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A Comment About a Separate Bankruptcy System

Cover Page Footnote

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A COMMENT ABOUT A SEPARATE BANKRUPTCY SYSTEM

Carl Felsenfeld*

INTRODUCTION

THE large bankruptcies of recent years involving courts of more than one country—generally called “international bankruptcies”—have led to a number of international efforts to resolve the differences in the laws of those countries.¹ If, for example, a bankrupt² has assets in two countries and submits itself to the formal bankruptcy procedures of both, what is the resolution if one country imposes a formal stay³ against creditor actions and the second prohibits such a stay? Take another case. Assume that the laws of one country prescribe that *all* assets of a debtor constitute its bankruptcy estate to be dedicated to the obligations of creditors.⁴ Now assume that some of those assets are located in another country where they are subject to a judicial lien in favor of creditors located there. The ultimate resolution of questions such as these can be resolved only by harmonizing the laws of the two countries.

A search for international harmony in bankruptcy proceedings is ongoing. A maxim of this search is that, in general, the greater the number of countries involved in the search, the fewer issues should be addressed for resolution. We thus see the European Union looking for a complete umbrella bankruptcy law to cover all member states.⁵ We also see the United Nations, through its private law division, the Commission on International Trade Law (“UNCITRAL”), starting to

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1. Some of the current efforts include The United Nations Commission on International Trade Law work on Cross-Border Insolvency, *see Draft Legislative Provisions on Judicial Cooperation and Access and Recognition in Cases of Cross-Border Insolvency*, U.N. Commission on International Trade Law, 19th Sess., U.N. Doc. A/CN.9/WG.V/WP.44 (1996), the Transnational Insolvency Project among the United States, Canada and Mexico, *see* A.L.I. Transnational Insolvency Project, *International Statement of Canadian Bankruptcy Law* (Preliminary Draft No. 1, 1995), and the European Union International Insolvency Treaty, *see* Convention on Insolvency Proceedings, initialed Sept. 25, 1995 [hereinafter EU Convention] (on file with the *Fordham Law Review*).

2. The United States Bankruptcy Code calls a bankrupt a “debtor.” 11 U.S.C. § 101(13) (1994).

3. A stay is a moratorium on creditor action. *See, e.g.*, 11 U.S.C. § 362 (1994) (defining stay in the United States Bankruptcy Code).

4. United States law purports to do this. *See* 28 U.S.C. § 1334(e) (1994) (“The district court in which a [bankruptcy] case under Title 11 is commenced or is pending shall have exclusive jurisdiction of all of the property, wherever located, of the debtor as of the commencement of such case . . .”).

5. *See* EU Convention, *supra* note 1.

develop one set of rules for at least all member states of the U.N.⁶ UNCITRAL is attempting initially to provide only some basic principles to deal with a method for "cooperation" among courts in different countries together with the "access" of a party to a bankruptcy in one country to both the courts of another country and "recognition" in those courts.⁷

UNCITRAL anticipates that at some future time it will be able to provide generally acceptable rules for more than judicial cooperation, access, and recognition as countries become more accustomed to the process of harmonizing bankruptcy issues.⁸ At this point, UNCITRAL does not consider itself ready for the kind of problem raised at the beginning of this piece. One question that will be addressed sooner or later is whether bankruptcies should be dealt with in a separate and specialized court of bankruptcy or should be included within the general jurisdiction of a larger court system.

Essential international harmonization can exist with different judicial or administrative approaches to bankruptcy in different countries. Substantive international cooperation need not depend on procedural comparability. Nevertheless, as countries grow more alike in their substantive laws, so will their procedural laws tend towards parity. Issues addressed in different national court systems will, I believe, be handled more similarly substantively if they are also handled with procedural similarity. Bankruptcy laws, both substantive and procedural, can be substantially harmonized among countries whether they are dealt with separately in one court system or as part of a larger judicial structure in courts of more general jurisdiction. I believe, however, that the structure of the judicial system will shape the results of issues appearing before the courts. Accordingly, as the world moves closer to international harmonization, the question as to which form of bankruptcy court system is best will ultimately be addressed.

This essay examines applying the United States judicial bankruptcy model to all nations. Part I examines the history of the United States judicial system and the separation of the bankruptcy courts from the courts of general jurisdiction. Part II examines the benefits of a sepa-

6. The ultimate product of UNCITRAL may, one assumes, be adopted by any state, whether or not a UN member.

7. The words in quotations are the words regularly used in UNCITRAL. See *Report on UNCITRAL-INSOL Judicial Colloquium on Cross Border Insolvency, Note by the Secretariat*, U.N. Commission on International Trade Law, 28th Sess., 1022, at 5, U.N. Doc. A/CN.9/413 (1995) ("The Judicial Colloquium reflected a consensus view that the development by UNCITRAL of a legislative test of limited scope (e.g., in the form of model statutory provisions facilitating judicial cooperation and access and recognition) was both desirable and feasible.").

8. *Report on UNCITRAL-INSOL Judicial Colloquium on Cross-Border Insolvency, Note by the Secretariat*, U.N. Commission on International Trade Law, 27th Sess., at 7, U.N. Doc. A/CN.9/398 (1994) ("A third possibility that might in due time be considered for work by the Commissioning [sic] the formulation of a set of model legislative provisions on insolvency.").

rate bankruptcy system. This essay concludes that other nations should adopt a separate bankruptcy system to aid in the harmonization of international insolvency laws.

I. THE UNITED STATES JUDICIAL SYSTEM

Today, the United States is the only country with separate bankruptcy courts. Since bankruptcy is a matter of federal law,⁹ the bankruptcy courts exist within the federal judicial system. As a result of the Bankruptcy Amendments and Federal Judgeship Act of 1984, these courts are established as a "unit" of the district courts¹⁰ and exist in each federal judicial district. Despite some shared jurisdiction with the district courts¹¹ and although the judges of the bankruptcy courts are not "real," or Article III, judges under the Constitution,¹² they must be regarded as a separate court system with major economic power.

No other country has such a separate bankruptcy court system. Some countries delegate bankruptcy cases from time to time to particular judges—the delegation usually to end after some years and transferred to other judges—but none have, as the United States has, a separate system with rules of court, clerks, official reporters, separately designated decisions, a system of appeal, its own judges, its own courtrooms, and all the other accouterments of courts.

At some time, representatives from different countries will probably meet together to decide whether the rest of the world should follow the United States model or the United States should conform to the overwhelming majority of systems elsewhere. I believe that (with the arrogance long observed in the United States' approach to international efforts) subject to practicalities like an insufficiency of bankruptcy cases to warrant a separate court structure, the United States system should be the model.¹³

9. The Constitution gives the power to enact laws of bankruptcy to the Congress. U.S. Const. Art. I, § 8. It does not, however, take the power away from the states. Therefore, the states may enact bankruptcy laws if Congress does not, as long as it is within interstices left by Congressional enactment. *Id.* Congress has, of course, had umbrella bankruptcy laws in place since 1898 and from time to time before then. One can reasonably assume that Congress will dominate the field of bankruptcy.

The states, pursuant to laws providing for the liquidation of insolvent estates, generally termed "Assignment for the Benefit of Creditor Laws," do have judicial structures that provide a kind of subsidiary bankruptcy coverage compatible with federal law.

10. 28 U.S.C. § 151 (1994).

11. The bankruptcy courts divide litigated proceedings between "core" proceedings in which those courts may render decisions and "non-core" proceedings in which the bankruptcy courts may only propose findings of fact and conclusions of law to the district courts. 28 U.S.C. § 157 (1994).

12. They have neither the life tenure nor the compensation assured of no diminution required by the Constitution, Article III, § 1. See 28 U.S.C. §§ 152, 153 (1994).

13. I am reminded of the opening UNCITRAL Study Group session on what ultimately became the Model Law on International Credit Transfers. It was UNCI-

Determining what judicial procedure is best to handle bankruptcy cases has periodically been part of United States' consideration of its bankruptcy laws. While foreign statutory history is rarely available in the United States, the history that we do know strongly suggests that a separate bankruptcy court has not been taken as a serious option elsewhere. As far back as 1842, concern has been voiced for the administrative machinery that drives United States law. A New York Representative then observed that "the Act was so incomplete as to machinery, that it could hardly be executed at all."¹⁴

The 1898 Bankruptcy Act,¹⁵ the first United States bankruptcy law in the series of laws that has existed without interruption to date, actually allocated decision-making powers between district courts and bankruptcy referees, the predecessors of today's bankruptcy judges. These referees figured strongly in bankruptcy law history as part of the judicial machinery.

For example, a referee was defined to "mean the referee who has jurisdiction of the case or to whom the case has been referred."¹⁶ It was further provided that "[i]f the judge is absent from the district, or the division of the district in which the petition is pending . . . the clerk shall forthwith refer the case to the referee."¹⁷ A later section called, "Jurisdiction of Referees," provides that the referees had jurisdiction to "perform such part of the duties, except as to questions arising out of the applications of bankrupts for compositions or discharges, as are by this Act conferred on courts of bankruptcy"¹⁸

Thus, a century ago there was recognition that the burden of bankruptcy cases required some extra-judicial machinery to manage the load. The burden that the bankruptcy system has placed upon the referees and the respect in which they were held have both grown throughout the years.

The pure power of the bankruptcy referees apparently was difficult for the commentators to absorb. For example, in 1956, Remington on Bankruptcy straddled the nature of a referee's functions as follows:

A referee, under the present system, is an officer of the court without independent judicial authority. His function is to facilitate the

TRAL's plan to develop a law governing principally international electronic funds transfers. Close to the beginning of the negotiations, a representative of the United States recommended to the assembled group that the United States had recently enacted Article 4A of its Uniform Commercial Code, that this had taken years of study and that the best computer, banking, and legal minds had pooled their knowledge in the effort. Therefore, to save a great deal of time, it was suggested that UNCITRAL should simply adopt 4A as international law. The recommendation was barely considered. After several years of work, UNCITRAL ultimately delivered a model law much like 4A.

14. Charles Warren, *Bankruptcy in United States History* 82 (1935).

15. 30 Stat. 544 (1898).

16. Ch. I, § 21, 30 Stat. 544, 545 (1898).

17. Ch. IV, § 18(f), 30 Stat. 544, 551 (1898).

18. Ch. V, § 38, 30 Stat. 544, 555 (1898).

handling of bankruptcy cases, in which connection, after a matter is referred to him, he acts as the court except in the relatively few instances where the Act requires action by the judge.¹⁹

Recognizing the potency of the referee in the administration of the bankruptcy laws, the Supreme Court by rule changed his title in 1973 from "referee" to "judge."²⁰ The newly-constituted bankruptcy judge was not, however, a judge in the sense that the term is used in Article III of the Constitution. The bankruptcy judge neither holds his office "during good Behaviour" nor receives for his services "a Compensation, which shall not be diminished during their Continuance in Office."²¹

The decision-making powers of the referees/judges reached their peak in the Bankruptcy Code of 1978. The 1978 Code was based mainly upon the work of a Federal Bankruptcy Commission established under a Joint Resolution of Congress passed in 1969. The enabling Resolution stressed in its Preamble that "the number of bankruptcies in the United States has increased more than 1000 per centum annually in the last twenty years."²² Obviously, the burgeoning number of cases emphasizes the district courts' need for the bankruptcy court and its system of Bankruptcy referees/judges.

The American College of Trial Lawyers, however, stated that "the College opposes the creation of separate specialized courts to handle bankruptcy cases."²³ Essentially, the College believed that a federal judiciary would better be able to honor its full range of judicial duties if it was required to deal with bankruptcy cases along with the remainder of its case load and not relegate bankruptcy cases to a lesser, specialized court.

The resulting law, however, was the reverse from that espoused by the College. After receiving various opinions on the subject, Congress not only retained the bankruptcy court but gave it more pervasive powers under the 1978 Bankruptcy Code than it had had under the prior Bankruptcy Act. As the Supreme Court stated:

19. 2 Harold Remington, *A Treatise on the Bankruptcy Law of the United States* § 587 (1956).

20. *Northern Pipeline Const. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 54 (1982).

21. U.S. Const. Art. III, § 1. The argument has been made and discredited that the bankruptcy judge is an Article III judge through the powers exercised by Congress in his creation. Compare Emmet J. Bondurant II, *The Bankruptcy Court as a Constitutional Court*, 45 Am. Bankr. L.J. 235 (1971) (arguing that the bankruptcy court is a constitutional court) with Richard F. Bronde, *The Referee in Bankruptcy as an Article I Judge: A Reply to Mr. Bondurant*, 46 Am. Bankr. L.J. 39 (1972) (refuting Bondurant's argument).

22. S.J. Res. 88, 91st Cong., 1st Sess., 1 (1969).

23. *Bankruptcy Court Revision: Hearings on H.R. 8200 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 95th Cong., 1st Sess. 8 (1977) (statement of Hon. Simon Rifkind).

The jurisdiction of the bankruptcy courts created by the [1978] Act is much broader than that exercised under the former referee system [T]he Act grants the new courts jurisdiction over all "civil proceedings arising under title 11 [the Bankruptcy title] or arising in or related to cases under title 11." This jurisdictional grant empowers bankruptcy courts to entertain a wide variety of cases involving claims that may affect the property of the estate once a petition has been filed under Title 11. Included within the bankruptcy courts' jurisdiction are suits to recover accounts, controversies involving exempt property, actions to avoid transfers and payments as preferences or fraudulent conveyances, and causes of action owned by the debtor at the time of the petition for bankruptcy. The bankruptcy courts can hear claims based on state law as well as those based on federal law.²⁴

Northern Pipeline Co. v. Marathon Pipe Line Co. represents one of the few times the Supreme Court disapproved of Congressional action in the field of bankruptcy. The Court rejected Congress' 1978 decision to give the bankruptcy judges essentially plenary—or Article III—power, subject only to appeals, over the bankruptcy process and instead held that an Article I judge could not exercise jurisdiction over a purely state court cause of action.²⁵

Congress amended the reach of the bankruptcy courts in 1984 to comport with the jurisdictional constraints imposed by the Supreme Court. The new law provided that, while the district courts have original and exclusive jurisdiction of all bankruptcy cases,²⁶ the district courts may provide that all bankruptcy cases and all proceedings in those cases "shall be referred to the bankruptcy judges for the district."²⁷ In the final analysis, the powers of the non-Article III bankruptcy courts have actually diminished only slightly below those accorded by the 1978 Act.

The 1984 enactment gave the bankruptcy courts and their bankruptcy judges jurisdiction to decide what it defined as "core" proceeds, and "the legislative history of the new statute indicates that Congress intended that 'core proceedings' would be interpreted broadly, close to or congruent with constitutional limits. The sponsors repeatedly said that [ninety-five] percent of the proceedings brought before bankruptcy judges would be core proceedings."²⁸ The bankruptcy judges, though, still not "real" or Article III judges, are a major tributary of the federal court system that receives the bankruptcy cases and enables the federal district courts to function as courts of general jurisdiction.

24. *Northern Pipeline Const. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 54 (1982) (citation and footnote omitted).

25. *Id.* at 76, 87.

26. 28 U.S.C. § 1334(a) (1994).

27. 28 U.S.C. § 157(a) (1994).

28. *In re Arnold Print Works, Inc.*, 815 F.2d 165, 168 (1st Cir. 1987).

With this summary of historical progress, the inevitable question is finally reached: Is the separate bankruptcy court system desirable? It makes little difference to the rest of the world whether the United States deals with referees or judges or with power under Article I or Article III. These uniquely American issues will be present in the much broader context of whether bankruptcy is better handled in a separate bankruptcy court or as part of the case load of a court of general jurisdiction.

II. THE BENEFITS OF A SEPARATE BANKRUPTCY COURT FOR INTERNATIONAL INSOLVENCY LAW

Bankruptcy law represents a concentrated body of knowledge whose issues can logically be dealt with in a separate court. The United States has become accustomed to this separate judicial structure and accepts it almost without question. As bankruptcy matters regularly come before Congress for legislative resolution (as, for example, Congress ponders whether the wasteful machinery of Chapter 11 is worth the delay, expense, and inequity), no serious proposal exists any longer that the United States dismantle the bankruptcy court system. With this confidence, I propose imposing it, through the international negotiation processes described above, upon the rest of the world. I also ask the question of whether the concentration of information in the bankruptcy courts has the disadvantages noted in the past that counterbalance the advantages.

To the extent that bankruptcy judges are specialists in bankruptcy law, one may fear that their knowledge of other laws might wither and their bankruptcy decisions suffer from not partaking of wider and more extensive doctrines of other law. The American College of Trial Lawyers pressed, and lost, this argument in the debates leading to the 1978 Code.

American experience has demonstrated that the objection asserts too much. Bankruptcy law is hardly a limited field. While it does revolve around certain principles, it partakes of virtually a limitless view of the law; everything from securities and antitrust issues on through doctrines of negligence and even into matrimonial issues. A bankruptcy judge is not limited to bankruptcy alone and is expected to develop expertise in different areas of law connected to bankruptcy.

Conversely, other judges with more general jurisdiction can deal with their various fields without the endless economic distractions and specialized requirements of the bankruptcy laws. This is particularly true of United States federal courts, the fundamental protectors of our liberties under the Constitution. These other federal judges will be better judges, better able to deal with the issues of freedom of speech and assembly, rights of religion, habeus corpus and freedom from unreasonable searches and seizures if their work is undiluted by the separate, essentially economic and numerically vast issues of bankruptcy.

The separate court structure has also served as a focus to make the administration of bankruptcy cases more responsive to the needs of the system. Between 1984 and 1992, the number of bankruptcy cases filed has more than tripled,²⁹ while the number of bankruptcy judges has increased by only a third. The separation of bankruptcy cases from the remainder of the federal court caseload has enabled the specialized bankruptcy bar to cope with the increased load. Among other things, the 1991 Judicial Conference approved an empirical case-weight system for evaluating bankruptcy judgeship needs.³⁰ This has resulted in judicial districts with the greatest needs to obtain the greatest number of new judges. Such an adaptation of fulfillment to needs would have been impossible without a separate identification of bankruptcy cases.

Similarly, plans for the future of bankruptcy litigation are being shaped with regard to the operation of the separate court system. While there is no thought of abolishing the separate bankruptcy court, considerable thought has been given to making that court more efficient. For example, a complete Article I non-"judge"/judge trial court from which appeal lies to an Article III judge appellate court is one of the schemes under consideration.³¹ Whether a revised system of bankruptcy court will ever evolve is speculative. What is clear is that this kind of thinking could only exist in the distinct bankruptcy system of the United States.

As bankruptcy laws develop a commonality among countries, the interpretation and application of those laws will likewise have a common foundation strengthened to the extent that interpretation and application are by a continuing, segregated group of judges. A common understanding will develop in the international judiciary as has developed in the American bankruptcy bench. For example, the international judiciary may jointly examine such questions as whether a transfer into exempt assets *before* bankruptcy is a legitimate consumer act of a fraud on the system, whether the recipient of a fraudulent transfer has taken in good faith, or whether an illegal bargain should be enforced in bankruptcy. The law will better develop its "life" so well understood by Justice Holmes, but now on an international stage.³²

Finally, and perhaps most importantly, if bankruptcy courts are established internationally separate from other court systems, the bankruptcy judges will inevitably develop an international camaraderie, as already happens with lawyers in common fields. This carries great po-

29. Lloyd D. George, *From Orphan to Maturity: The Development of the Bankruptcy System During L. Ralph Mecham's Tenure as Director of the Administrative Office of the United States Courts*, 44 Am. L. Rev. 1491, 1499 (1995).

30. *Id.*

31. *Id.* at 1500.

32. Oliver Wendell Holmes, Jr., *The Common Law* 1 (1938).

tential for harmonization of international insolvency law. Courts in different countries working compatibly—whether formally or informally—are best able to resolve differences of great complexity. Thus, I commend the United States bankruptcy system to the rest of the world.

