HISTORY AND NATURE OF BANKRUPTCY
IN THE UNITED STATES

By: Edilberto Berríos-Pérez
(787) 753-0884

"A pound of flesh, no more, no less", the classic phrase from Shakespeare's The Merchant of Venice, is a lively example of society's concern for the consequences to those that could not pay their debts. Such drastic consequence was not illusory or hypothetical, as in fact it was the law in ancient Rome. The Law of the Twelve Tablets, dated around 450 B. C., gave creditors the right to take a share of the debtor's body or flesh that was proportionate to their delinquent debt . Such brutal approach to insolvency was discontinued in Rome by Cayo Julius Cesar, with the adoption of the *Cessio Bonorum,*[1] which was enacted approximately 55 years B.C.

The *Cesario Bonorum*, which could only be voluntarily invoked by the debtor,[2] required the surrender of all assets for equitable distribution among creditors. The debtor was examined and, provided he cooperated and complied with the law, would be immune from punishment, but not released from the unpaid portion of the debts.

A Draconian approach to financial insolvency was also followed in ancient Greece. The famous Seventh Century B.C. Athenian lawgiver "Draco" codified multiple laws which became famous for their extraordinary harshness. Those **Draconian laws** punished most crimes, including trivial ones, with death. Those same laws permitted a creditor to execute a money collection against the physical person of the debtor, making him/her a slave. Those laws prevailed between 624 B.C. and 574 B.C., at which point most of those laws were repealed by Solon's economic reforms known

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[1]Ironical that such humanitarian law was introduced at the moment when Rome had just lost its Republican rule and the centralized power to establish a dictator.

[2]David S. Kennedy and R. Spencer Clift, III, *A Historical Analysis of Insolvency Laws and their Impact*, Journal of Bankruptcy Law and Practice Vol 9, Sec 2, Page 165

as **“Shaking of Burdens”**. The primary concern of these reforms was to relieve the distress caused by debt. Solon redeemed forfeited land and emancipated all those who had been enslaved due to their debts. In addition, he prohibited all future loans secured by the person of the debtor.

The principle of not physically punishing insolvency had been preserved during the Middle Ages in Continental Europe; however, insolvency was still inexcusable. The failing merchant would be totally banished from the business community.[3] Various Bankruptcy Laws still preserve that principle today (e. g. France[4]).

The etymology of the term “Bankruptcy” has been traced back to the northern Italy of the Eleventh Century, in the town of Lombardy, to be more precise. Merchants, bankers and creditors operated from benches in open markets and plazas. When a particular merchant became delinquent or insolvent, a need arose to give publicity to said circumstance. Limitations on publicity and communication generated an ingenious way to inform the insolvency: the creditors would gather in front of the delinquent merchant’s store or bench and break it. Thus the broken bench or “banco-rotto” became the symbol and synonym of economic insolvency. The word and concept disseminated throughout Europe, and was subsequently imported into the Americas (*Davis S. Kennedy,* supra).

In England, insolvency laws continued to be somewhat brutal for a longer period of time. As early as 1285, and through the nineteenth century, imprisonment was a real remedy for the creditor against the delinquent debtor. The first bankruptcy law that was enacted in England which gave creditors remedies –other than imprisonment– against seriously delinquent debtors came into effect

[3]Id at 168

[4]La Quiebra Internacional, Carlos Espluges Mota Ed. 1993

in 1542. The statute deemed debtors as being quasi-criminals or "offenders". That law, approved in 1570, as well as its successor, pursued to provide a remedy for creditors, not for debtors, and could only be used against merchants.

The 1570 statute only permitted a bankruptcy case to be commenced by creditors. This was so, because the remedy was meant to protect the creditors' interest, not the debtors'. In order for a creditor to enable the commencement of a bankruptcy proceeding, the debtor must have committed an "act of bankruptcy". To some extent, that concept still lives on today in involuntary bankruptcies.

An act of bankruptcy was considered as being some wrongdoing by merchants, which was destined to delay or prevent creditors from collecting their debts. At the time, becoming indebted by a person who was not a merchant was merely viewed as unethical and immoral (i.e. purchasing more than what one was capable of paying was a kind of dishonesty).

Once commenced, the process consisted of the same basic historically-rooted concept: a universal foreclosure of the debtor's assets for a pro rata distribution among creditors. Such concept seems to be ubiquitous in the various bankruptcy laws found throughout our contemporary world. The nature of things commands such procedure, as only available assets can be used to pay existing debts. Substantive and Procedural variations emerge according to the peculiar national policy on the subject (i.e. how many assets can the debtor retain, how far back in time must be reached to recover assets, is a discharge to be given, what can creditors do or not do, and so on).

The British Bankruptcy Law[5] that was enacted in 1705, pursued to create incentives for the debtor to cooperate and punishment for his/her obstruction. The incentive consisted in the debtor's retention of a certain number of limited property, and the granting of a discharge or cancellation of

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[5]Statute of Anne, 4 Anne ch. 17

all prior debts.[6] Albeit the fundamental principles being present, the law, in fact, remained very pro creditors, as only creditors could commence bankruptcy proceedings, and the creditors' consent was required for a discharge to be granted. These were the principles and concept that were used as an outline for bankruptcy legislation that served as background when the United States Constitutional Assembly was debating. Commerce and the creation of wealth were simultaneously undergoing a conceptual revolution, as Adam Smith's The Wealth of Nations had recently been published.

The United States Constitution, as well as any other law, has a set of purposes that guides its adoption. The various powers that were given to the Federal Government pursue to attain and preserve certain objectives; the bankruptcy power is no exception. There was little debate in the Constitutional Convention, when the bankruptcy power of Congress was first suggested by Charles Pinckney, of South Carolina. Mr. James Madison, in paper 42 of The Federalist, classified Bankruptcy Power as one of "those which provide for the harmony and proper intercourse among the states." Mr. Madison published the following statement, which guided public debate and, ultimately, the adoption of bankruptcy power for Congress:

> "Under this head might be the particular restraints imposed on the authority of the States, and certain powers of the judicial department; but the former are reserved for a distinct class, and the latter will be particularly examined when we arrive at the structure and organization of government. I shall confine myself to a cursory review of the remaining powers comprehended under this third description, to wit: to regulate commerce among the several States and the Indian tribes, to coin money; to provide for the punishment of counterfeiting of the currency coin and securities of the Unites States; to fix the standard of weights and measures; to establish a uniform law of naturalization, and **uniform laws of bankruptcy**; to prescribe the manner in

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[6]This concept has a biblical origin, which is dated prior to David and Solomon. Chapter 15 of the Deuteronomy contains the first release of debtors from their debts. The concept is rooted in generosity and the religiously-mandated good heartedness, but not a legal entitlement (David S. Kennedy, infra).

> which the public acts, records and judicial proceedings of each State shall be proved, and the effect they shall have...
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> The power of establishing uniform laws of **bankruptcy is so intimately connected with the regulation of commerce**, and will prevent so many frauds where the parties or their property may lie or be removed into different States, that the expediency of it seems not likely to be drawn into question"

The power of Congress to legislate bankruptcy received little debate in the Constitutional Convention. Therefore, the decision to prohibit states from impairing obligations of contracts[7] was decided early.[8] The impairment of contracts is a part of the exclusive powers granted to the Federal Government, thus it is expressly prohibited to the states. It is clear that the Federal Government is not prohibited from impairing obligations of contract, while states are. A simple comparison of the Fifth Amendment to the United States Constitution with Article I, Section 10 of said Constitution, establishes the difference. Extending the prohibition on impairment of contractual obligations to the Federal Government would have seriously curtailed that government's ability to legislate on the subject of bankruptcy.

The historical framework provides further clarity on the subject. England had already adopted a legal cancellation of debts doctrine as part of a bankruptcy process. If the government cannot impair contractual obligations, then a discharge in bankruptcy would be impossible. The higher ends of an individual's incentive to produce by rewarding the honest cooperating debtor would be severely hindered. This policy was established to aid the harmony and intercourse among

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[7]The phrase has been defined as : "Any law which enlarges, abridges, or in any manner changes this intention when it is discovered, necessarily impairs the contract itself, which is but the evidence of that intention." See *Ogden v. Sauders*, infra.

[8]The Federalist 44, Madison

the states, and, in order to enable an effective legislation, Congress was freed from **ONE** restriction, which all other governments within the nation have. All other restrictions remain in place, with their limitations extending to the Federal Government as well. Further limitations were placed on the Federal Government at the time of the Constitution's inception and shortly thereafter. Some of those include the limitations to the judicial power of the United States, the Fifth, Eleventh and Fourteenth Amendments.

When the Constitution was adopted, various states already had bankruptcy legislation in place. Congress did not enact any bankruptcy legislation for some time. The first attempt was in the year 1800, when an economic crash in the years 1792 and 1798 caused much ruin and the imprisonment of thousands. Well-respected citizens, such as Supreme Court Justice James Wilson[9], faced similar fate. Interim legislation was enacted in 1800, which was supposed to expire in five years, but it ended up being repealed in 1803.

The statute mirrored the 1732 English act: only merchants were eligible; an act of bankruptcy was required; only creditors could commence proceedings, and a commissioner would be appointed by the District Court, who, in turn, would designate an assignee to supervise, liquidate and distribute the debtor's assets (note the two layers of delegation). A discharge was contingent upon cooperation and vote of two thirds of the creditors. The small distributions, perceived abuses, and favoritism triggered the repeal, and state statutes continued to fill the void.

Imprisonment for unpaid debts continued to be the applicable standard. In the year 1830 the number of imprisoned persons due to their debts was at least three times as many for other "crimes" in the four states of Massachusetts, New York, Pennsylvania and Maryland. The void continued

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[9]See History of Bankruptcy Law 3:5 ABI Law Review (1995)

until 1898, with the exception of two intermissions in 1841-1843 and in 1867-1878. The general and prolonged void caused the states to continue having laws on the subject. Several United States Supreme Court cases during the period enlighten the operation of the bankruptcy power, constitutional limitations and the states position therein [see *Sturges v. Crownshield* 17 U.S. 122; 4 Wheat (1819) and *Ogden v. Saunders* 25 U.S. 213, 12 Wheat 213 (1827)]. Both rulings narrowed down the constitutional limitation of states on the impairment of contractual obligations.

The basic question in *Ogden* was whether "the obligation of contract is impaired by a state bankrupt or insolvent law, which discharges the person and the future acquisitions of the debtor from his liability under a contract entered into in that state after the passage of the act." The final holding in multiple opinions was that states can prospectively legislate on the subject of bankruptcy[10] and, therefore, impair obligations of contract, but those discharges do not have any extraterritorial effect. Such effect causes a jurisdictional, sovereignty and constitutional collision that the Constitution had resolved by wholly granting such power to Congress. Full faith and credit does not resolve the issue, therefore, the power was prohibited to the states in any extraterritorial implication.

The 1841 Bankruptcy Statute provided for voluntary petition[11] to all classes of debtors, while abolishing imprisonment for indebtedness. The Statute granted a discharge to all the debtors who tendered all of their property and cooperated with the Court. The trustee was appointed by the Court,

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[10]It is to be noted that the case was decided in the year 1827, during one of the moments in time when Congress did not have any federal bankruptcy law in place. Some of the court opinions do make reference to the consequence of a federal occupation of the field. A solid argument for recognizing power in the states to legislate on the subject of bankruptcy is that nothing in the Constitution explicitly prohibits the states from such legislation. Subsequent to the adoption of the constitution, the states continued legislating and enforcing their own bankruptcy laws. On the other hand, laws on subjects thought to be controlled by the new government where abandoned by state legislatures, such as admiralty, navigation and others.

[11]This characteristic is said to of a ground-breaking nature: for the first time in history, a voluntary petition was permitted. The Statute followed the outline of the then existing Massachuset Bankruptcy law.

not the creditors, while powers were given to recover preferential and fraudulent transfers. Jurisdiction was vested in the District Court "in the nature of summary proceedings in equity."[12] Strangely, the right to trial by jury[13] <u>was preserved and, even the debtor could invoke such right</u>. The statute was short-lived, having been repealed in 1843. The main objections to the statute were that it did not preserve the State exemptions[14] from attachment and its high administrative cost.

The Civil War had devastated the national economy, while England had significantly evolved its own bankruptcy laws by abolishing the requirement of creditor's consent for discharge and by adopting voluntary bankruptcy for all debtors. The United States Supreme Court, in the cases of *Ogden v. Saunders*, supra, and *Struges v . Crownshield*, supra, had consolidated the constitutional prohibition on states to impair obligations of contract; federal legislation was the only answer, and the post Civil War national economy was less localized, which led to the passage of the third Federal Bankruptcy Act in 1867.

The Third Federal Bankruptcy Act extended its application to corporations, provided for voluntary and involuntary bankruptcy to all debtors, and expanded the definition of an "act of bankruptcy." Jurisdiction placed again with the United States District Court as "courts of bankruptcy". The Court was to appoint "registers in bankruptcy to assist the judge of the district court in the performance of his duties." For the first time, the statute permitted a variation to a complete liquidation. A 1874 amendment to the statute permitted the composition, or rather a recomposition, of debts in pursuit of rehabilitation, with limitations being imposed. Nevertheless,

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[12]Charles Jordan Tabb, supra at 17

[13]5 Stat. At 444

[14]Although the statute created a few federal exemptions, the objection is reasonable: how can Congress deprive a debtor's acquired right to exempt or exclude certain property from his creditors?

the concept was born and put into application. The complete statute was repealed in 1878, primarily due to the high fees and excessive cost of administering the bankruptcy. One significant contribution of the repealed statute was that the debt re-composition was acknowledged as existing within the bankruptcy power of Congress.

The 1898 Bankruptcy Act was enacted. The social, political and economic forces that drove its adoption differed from previous bankruptcy legislation. At the time there was no economic crisis, although the economic depression in1893 had taken place. The statute had been outlined and discussed for some time. Having the North prevailed in the Civil War, agriculture then became a less dominating economic factor, with the territories in the West being opened.

The United States was amidst prosperous expansion: new territories were being acquired; industrialization was dominating; new products and means of transportation were being developed; the railroad and automobile accelerated and expanded commerce, which led to the accumulation of wealth, and there was no economic emergency that compelled the fast adoption of bankruptcy legislation. Therefore, the process was somewhat more detained and studied, although hotly debated.

The southern states saw Bankruptcy, primarily the involuntary type, as a means for northern creditors to collect. However, the consciousness for its need took root in the economic panics of 1884 and 1893. Congress took its time, and two bills were primarily considered: one by Judge Lowell of Massachusetts and the other by Atty. Jay Torrey, of St. Louis. The latter, supported by creditors, ultimately became the backbone of the 1898 Bankruptcy Act.

The main characteristics of this act are the following:

1. Provided for a discharge to bankrupts with the idea of a fresh start
2. Permitted voluntary and involuntary filing

3. The bankrupt could select a re-composition of debts in lieu of total liquidation of assets

4. Partnerships and most corporations could seek relief

5. Provided for pro-rata distribution of the funds generated through liquidation after recovery of fraudulent transfers

6. Insolvency was not required

7. Only state exemptions were permitted

8. The discharge was broad, excluding only few types of debt

9. Enabled a stay of all proceedings by and against the debtor

One aspect that deserves special attention is the jurisdiction and structure that had been given to the Bankruptcy Court. Federal District Courts acted as Bankruptcy Courts: these courts appointed a "referee" to whom a majority of the judicial and administrative functions were assigned or referred. Such delegation was in the nature of appointing a special master under the Federal Rules of Civil Procedure. The jurisdiction on many matters was concurrent with state courts, while the referee was exercising most of the jurisdiction Congress had given to the District Court.

The term **"summary jurisdiction**" was used to describe the power and fashion in which the power was exercised.(i.e. without any pleadings). Said summary jurisdiction consisted of proceedings to administer the bankruptcy estate, while **"plenary jurisdiction"** was the authority to decide disputes between the trustee and third parties. One important aspect of the referees is their compensation. Referees were compensated on a fee basis,[15] in addition to being entitled to the reimbursement of certain expenses. This aspect has the end result of referees having <u>an economic interest</u> in any case being administered and decided by them.

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[15]Sec. 40, 30 Stat. At 156

The 1898 statute was constitutionally challenged in *Hanover v. NationalBank v. Moyses* ,186 US 181 (1902). The requirement for the uniformity of bankruptcy laws was the main thrust of the challenge. The factual basis was the statutory provision making state of residence exemptions applicable to each particular bankruptcy. The Court concluded that the uniformity required was territorial, and not personal. The Court described the dual aspect of the debtor-creditor relation, namely a personal obligation and the right to pursue specific property. The Court further correlated that distinction to the difference between the federal and state power over contracts and bankruptcy. The outline was established to delimit the contours of congressional power in bankruptcy matters.

Between the late 1920's to early 1930's, the credit industry pressured for the passing of an amendment that would restrict the benefits that bankruptcy provided, or at least the terms under which a discharge was granted. Basically, the creditors wanted some payment from those who could[16] be envisioned in the future as being able to do so. The Great Depression of the 1930's did not provide a fertile ground for the pro-creditor perspective. In the year 1933, on the last day of the Hoover administration, Congress enacted several changes to the Bankruptcy Act. The most relevant one was section 77[17] enabling the reorganization of railroads, a service of great public interest, more so in the middle of such economic need.

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[16]That philosophical debate survives today (see professor's Larry King public statements on the subject on these days prior to his death).

[17] A Canadian insolvency case had generated important jurisprudence in the United States v: *Canada Southern R. Co. v. Gebhard,* 109 U.S. 527, 3 S.Ct. 363, 366, 27 L.Ed. 1020. In that case, a Canadian statute permitted a railway company, unable to meet their engagements, to unite with their creditors in the preparation of 'schemes of arrangement'. A structure for repayment in time was agreed to by the holders of mortgages, bonds, stocks, rent charges, and preferred shares when assented to in writing by a designated majority of the holders of each class of security. The agreement, when confirmed by the court, became binding upon the non-assenting minority.

The United States Supreme Court held the agreement to be binding upon bondholders who were citizens of the United States and who sued in courts of the United States to recover on their bonds. Section 77 of the Bankruptcy Act, enacted in 1933, mirrored that legislative structure.

Shortly thereafter, Congress continued amending the Bankruptcy Act: Sections 74, for re-composition of debts to individuals; Section 75, providing relief to farmers, and Section 83, permitting reorganization of municipalities and political subdivisions. As could be expected, litigation ensued, thereby generating some of the most significant bankruptcy jurisprudence, which was significantly important, from the standpoint of the limits of the bankruptcy power granted to Congress [see *Lynch v. US* 292 US 571 (1934);[18] C*ontinental Illinois Nat. Bank & t. co. v. Chicago, etc., co.* 55 S.Ct. 595, 294 U.S. 648, 79 L.Ed. 1110 (1935); *Lousville Joint Stock Land Bank v.*

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[18]Mr. Justice Brandeis' decision holding that a valid contract is property. The case dealt with war risk insurance policies for which the US Government had charged premiums but in 1933 by statute attempted to void.

The United States moved to dismiss on the ground that the court was without jurisdiction, because the consent of the United States to be sued had been withdrawn by the Act of March 20, 1933, commonly called the Economy Act (38 USCA s 701). The Court sustained the complaint stating:

> "On the other hand, war risk policies, being contracts, are property and create vested rights. The terms of these contracts are to be found in part in the policy, in part in the statutes under which they are issued and the regulations promulgated thereunder."
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> "The Fifth Amendment commands that property be not taken without making just compensation. **<u>Valid contracts are property</u>**, whether the obligor be a private individual, a municipality, a state, or the United States. Rights against the United States arising out of a contract with it are protected by the Fifth Amendment." United States v. Central Pacific R. Co., 118 U.S. 235, 238, 6 S.Ct. 1038, 30 L.Ed. 173; United States v. Northern Pacific Ry. Co., 256 U.S. 51, 64, 67, 41 S.Ct. 439, 65 L.Ed. 825. When the United States enters into contract relations, its rights and duties therein are governed generally by the law applicable to contracts between private individuals. That the contracts of war risk insurance were valid when made is not questioned. As Congress had the power to authorize the Bureau of War Risk Insurance to issue them, **<u>the due process clause prohibits the United States from annulling them</u>**, unless, indeed, the action taken falls within the federal police power or some other paramount power."

<u>The constitutional restriction of Due Process limits the Federal power to impair obligations of contract</u>. **Contracts are property**, a special kind of property that can be impaired through specific mechanisms related to the concept of Bankruptcy. Undoubtedly, the outrageous unfairness and abuse of charging for something and not keeping the promise lingered in the reasoning.

Radford 295 US 355 (1935); *Ashton v. Cameron County District*, 298 U.S. 513, 56 S.Ct. 892, 80 L.Ed. 1309 *(1936);*[19]*Wright v. Union Central*,[20] 311 US 273, 61 S.Ct. 196, 85 L.Ed 184 (1940)].

The results reached, the expressions made, and the constitutional tests applied in those cases, provided guidance for Congress to approximately identify the boundaries of the bankruptcy power.

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[19]In a six to three decision, Chapter Nine, which allows state instrumentalities to file for debt reorganization ,was declared unconstitutional. The reasoning was that the sovereign power of states, in conjunction with the prohibition on impairment of contracts, could not cause a delegation by the states to Congress of a power that the states did not have, not even by consent.

The *Ashton* case and its holding must be read within the confinement of its facts, primarily what the assailed statute intended to attain. The precise crucial facts that must be considered include that:

a. the statute did not require the bankrupt to surrender any property whatsoever,

b. the proposed plan provided for payment of 49.8 cents on the dollar, and that

c. the bankrupt entity was only part of the state and lived on its credit.

The challenge was issued under the Fifth Amendment, on the grounds that the legislation did not pertain to being one on the subject of bankruptcy, and for a lack of power in the state to impair contractual obligations. The Court assumed, for that decision, that the statute was adequately related to the subject of bankruptcy. It is inescapable that the unconstitutionality holding occurred under the Fifth Amendment; that is, due process in its conjunction with the limitations on the powers of the states to impair obligations of contract and the states sovereignty.

The dissenting opinion expressed that, for bankruptcy, it is not necessary for the debtor to have any property to surrender, as the composition of debts, as part of bankruptcy, is firmly established.

It must be remembered that the issued bond was meant to build the water facilities. That has value, but the juridical personality was used to keep the value for the state, not to comply with the contract or obligation assumed. Ashton has not been reversed, but Chapter 9 is a reality nowadays; therefore, the pure concept of municipality or political subdivision filing for reorganization is not void (at least as it is presented in the Ashton case). Such structure constituted an inherent unfairness that shocked the conscience, as it was a blatant breach of due process, which does bind Congress.

[20] Holding that since **security interest is property**, protected from "taking", without just compensation, the Bankruptcy Court cannot allow dissipation or threat to that interest. The Act preserved the right of the mortgagee to realize upon the security by a judicial sale. The interpretation stated this right is merely deferred or postponed until the other conditions and requirements of the Act prescribed for the protection of the debtor have been met.

In the ***Continental Illinois*** case, the challenge was issued to the Universal Injunction[21] to bondholders of a bankrupt railroad, which prevented them from selling their collateral to attain collection. The Court addressed several important issues including the following:

a. A composition of debts is within the bankruptcy power, even if it does not result in a total liquidation of assets for distribution. The bankruptcy field deals with the relations between an insolvent or non-paying/fraudulent debtor and his/her creditors, thereby extending relief to both parties, which has been previously upheld. This same view sustains the validity of Section 77. If the statute provides for the adjustment of a failing debtor's obligations, these are nonetheless applicable laws in bankruptcies.

b. Making the will of the majority of assenting creditors binding upon minority dissenting ones, does not deprive creditors of property without due process. The Court stated as follows:

> "In no just sense do such governmental regulations deprive a person of his property without due process of law. They simply require each individual to so conduct himself for the general good as not unnecessarily to injure another. Bankrupt laws have been in force in England for more than three centuries, and they had their origin in the Roman law. The constitution expressly empowers the congress of the United States to establish such laws. Every member of a political community must **necessarily part with some of the rights which, as an individual, not affected by his relation to others, he might have retained.** Such concessions make up the consideration he gives for the obligation of the body politic to protect him in life, liberty, and property. Bankrupt laws, whatever may be the form they assume, are of that character." (Emphasis supplied)

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[21] This is the genesis of today's stay of proceedings under 11 USC § 362. The confines of the opinion are urged to be compared to the present stay and its operation. This would include the end result (as applied), which prohibits the filing of any case or document anywhere, except in the place where it is argued, as it would result in the waiver of multiple fundamental constitutional rights, that is, the Bankruptcy Court.

Furthermore, the Court cited *Canada Southern* as follows:

> "Unless all parties in interest, wherever they reside, can be bound by the arrangement which it is sought to have legalized, the scheme may fail."

c. The question posed was: "Under section 77, does the Bankruptcy Court have authority to enjoin the sale of the collateral here in question if a sale would so hinder, obstruct and delay the preparation and consummation of a plan of reorganization as probably to prevent it?" The question was answered in the affirmative. The mechanism used to attain that end, the enjoinment, was an injunction *erga omnes*.

d. Crucial to the decision, the Court stated, was the fact that the injunction there in question **in no way impaired the lien**, or disturbed the preferred rank of the encumbrance. It did no more than **suspend the enforcement of the lien** by a sale of the collateral pending further action.

In *Lousville Joint Stock Land Bank v. Radford*, supra, the Court confronted a constitutional challenge to the Fraizer Lemke Act. Said statute, enacted during the Great Depression, allowed farmers to repurchase their farms for the appraised value, in addition to paying a one percent interest rate during the course of five years. The then prevailing interest rate was six percent. The Supreme Court struck down the statute as being unconstitutional. The main foundations were that, considering the difference in interest rate between market and the statute, the deferral of the purchase price in reality permitted bankrupts to pay less than the real value, thereby depriving creditors of their property and equivalent value without due process.

Additionally, during those five years, the collateral could depreciate. Various other rights were enumerated as being impinged upon by the statute, such as the right to bid the credit at the sale. The necessary equation between payment deferral and value of the collateral was established as being a constitutional limitation to the Federal Government, including to the bankruptcy power of Congress. Such principle extends to all judgements, takings and compensations.

Various subsequent amendments were passed, including those that took place in 1946, 1952 and 1966. The most relevant changes were in 1946. The compensation of referees was established to be on a salary basis [60 Stat. 326 (1946)], but it was still funded by fees that were charged to each bankruptcy estate on a scaled percentage basis [House Report No. 1037, 79th Congress, 1st Sess. (1945)]. Up to that moment, referees had the responsibility of financing their own office. The 1952 amendment clarified that in Chapter XI, the plan need not be "fair and equitable" to be confirmed. Fair and equitable is intimately linked to what has come to be known as the "Absolute Priority Rule": the rank of distribution among classes of creditors[22].

The dynamics of the rule operate exactly the same as in the distribution of the foreclosure sale proceeds among the various mortgage holders (i.e. according to their rank). The Bankruptcy Act established the order, rank or priority for each class of creditor. Said rank refers only and exclusively to unencumbered assets. An encumbrance or lien is property and, therefore, protected by the Fifth Amendment.

In 1970, Congress, concerned with the exponential increase in bankruptcy filings in the preceding twenty years, created a commission that was led by Professor Frank Kennedy, to review,

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[22]The Absolute Priority Rule is the cornerstone of bankruptcy. The very nature of bankruptcy is the distribution of available value among existing creditors, which constitutes the due process in order to deprive property rights through the impairment of contractual obligations. Said structure also harmonized the process with the Equal Protection of the Law provision, by providing equal treatment to all those similarly situated.

study, analyze and recommend changes to the 1898 Act, in order to "adequately meet the demands of present technical, financial and commercial activities."[23] The main recommendations of the commission were:

a. enlargement of jurisdiction,
b. separating the administrative and judicial functions, and
c. establishing a unified debt reorganization chapter.

It is to be duly noted that there were significant concerns in relation to the court's power and the way that it was displayed. Ample congressional debate was devoted to the jurisdictional scope, to the nature of the appointment of the bankruptcy judges,[24] and to the dual function of the bankruptcy judge. Such concerns and debate demonstrate a profound preoccupation for the fundamental fairness and validity of the system: serious and entrenched problems were being addressed.

The House favored the adjudication of an Article III status for bankruptcy judges, while the Senate opposed it. Chief Justice Burger opposed such appointment, as the reasons seem obvious to him: the power of *"the pen"*[25] is much weaker than *"the purse"* or *"the sword"*. If *"the pen"* is to maintain the balance of power, it is imperative that the quality of the letter be maintained at its highest level and respect, and that the "natural feebleness of the judiciary"[26] be not increased by

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[23]Pub. Law no. 91-354, Sec. 1 (b)

[24]That is whether to give lifetime tenure and protection against the reduction of salary or an Article I appointment.

[25] See The Federalist Number 78, Hamilton, citing Montesquieu, Spirit of the Laws

[26] Id

union with *"the sword"* or *"the purse"*. The continued dual functions[27], the high volume of work that the bankruptcy judge undertakes and the immense jurisdictional concentration must and do have a direct effect on the subjacent premises and quality of their pen. Such is too high a risk for the Nation's balance of power ordered liberty.

Ultimately, the position that was promoted by the Senate and Justice Burger prevailed. Bankruptcy judges were appointed as Article I judges under the executive branch, without lifetime tenure, which is more akin to an administrative agency, although still being a tribunal.

In 1982, concerns materialized over the constitutionality of an Article I judge exercising ample jurisdiction, as broad or even broader than the complete judicial jurisdiction of the Federal

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[27]Dual function in more than one aspect, for example: simultaneously deciding public and private rights; administering that over which they have to decide; claiming adverse possession over those whom they have to decide the right to possess, and so on. Such person or office cannot be the "citadel of public justice and public security." Id. Said union can render all reservation of rights meaningless. An article III judge, with such duality, damages the judiciary, more so if it is an Article III appointment. The problem is increased exponentially if the right to a jury trial is waived. What protection remains?

It must be remembered that the ultimate decision, the end result that is pursued in a public right scenario, is very different from one where ONLY private right is in view. The real danger occurs, in theory and on a daily basis, when the private right is used as a tool to attain the greater public right at the expense of our fundamental rights and ordered liberty. That which is irrelevant in a purely private right scenario, becomes controlling, but not amenable, of a confrontation (cross examination, analysis, and so on.) in a public right environment. That ultimate goal controls, and the private right MUST be placed so as to enable that public right (ultimately equitable distribution?), but cannot even be objected, which is done at the expense of our most treasured traditions and ordered liberty.

An Article III appointment does not seem to be the correct route, the harm done appears to exceed the good attained. The very nature of bankruptcy –the equitable distribution among all of that which is not sufficient– commands that sacrifices be required from and imposed on all parties. But such sacrifice is circumscribed to the amount of available value for distribution. The sacrifice does not extent, by the nature of things, to our fundamental rights and values. Not even trained judges can fully depart from that higher command (increase the value of the estate up until maximization) when deciding a two party dispute (a private right). Just too often the sacrifice imposed (in a private right scenario) exceeds the simple, fair, equitable and due process-friendly impairment of contracts. The sacrifices required from all the parties involved may never exceed the limits that are imposed by the constitutional rights; that is, if rights are to remain as –with any real meaning/function.

Government. The United States Supreme Court declared that system to be unconstitutional in the case of *Northern Pipeline v. Marathon Pipeline Co.*, 458 US 50; 102 S. Ct. 2858, 73 L. Ed. 2d 958 (1982).

The primary rationale for the decision was that the Constitution plainly demands judges to have a lifetime tenure and to be protected against salary reduction. The system returned to a sort of a referee system, where bankruptcy judges receive a referral from the District Court on all cases, with this being akin to a special master that exercises limited delegated powers.

Congress enacted 28 USC §157, which bifurcates the bankruptcy proceedings into "core bankruptcy" matters and "none core" bankruptcy matters. In *Marathon*, the Court had noted that "the restructuring of debtor-creditor relations in bankruptcy **MAY** well be a 'public right'." The difference between "public rights" and "private rights", and the required constitutional treatment of each is subjacent in the dichotomy. **"Public right" can be or may be** the traditional bankruptcy function of achieving an equitable distribution of property between creditors, by rank-ordering the priority of their respective claims and/or restructuring the debtor-creditor relationship. **"Private rights"** refers to adjudication of state-created private rights. These are none core proceedings, which are generally referred to as those as being "related to" a case under Title 11, as the term is used in 28 USC § 157 (a).

Another crucial aspect of the historical evolution of Bankruptcy Law within the Constitutional framework took place in 1989, with the case of *Granfinanciera, S. A. v Nordberg*, 492 US 33; 106 L Ed 2d 26, 109 S. Ct. 2782 (1989)[28]. In this case, the Court held that in core

[28]The case was decided squarely under the constitutional right. There was no independent statutory basis for the right to trial by jury. See *Granfinanciera*, at footnote 3

proceedings[29] within the Bankruptcy Court, the constitutional right to a trial by jury is applicable. The non-bankrupt party had not filed a proof of claim.[30]

The determination of whether a particular action is one that is rooted at the Common Law that requires a trial by jury depends on the *nature of the action* and the *remedy sought*.[31] The concept of a Common Law[32] suit, as was understood when the Constitution was adopted, is frequently, if not always, invoked by resorting to the treatment of a particular action that was received in England at the time of the Constitutional Assembly . Actions in equity[33] are commonly

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[29]The core proceeding being pursued by the trustee in that case was avoidance of a fraudulent conveyance, recovery of 1.7 million dollars transferred within the year preceding bankruptcy, allegedly without consideration.

[30]See *Katchen v. Landy* 382 US 323, 15 L. Ed 2d 391, 86 S. Ct. 467 (1966).

[31]*Tull v. U. S.*, 481 US 412, 95 L Ed 2d 365, 107 S. Ct. 1831 (1987). There the Court held defendant entitled to trial by jury in an action pursued by the United States Government. The action for imposition of a civil penalty was in law, where the jury was to determine the liability.

The Court stated: "The Seventh Amendment provides that, "[i]n Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved....'"

The Court has construed this language to require a jury trial on the merits in those actions that are analogous to "suits at common law." Prior to the amendment's adoption, a jury trial was customary in suits brought in the English Law Courts. In contrast, those actions that are analogous to 18th. Century cases tried in courts of equity or admiralty do not require a jury trial. See *Parsons v. Bedford,* 3 Pet. 433 (1830).

This analysis applies not only to Common Law types of action, but also to causes of action created by congressional enactment. See *Curtis v. Loether,* 415 U.S. 189, 193, 94 S.Ct. 1005, 1007, 39 L.Ed.2d 260 (1974).

[32]The Seventh Amendment right to trial by jury extends to enforcement of statutory rights, which are said to be analogous to Common-Law causes of action. See Granfinanciera, supra, at US 41-42.

[33]As distinguished from an action that combines actions in law and actions in equity, where the jury trial is preserved, particularly if the dominating action is one in law.

held not to require trial by jury. Bankruptcy courts essentially are courts of equity (see *Katchen v. Landy*, supra).[34]

We have seen that bankruptcy proceedings existed in England at the time when the United States Constitution was adopted. In *Granfinanciera,* the United States Supreme Court quoted a long list of bankruptcy cases from the Kings Bench, which were contemporaneous to the adoption of the Constitution, and in each a jury trial was demanded and granted. We have bankruptcy courts as being courts of equity. Cases in equity are not entitled to a jury trial coextensively with absence of jury trial in England in the 18th. Century. Simultaneously, in the 18th. Century, England's two-party disputes, in pursuit of a remedy at law or for monetary relief, within a bankruptcy case were tried by jury. It only follows that the equity characteristic of the Bankruptcy Court **is not** what can solely deprive of the constitutional right to a trial by jury.

In *Granfinanciera*, the United States Supreme Court explained its *Katchen* holding as follows:

> "Our decision in *Katchen v Landy*, 382 US 323, 15 L Ed 2d 391 86 S Ct 467 (1966), under the Seventh Amendment rather than Article III, confirms this analysis.

[34]There the Court stated these general principles:

These courts are essentially courts of equity, Local Loan Co. v. Hunt, 292 U.S. 234, 240, 54 S.Ct. 695, 697, 78 L.Ed. 1230; Pepper v. Litton, 308 U.S. 295, 304, 60 S.Ct. 238, 244, 84 L.Ed. 281, and they characteristically proceed in summary fashion to deal with the assets of the bankrupt they are administering. The bankruptcy courts '**have summary jurisdiction to adjudicate controversies relating to property over which they have actual or constructive possession**.' Thompson v. Magnolia Petroleum Co., 309 U.S. 478, 481, 60 S.Ct. 628, 630, 84 L.Ed. 876; Cline v. Kaplan, 323 U.S. 97, 98--99, 65 S.Ct. 155, 156, 89 L.Ed. 97; May v. Henderson, 268 U.S. 111, 115--116, 45 S.Ct. 456, 458, 69 L.Ed. 870; Taubel- Scott-Kitzmiller Co. v. Fox, 264 U.S. 426, 432--434, 44 S.Ct. 396, 398, 68 L.Ed. 770. They also deal in a summary way with 'matters of an administrative character, including questions between the bankrupt and his creditors, which are presented in the ordinary course of the administration of the bankrupt's estate.' Taylor v. Voss, 271 U.S. 176, 181, 46 S.Ct. 461, 463, 70 L.Ed. 889; U.S. Fidelity & Guaranty Co. v. Bray, 225 U.S. 205, 218, 32 S. Ct. 620, 625, 56 L.Ed. 1055. This is elementary Bankruptcy Law, which the petitioner does not dispute (emphasis supplied).

Petitioner, an officer of a bankrupt corporation, made payments from corporate funds within four months of bankruptcy on corporate notes on which he was an accommodation maker. When petitioner later filed claims against the bankruptcy estate, the trustee counterclaimed, arguing that the payments petitioner made constituted voidable preferences because they reduced his potential personal liability on the notes. We held that the bankruptcy court had jurisdiction to order petitioner to surrender the preferences and that it could rule on the trustee's claim without according petitioner a jury trial. Our holding did not depend, however, on the fact that [‘bankruptcy] courts are essentially courts of equity’ because ‘they characteristically proceed in summary fashion to deal with the assets of the bankrupt they are administering.” Id., at 327, 15 L Ed 2d 391, 86 S Ct 467. Notwithstanding the fact that bankruptcy courts ‘characteristically’ supervised summary proceedings, they were statutorily invested with jurisdiction at law as well, and could also oversee plenary proceedings. See Atlas Roofing, 430 US, at 454, n 11, 51 L Ed 2d 464, 97 S Ct 1261 (Katchen rested ‘on the ground that a bankruptcy court, *exercising its summary jurisdiction,* was a specialized court of equity’) (emphasis added)*; Pepper v. Litton*, 308 US 295, 304, 84 L Ed 281, 60 S Ct 238 (1939) ("[F]or many purposes 'courts of bankruptcy are essentially courts of equity’”) (emphasis added). Our decision turned, rather, on the bankruptcy court's having **"actual or constructive possession"** of the bankruptcy estate, 382 US, 15 L Ed 2d 391, 86 S Ct 471, **and** its power and obligation to consider objections by the trustee in deciding whether to allow claims against the estate. Id., at 329-331, 15 L Ed 2d 391, 86 S Ct 467. Citing *Schoenthal v Irving Trust Co.*, supra, approvingly, we expressly stated that, if petitioner had not submitted a claim to the bankruptcy court, the trustee could have recovered the preference only by a plenary action, and that petitioner would have been entitled to a jury trial if the trustee had brought a plenary action in federal court. See 382 US, at 327-328, 86 15 L Ed 2d 391, 86 S Ct 467. We could not have made plainer that our holding in Schoenthal retained its vitality: ‘[A]lthough petitioner might be entitled to a jury trial on the issue of preference if he presented no claim in the bankruptcy proceeding and awaited a federal plenary action by the trustee, *Schoenthal v Irving Trust Co*., 287 US 92, 77 L Ed 185, 53 S Ct 50, when the same issue arises as part of the process of allowance and disallowance of claims, it is triable in equity.’ Id., at 336, 15 Ed 2d 391, 86 S Ct 467.” (underline supplied)

It is then clear that the Court’s **possession** of the estate’s assets is what may provide the Court with power to decide a two-party dispute over a private right without a trial by jury. Possession of the asset has historically given *in rem* jurisdiction to a Court that has actual possession of certain property. Obviously, the jurisdiction[35] is coextensive with actual possession and up to the

[35]Provided all other constitutional guarantees are preserved.

value of that property. Now, further questions are posed: Are all possessions equal? Do different concepts of possessions confer different degrees of jurisdiction? The rights, powers and prerogatives that are derived from possession are established by State Law. How does State Law influence the level or extent of jurisdiction through the possession concept? Are the facts about the way possession was acquired relevant? Do they affect jurisdiction and, if so, how?

The obvious and established answer to these questions seems to be in the affirmative. For example, if the bankrupt has possession of real estate pursuant to a lease, no attempt has ever been made to extend the Courts' power to selling the leased real estate. Furthermore, if the bankrupt's lease has expired, possession must be relinquished with or without bankruptcy. But such simple and entrenched principles are not the only possible variations on the concept of possession, and thus of its effect on the Court's jurisdiction.

PERSPECTIVE

The writer has devoted various decades to the understanding of how does bankruptcy power fit within the constitutional framework. This historical perspective provides to all those concerned some guidance to understand and properly use the bankruptcy power without unnecessarily damaging the fundamental constitutional rights of our citizens. Multiple questions are posed and many more will identify the state of evolution of this field of law and related social behavior. We intend that said evolution be one that will be well-thought out and constructed on solid historical and constitutional grounds, understanding the genesis, purpose and relation on the rights that intertwine.