions: for instance, the expression ‘*asset diversion*’ used by Article 216 to define the crime of ‘fraudulent *bancarotta*’ may even target the payment of salaries higher than the average to the managers, or the sale of goods at a lower price than the market value.<sup>72</sup> Moreover, the expression ‘*asset dissipation*’ established in the same article may even hit too risky investment decisions.

The common denominator of such crimes is that they mostly consist in the criminal perpetrator’s disposing of his own assets at will.<sup>73</sup> Because such conduct may be perfectly lawful at the time (or constitute a lesser crime than bankruptcy), the criminal relevance it bears has been defined as an “enigma”.<sup>74</sup> It is worth pointing out that the same can also be said for Section 152(7), Title 18 USC:

“the section can be used to reach conduct occurring prior to the filing of a bankruptcy case, which, but for the filing of a bankruptcy, would not necessarily be criminal”.<sup>75</sup>

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<sup>70</sup> See CESARE PEDRAZZI (2000), in C. PEDRAZZI et AL., *Manuale di diritto penale dell’impresa*, Bologna.

<sup>71</sup> See, e.g., *De Benedetti v. Italian State*, *supra* (note 68): “in ‘fraudulent *bancarotta* on assets’(Article 216, 1<sup>st</sup> par., no.1, Law 267/42, *supra* note 66) detraction facts bear penal relevance, once the firm has adjudicated bankrupt, in every time they have been perpetrated and so even when the firm was not insolvent yet”.

<sup>72</sup> See, e.g., *Vichi v. Italian State*, Cassazione penale, Sez. V, 10<sup>th</sup> June 1998, no. 2876, *RIV. TRIM. DIR. PEN. ECON.* 1999 at 1212.

<sup>73</sup> ANDREA PERINI (2001), *La bancarotta fraudolenta*, Padova, at 3.

<sup>74</sup> C. PEDRAZZI (1984), *supra* (note 68) at 1111.

<sup>75</sup> S. WICKOUSKY, *supra* (note 36) at 79.

Nonetheless, there is also an important difference between this section and Article 216.1(1) of Law 267/42. This is related to the different mental state required by the two provisions, because – as we have seen above – Section 152(7) does not only require that the transfer or concealment be made knowingly and fraudulently, but also requires a ‘specific intent’ focused on the bankruptcy procedure (i.e. the contemplation of a case under Title 11, or the intent to defeat the provisions of Title 11). Instead, Article 216 Law 267/42 provides solely for a ‘generic intent’ that, following the dominant courts’ opinion, may be met even in presence of ‘recklessness’,<sup>76</sup> on condition that it is possible to prove the acceptance of the risk inherent to the reckless conduct by the actor. In fact, as it has been recently stated by the Italian Supreme Court,

“the necessary mental intent is present whenever there is a conscious will to give to the firm’s assets a different destination from the firm’s ends and to perform acts that harm or may harm creditors. This can happen even if the actor does not directly pursue this result, but he foresees it and nevertheless (despite this forecast) acts, making it possible to happen”.<sup>77</sup>

As set forth before, the entrepreneur’s or manager’s conduct can later be evaluated under the Italian bankruptcy crimes, even after many years, once the firm has been declared bankrupt. But the crucial point here is that the judge should reconstruct and evaluate *ex-post* the decisions adopted *ex-ante* by the entrepreneur or the company managers, without the benefit of hindsight. This creates a twofold problem: the judge does not necessarily have the best skills to reconstruct the initial conditions under which

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<sup>76</sup> According to common law, ‘recklessness’ requires proof that the actor consciously disregarded a substantial and unjustifiable risk of which he was aware. See *Farmer v. Brennan*, 511 U.S. 825, 837-38 (1994). According to the Model Penal Code, sec. 20.2(2)c, “a person acts recklessly if he consciously disregards a substantial and unjustified risk that the material element exists or will result from his conduct”. Moreover, section 20.2(1) provides that except in cases of ‘violations’ (violations are offenses – but not ‘crimes’ – for which no sentence other than a fine or civil penalty is authorized, §1.04(5)), a person can not be condemned unless “he acted purposely, knowingly, recklessly or negligently, as the law may require, with respect to each material element of the offense”.

<sup>77</sup> See *Tassan Din v. Italian State*, Cassazione penale, sez. V, 6<sup>th</sup> Oct. 1999, no. 12897, *RIV. TRIM. DIR. PEN. ECON.*, 2000, at 477.

the entrepreneur acted<sup>78</sup> and, regardless in doing so, he is likely to run into the so-called ‘*hindsight bias*’. This is the tendency, demonstrated by empirical evidence, that individuals after receiving outcome information deem having had it ‘all along’: once past, the events seem more comprehensible and predictable than before.<sup>79</sup> Moreover, individuals who have received this outcome information are largely unaware of its effects on their judgments. Thus, even risky business decisions that, at the time they are made, do not have any prejudicial purposes to the creditors’ interests, could be adjudged criminal. The judge, in fact, in case of default of the firm, might be induced to underestimate the *ex ante expected value* of the business choices adopted by the entrepreneur or by directors and so deem these decisions relevant under the provision of Article 216(1), Law 267/42 that forbids ‘*assets’ dissipation*’. That outcome would be possible exactly because, as we have seen above, the courts are used to considering the required mental state met even in presence of mere ‘recklessness’ (with acceptance of the related risk) and therefore without actual fraudulent will.

Nonetheless, even if risky business decisions were not deemed relevant under Article 216(1), they could surely be considered under Article 217(2), Law 267/42 that targets the consumption ‘*of a relevant part of the agent’s estate in purely chancy or manifestly imprudent transactions*’.<sup>80</sup> Moreover, according to the Supreme Court opinion, the mental state required to perform this crime can be intent as well as negligence.

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<sup>78</sup> Note that one of the traditional rationales for the *Business Judgment rule* (that – in case of corporations – prevents most of the decisions adopted by the board of directors from any judicial review) is exactly the argument that directors might sometimes be incompetent, but courts are likely to be even more incompetent. See *infra*, note 85.

<sup>79</sup> See the seminal contribution of BARUCH FISCHHOFF (1975), *Hindsight ≠ Foresight, the Effect of Outcome Knowledge on Judgment under Uncertainty*, *JOURNAL OF EXPERIMENTAL PSYCHOLOGY, HUMAN PERCEPTION AND PERFORMANCE* 1, at 288-299 and with regard to legal proceedings: JEFFREY RACHLINSKY, (1998) *A Positive Psychological Theory of Judging in Hindsight*, 65 *U. CHI. LAW REV.* 2.

<sup>80</sup> See, e.g., *Bazzano v. Italian State*, Cassazione Penale, 14<sup>th</sup> January 1976, *GIUST. PEN.* 1976, II at 426: “manifestly imprudent transactions are transactions totally or partially depending on the chance or transactions carried out in such a careless way that it was clear that the risk faced was not proportioned to the success’ probabilities”.

On the contrary, in the U.S. system *genuine business decision* cannot be revised under criminal standards, because the pre-bankruptcy crimes target only conduct of *transfer or concealment* enacted with the intent to defraud. Moreover, a strict link with the forecast of a bankruptcy procedure is needed, in such a way that the period of time in which this crime can be committed is mostly restricted to the proximity of the actual insolvency. This limitation seems opportune, because it leaves the economic actors free to dispose of the firm's assets according to their business plans as long as the firm is solvent, without affecting the risk level assumed by the enterprise. Instead, as the insolvency becomes likely or at least predictable, this section aims to prevent the worst entrepreneurial and/or managerial opportunistic behaviors that can harm the creditors from happening.

The remaining U.S. pre-bankruptcy crimes address exclusively the conduct of falsification or alteration of the accountant books or of any other material information in contemplation of a bankruptcy filing (§§ 152.8 and 1519) and of deliberate abuse of the bankruptcy procedure for fraudulent ends (§ 158). Thus, it is clear that they can by no means interfere with any business judgment.

### **8. Concluding remarks.**

The historical evolution of bankruptcy regulation in the U.S. shows a change of perspective from an early punitive approach against the defaulted debtor to a legislation much more oriented towards selecting between good faith bankrupt (defaulted because of misfortune) and fraudulent bankrupt (defaulted because of patrimonial mishandlings). This approach has antique origins: as we have seen before, toward the end of the 1700s Daniel Defoe already argued for the necessity of distinguishing between the two kinds of defaulted debtors. The first attempt to perform this task dates in fact to 1705, the year during which the Statute of Anne was enacted in England. From this early 'carrot and stick approach', aiming exclusively to give debtors incentives to cooperate in the recovery of debts by surrendering all their goods, the modern American bankruptcy

legislation – that is commonly regarded as one of the most debtor-friendly regulations – developed. This path moves from prison and death penalty for defaulted debtors and arrives to discharge and exempt property for the individual debtor in order to guarantee a second opportunity (fresh start) to the unlucky entrepreneur. It is worth noting that the discharge provisions are not applicable to corporations, because in this case the same function of preventing stockholders from the possible loss of all their estates is achieved through limited liability.<sup>81</sup>

However, the same distinction between the two kinds of debtors that was made with the English Statute of Anne is still present today: in fact, Title 18 U.S.C. provides penal sanctions for the fraudulent defaulted debtors that, as collateral consequence, prevent the (individual) debtor from the discharge of debt. The same happens even with Italian bankruptcy law, but the consequences of the distinction as well as the distinguishing criteria are different. Italian law does not indeed recognize the discharge for honest individual debtors, and, in any case, it opts for a broader criminalization of the pre-bankruptcy misconduct of the debtor. In some cases this may result in the penalization of conduct that has been performed without the intent to harm creditors. As stated above, the typical examples of such conduct are risky investment decisions that can be sanctioned with sentence to prison. This possibility is likely to give rise to bad incentives for the economic actors: optimal risk taking may be discouraged, as well as entrepreneurship may be weakened. Vice versa, as long as the insolvency probability increases, the economic actors might engage in too high risk activities, trying to avoid the default and the penal consequences that they possibly bear. In addition, an ‘*adverse selection*’ problem could also arise: in fact only too risk-loving entrepreneurs or entrepreneurs who underestimate the bankruptcy risk could be willing to initiate an economic activity. In this way, the entrepreneurs more likely to run the firm into bankruptcy would be paradoxically self-selected.

Common requirement of the U.S. pre-bankruptcy crimes is ‘intent to defraud’ with a strong mental nexus between the conduct and the bankruptcy petition. In such a

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<sup>81</sup> See T. JACKSON, *supra* (note 28) at 228.

way the judicial discretion is strongly limited and only fraudulent conduct in an *ex-ante* perspective seems to bear penal relevance.

Moreover, in the case of corporations, the genuine economic decisions of directors may be revisited exclusively under fiduciary duties standards,<sup>82</sup> once the *business judgment rule* (BJR) has been reversed. BJR is the common law doctrine that shields most of the decisions of the board from any judicial review. It creates a

“presumption that in making business decisions the directors of a corporation act on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company”.<sup>83</sup>

BJR applies, preventing directors from any liability, whenever the three following conditions are met: (1) the board members who are voting on the decision are at the same time disinterested, i.e. they do not personally have anything at stake in the transaction or decision; (2) they are independent from the party that benefited from transaction; and (3) they are well informed about the transaction<sup>84</sup>. Thus the American system seems more attuned to the idea that judicial review of business decisions can lead to undesirable outcomes. The traditional rationale for the BJR is indeed the concern that, even if

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<sup>82</sup> Under US law, officers and directors of a corporation are charged with two primary fiduciary obligations: the ‘*duty of care*’ and the ‘*duty of loyalty*’. The duty of care requires the directors to exercise the standard of prudence that a lay person would exercise under the same or similar circumstances. The duty of loyalty prohibits self dealing and appropriation of corporate opportunities. When a corporation is solvent, officers and directors owe fiduciary duties to the owner of the corporation, i.e. the stockholders. In fact the relationship between a corporation and its debenture holders is contractual in nature and does not give rise to a trust relationship with concomitant fiduciary duties. But in case of insolvency (even when formal insolvency proceedings have not begun) those duties shift and the management has a duty to protect the creditors’ interest. See L. LIN (1993), *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Director’s Duties to Creditors*, 46 *VAND. L. REV.* 1485, 1511 and, among the others, *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787-90 (Del. Ch. 1992).

<sup>83</sup> According to *Aranson v. Lewis*, 473 A.2d 805, 812 (Del. Ch. 1984).

<sup>84</sup> See, e.g., *Kamin v. American Express Co.*, 383 N.Y.S. 2d. 807 (N.Y. Misc. 1976): “it is not enough to allege [...] that the directors made an imprudent decision [...]. More than imprudence or mistaken judgment must be shown”.

directors might sometimes be incompetent, courts are likely to be even more incompetent<sup>85</sup>. Several decisions will appear wrong or poor in retrospect, especially to courts not trained in business matters. Therefore, making directors liable for quality of their business decisions will make them much more risk-averse, undermining the *ex-ante* efficiency of the firm that, as we have seen, should be one of the primary goals of a good bankruptcy regulation.

As for the Italian legislation, it is possible to conclude that pre-bankruptcy crimes should be redefined in order to make the boundary between a firm's legal and illegal management more clear-cut. In order to do so, the path to follow ought to be the introduction of a strong (at least mental) nexus between criminal conduct and bankruptcy, in order to restrict the conduct through which the mentioned crimes can be perpetrated. Moreover, the criminalization of merely negligent conduct seems to be particularly problematic because of the 'hindsight bias' which courts are likely to run into. Thus, the preferable solution should be the repeal of these provisions. Otherwise, judges should be at least obliged to thoroughly reconstruct the *ex-ante* expected value of the investment plan adopted by the entrepreneur.

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<sup>85</sup> See, e.g., *Joy v. North*, 692 F.2d 880 (2<sup>nd</sup> Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983) according to which "courts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstruct in a court-room years later, since business imperatives often call for quickly decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time may seem a wild hunch viewed years later against a background of perfect knowledge".