

# CHAPTER 3: JURISDICTION, PROCEDURE AND ADMINISTRATION

## INTRODUCTION

Since the inception of a comprehensive bankruptcy system in the United States nearly a hundred years ago, there has been a constant search for the best way to supervise the progress of cases and to resolve the inevitable procedural disputes that arise during the course of a bankruptcy case. Bankruptcy differs from all other forms of litigation in the federal courts, and it always has. Bankruptcy, essentially, is an *in rem* proceeding as distinguished from a simple (even complex) dispute between two parties. Rather than being a legal action in which one person sues another, with a plaintiff seeking a judgment of liability against a defendant, bankruptcy is a collective proceeding to determine the status of a number of obligations affecting several or many diverse parties.

The collective nature of the proceeding causes the creditors seeking repayment of their debts to act as a group, although their individual interests often may diverge or conflict. Absent a bankruptcy case, individual creditors would bring suit against a recalcitrant or insolvent debtor to obtain satisfaction from whatever property the debtor may have, followed by a race to the courthouse by individual creditors to

obtain liens on the debtor's property for eventual seizure and sale. Bankruptcy stops any race, instead imposing on everyone a cooperative effort to obtain satisfaction of debts. In a liquidation case, a trustee in bankruptcy leads an investigation of the debtor and collects assets on behalf of the bankruptcy estate or, more specifically, the unsecured creditor body. In a Chapter 13 repayment case, a trustee also examines the debtor and monitors repayment, while in a business reorganization the debtor remains in possession of the business, but it has heightened responsibilities to act on behalf of the all of its creditors.

In a single collective proceeding, there almost always will be a number of different entities involved. The creditor group may well be made up of secured and unsecured creditors, whose rights and expectations differ from each other, as well as landlords, employees, taxing authorities, guarantors, tort claimants, parties who have outstanding contracts with the debtor to buy or sell goods, and anyone else to whom the debtor owes or may owe money. Creditors may have long past due obligations, or they may be the victims of the debtor's negligent acts that have caused injuries that are yet unknown. Because their interests will often vary, there also may be inter- as well as intra-group differences. A variety of disputes will arise, and the debtor may discover that it can bring legal actions that, if successful, will enhance the value of the estate for the benefit of all the creditors. Ultimately, the court may be called on to confirm a plan of reorganization for the debtor, requiring thoughtful business and policy judgments as well as legal and factual ones.

Bankruptcy courts are required to resolve a number of competing issues with a myriad of affected parties. They must do so under sharp constraints on both time and resources. Because business reorganization cases often involve operating entities, decisions about payments and the resolution of disputes often must be made quickly. Delay can kill the business or irreparably injure the interests of a creditor. Lengthy litigation, usually the decision of the parties in ordinary civil litigation, would divert the resources of a failing business, depriving all the creditors of a distribution that would otherwise be theirs. Bankruptcy is a little like Ginger Rogers dancing with Fred Astaire: these courts have to do everything the other courts do, only backwards and in high heels.

Working out the disputes, whatever their nature, is time consuming; yet, the very essence of a bankruptcy case requires prompt resolution. The time value of money is of particular importance in a bankruptcy setting because a loss will already have been generated through nonpayment of a debt, and the ultimate recovery will almost always be less than 100 cents on the dollar. Additionally, a basic principle of bankruptcy is that interest ceases to accrue once a bankruptcy case begins. Therefore, the more smoothly a case proceeds, the more efficient the judicial process and the less money lost all around even by those not involved in the particular dispute. The

recommendations of the Commission are based, in large part, on this critical factor of time.

The judicial system, to achieve the primary goals of the bankruptcy law, must be efficient and predictable, and Congress over the last 100 years provided several different approaches in this regard. Referees in bankruptcy, as assistants for district judges, came on the scene with the Bankruptcy Act of 1898, and their responsibilities encompassed both administrative and judicial functions.<sup>1722</sup> From 1898 until 1946, referees were compensated by fees based on a part of the filing fee and a percentage of the money distributed to creditors. In 1946, the fee basis was abolished and referees became salaried.

While the Bankruptcy Act of 1898 gave referees jurisdiction over certain matters, other issues were left either to the United States district judge or to state courts for adjudication. For example, while the referee could determine whether a debtor was entitled to a release from debts through the discharge, the Bankruptcy Act was silent on the referees' jurisdiction to determine the effect of the discharge once it had been granted.<sup>1723</sup> There was, predictably, a great deal of confusion over who had proper jurisdiction: the referee, the district judge, or the state court judge. That confusion led to litigation to determine whether the referee had "summary" jurisdiction to hear a dispute or whether the bankruptcy trustee was relegated to the forum in which the debtor could have sued had there been no bankruptcy.

In the late 1960s, when the Bankruptcy Act was being amended to broaden the referee's jurisdiction in the discharge area, it became apparent that, in general, the bankruptcy law was outmoded and, in particular, the matter of jurisdiction required serious reconsideration. This prompted the legislation, introduced originally by Senator Quentin Burdick (D.-N.D.) to establish what became the Commission to Study the Bankruptcy Laws of the United States in 1970.

The 1970 Commission recommended that the bankruptcy courts should have broad jurisdiction so that, in effect, they could become a "one-stop" service center in the judicial process for bankruptcy. Giving the bankruptcy court authority to adjudicate any matter that arose during the pendency of a bankruptcy case made sense because it eliminated the need for multiple litigation, multiple courts, and unnecessary expense that would be borne ultimately by the creditors already suffering monetary loss from the debtor's inability to pay. Additionally, the time value of money was not

---

<sup>1722</sup> See Vern Countryman, *A History of American Bankruptcy Law*, 81 COM L.J. 226 (1976).

<sup>1723</sup> See *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934).

an insignificant consideration. Permitting the bankruptcy court to broaden its jurisdiction enabled the bankruptcy case to reach a final disposition more quickly.

The 1970 Commission recommended pervasive jurisdiction but felt it was unnecessary as a legal matter for the bankruptcy court to be established under Article III of the Constitution. There was an expectation that since Congress was granted explicit constitutional authority to promulgate a uniform law of bankruptcy,<sup>1724</sup> it could provide the appropriate judicial system to implement these laws within the framework of Article I of the Constitution. Thus, while expanded or pervasive jurisdiction was a major component of the recommendations of the Commission, the constitutional status of the bankruptcy courts was not.

In 1973, as a result of the promulgation of the Bankruptcy Rules, now the Federal Rules of Bankruptcy Procedure, the title of bankruptcy referee was changed to bankruptcy judge. This was the second step in the recognition of the major role played by the judicial officer charged with overseeing bankruptcy cases. There was “a deliberate attempt”, by the rules, “to enhance the dignity and stature of the referee's office.”<sup>1725</sup> Later in the 1970s, Congress took up legislation that had been introduced in response to the recommendations of the Commission. A major consideration of Congress was the need to make the bankruptcy courts efficient in the supervision and resolution of bankruptcy cases. These ideals were to be reached by giving the bankruptcy court pervasive jurisdiction and relieving it of administrative functions so that it would, for the most part, only resolve disputes.

There was a threshold issue: could pervasive jurisdiction be granted a non-Article III court? In seeking advice from constitutional experts, the House of Representatives was left without any real guidance because of the lack of definitiveness in the case law. The House of Representatives passed a bill that provided for the establishment of an Article III bankruptcy court with jurisdiction over any matter related to a bankruptcy case to ensure the status of the bankruptcy court and to avoid a constitutional problem from the broad grant of jurisdiction. The Senate concurred in the grant of expanded jurisdiction, but it did not approve the Article III status of the court and, as enacted, the Bankruptcy Reform Act of 1978 continued the bankruptcy courts as a non-Article III.

---

<sup>1724</sup> U.S. CONST. art. I, § 8, cl. 4.

<sup>1725</sup> Frank R. Kennedy, *The Proposed Bankruptcy Rules and Official Forms*, 46 AM. BANKR. L. J. 53, 58 (1972).

In 1982, the U.S. Supreme Court found that the jurisdictional structure of the statute unconstitutional,<sup>1726</sup> necessitating further action by Congress that occurred in 1984. Although the amendments were adopted to address the constitutional defects of the statute, the amendments themselves are not free of all constitutional doubt.

The U.S. Supreme Court has not revisited the jurisdictional issue affecting the non-Article III bankruptcy court. It is reasonable to assume that it will do so eventually and, when it does, it may well find fault with the present system. The bankruptcy judge continues to determine a variety of matters the 1984 amendments label as “core” and continues to hear, but not to determine, noncore matters. Identifying the issues that fall within core and that fall within noncore jurisdiction is open to doubt and at times requires a judicial determination. The issue of authority to dispose of counterclaims is not fully resolved by the case law and, absent a ruling from the U.S. Supreme Court, cannot be fully resolved.

The 1984 amendments included a specific authorization for a number of motions that can be made in any adversary proceeding -- including motions to determine whether the proceeding is core or noncore, to withdraw the reference so that the matter will be heard by the federal district judge, to abstain (for the proceeding to go to another forum, usually a state court), still another motion in the form of a demand for a jury trial, and yet another that a personal injury action has to be tried or transferred by the district judge and not the bankruptcy judge. While not all of these procedural hoops are required to buttress the exercise of jurisdiction and authority by the bankruptcy judge, they were part of the 1984 amendments -- some as a result of lobbying efforts by interest groups and others because of a fear that, perhaps, they were necessary for constitutional purposes.

Accordingly, the failure of Congress to create an Article III bankruptcy court, either before or after the *Northern Pipeline* decision, permits even today strategic motions and use of procedural devices to delay a bankruptcy case. Again, unnecessary expense is borne by those who cannot afford it -- the estate pays it directly and the creditors who pay indirectly through the loss of assets available for distribution. The current system involves an unnecessarily complex structure that could be simplified by establishing an Article III court. If these untoward consequences can be avoided, they should be. The Commission recommends that Congress establish the bankruptcy court as an Article III court that would decrease delay and expense as well as raising, inevitably, the quality of the entire judicial system.

---

<sup>1726</sup> *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982).

The bankruptcy judges serving today were not appointed under Article III. To avoid hardship and uncertainty, if Congress approves Article III status for bankruptcy judges, the Commission recommends that these judges be permitted to finish their terms of office as non-Article III judges, which would be for a maximum of 14 years, the current statutory term. Second, their retirement benefits should remain intact -- that is, there would be no change in their pension and other benefits. The transition to an Article III system will take some time, and the Recommendation addresses matters of jurisdiction during this period as well as the operation of the bankruptcy court. Moreover, because an Article III bankruptcy judge would not be appointed until a vacancy occurred by attrition, the appointment process itself will span several presidential elections.

Another major flaw in the bankruptcy system that results in unnecessary cost is the current appellate process. Appeals from bankruptcy courts go to district courts -- or, in some circuits, bankruptcy appellate panels -- and then to the courts of appeals before they are eligible for hearing by the U.S. Supreme Court. This two-tiered appeal system is found nowhere else in the federal judicial system. There should be no need for an appeal from one trial judge (the bankruptcy court) to another trial judge (the district court). Moreover, and most importantly, neither the appeal to the district court nor to the bankruptcy appellate panel, if one has been established in the particular circuit and district, settles anything except the dispute between the parties in their particular matter. No precedent is established for future cases in the judicial district and certainly not in the judicial circuit. One appeal should be all that is necessary. In time, the rulings of the courts of appeals will settle basic issues of bankruptcy law, ridding the system of repeated appeals involving the same matters.

To further expedite litigation in bankruptcy cases, the Commission recommends that a greater variety of appeals be permissible. Again, it is worth noting that a bankruptcy case differs from the ordinary civil action. In the appellate process, there are many orders that would be considered interlocutory and not subject to appeal -- at least, as of right. Necessarily, however, in the bankruptcy context, many of these orders may be of such importance to the of the liquidation or reorganization case that an immediate appeal should be allowed. The Judicial Code should be amended to provide for the appeal of some interlocutory orders. The Recommendation gives the courts of appeal the authority to permit the appeal of any interlocutory order by consent, which permits the courts of appeal to control the process.

*Procedural Changes to the Bankruptcy Code.* The procedural section of this chapter focuses on two types of claims: preference actions brought by the estate and tax claims asserted against the estate. Preference actions seek to recover all transfers of property (except under certain circumstances) made within 90 days of the debtor's filing date. By recapturing all transfers made within this time frame, the preference

power prevents one creditor from being “preferred” over other creditors on the eve of bankruptcy. The complaints voiced to the Commission focused on preference actions against small trade creditors that cost more for the creditors to defend than to settle, regardless of the merits of the action. The Commission concluded that the preference policy of equality of distribution to creditors was sound but agreed that certain of preference recovery procedures discriminated against small trade creditors. The Recommendation in this area is designed to reduce the number of actions that cost more for small trade creditors to defend than they do to settle. In addition, the Commission proposes to clarify the ordinary course of business exception to the preference power in the hope of expediting the litigation in this area.

The tax claim Recommendations reflect the Commission’s efforts in the tax area in addition to the comprehensive tax Recommendations that are discussed in Chapter 4. These proposals are designed to restore the balance between the tripartite interests of debtors, tax creditors and other creditors. The first Recommendation prevents the subordination of *ad valorem* tax liens to the payment of other priority claims in cases under Chapter 7. The second Recommendation shifts the burden of proof for tax claims from the taxing authority to the estate. The third Recommendation would grant taxing authorities an exception to the automatic stay to permit the setoff of prepetition income tax refunds against an undisputed prepetition income tax liability of an individual in a case under Chapter 7 or Chapter 13.

*Bankruptcy Administration.* In 1978, Congress adopted another of the 1970 Commission’s recommendations but on an experimental basis. This was the pilot program creating the United States Trustee system, which was assigned almost all of the administrative functions that had formerly rested with the bankruptcy court. It furthered the objective of freeing the court from such a role, reserving for the court the judicial role of dispute resolution. Thus, the separation of administrative from judicial functions and the grant of pervasive jurisdiction were two of the most important reforms enacted by Congress to improve the bankruptcy system.

In 1986, the United States Trustee Program was expanded to all districts and made permanent, effective in all states except Alabama and North Carolina. In its relatively short life span, the program has been the subject of several major studies, the latest in 1995 by the National Academy of Public Administration. The Recommendations made with respect to the U.S. Trustee Program also will help increase the efficiency of the judicial system and they are in harmony with the recommendations suggested by the National Academy.

The 1978 Bankruptcy Reform Act changed the venue standards for commencing a case under the Bankruptcy Code. For a corporate debtor, the major change was to permit the filing in the state of incorporation in addition to the location of its principal place of business or principal assets. Some corporations have used the opportunity to choose a forum that they believe will be friendlier to the debtor -- a practice that is, at the least, unseemly. Some debtors go to their state of incorporation, which may have no bearing on the actual location of any of the relevant parties including the creditors, shareholders, officers, and employees of the business. The proposal to eliminate state of incorporation as a venue choice was reached after a great deal of debate, both in working group sessions and in the open forum during full Commission meetings. The Commission did not reach its recommendations quickly or lightly; it deliberated carefully after the Commission had the opportunity to hear from all affected parties on the venue question.

The Recommendations also would limit the ability of one corporate debtor to follow an affiliate into the venue used by the affiliate. The limitation would permit a subsidiary to follow a parent corporation, but it would not permit other forms of selection of venue based on following a related entity. The Commission recognized the importance of keeping parent and subsidiary filings in the same jurisdiction to aid in the reorganization, but it recognized that affiliate venue also creates opportunities for inappropriate forum shopping.

The detailed suggestions in this part of the Report further the concept of making the judicial process more economical to the parties and the system overall. These include the ability of an attorney, admitted to practice in a federal district court, to represent a client in the bankruptcy court in any other judicial district in the country without the need to be specially admitted in a distant court. Any local rules of court that would require retention of local counsel, however, would remain in force. The practice in some courts of appointing "fee examiners" to review applications of professionals for compensation, when compensation is from the bankruptcy estate after court approval, has been rejected by the Commission. Another layer of professionals is unnecessary and adds to the cost of the bankruptcy proceeding. Both the bankruptcy judge and the United States Trustee review fee applications, and the Bankruptcy Code should bar the appointment of anyone else to do that.

Finally, the Commission discussed the U.S. Supreme Court's recent decision in *Seminole Tribe of Florida*<sup>1727</sup> and concluded that it was not in a position to recommend a legislative response since the issues involved matters of state sovereign immunity under the Eleventh Amendment. The *Seminole* Court held that Congress could not abrogate a state's Eleventh Amendment sovereign immunity under its Article I plenary powers, which includes the bankruptcy clause. The practical result of *Seminole* is that unless a state waives its Eleventh Amendment sovereign immunity, the bankruptcy court probably will not have jurisdiction over it -- regardless of the state's role in a particular bankruptcy proceeding. The

---

<sup>1727</sup> 116 S. Ct. 1114 (1996).

*Seminole* decision may change the bankruptcy system in many important ways, and Congress will want to keep the impact of this decision in mind as it considers any legislative changes.