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American Bankruptcy Law

Bankruptcy in the United States is a function of federal law. Under the United States Constitution, Congress is granted the exclusive power to regulate the subject of bankruptcy. There has been a national Bankruptcy Act in effect continuously since 1898. Major changes were made in the law in 1938, and a comprehensive revision of bankruptcy law and practice is now under consideration by Congress. The various states of the union are not permitted to pass bankruptcy laws. They are, however, authorized to adopt and to regulate various other insolvency devices such as the general assignment for the benefit of creditors, compositions and extensions among creditors and certain kinds of receiverships. The principal distinction between the kinds of insolvency law which a state may impose and the Federal Bankruptcy Act is that a state may not provide for the discharge of a debtor's obligations without the consent of the creditors. In addition, Congress has provided that certain specialized institutions such as banks, insurance companies, railroads, and municipalities, may not, as a matter of policy, be declared bankrupt. Banks and insurance companies may be liquidated under state law. Railroads and municipalities may be reorganized under special provisions of the Bankruptcy Act.

The Bankruptcy Act has two very broad and distinct objectives; namely, liquidation or rehabilitation. Liquidation consists of a proceeding in which all the non-exempt assets of the debtor are gathered up, liquidated and reduced to cash, and then the cash is distributed on a pro rata basis among the creditors, except for certain limited priorities which are paid first. These include principally the expenses of the case, a limited amount of wages, taxes, and claims of the United States. At the same time, the debtor is given a discharge from all of his debts with certain exceptions and it is contemplated that this procedure will achieve for the debtor a fresh start. If the debtor has been guilty of certain misconduct, he may lose his discharge entirely. Moreover, claims for taxes, intentional wrongdoing, and those arising from fraud may not be discharged in any event. Of approximately 200,000 bankruptcy cases filed annually in the United States, about 185,000 are cases involving individual wage earners in which there are few, if any, assets and the principal purpose of the proceeding is to obtain for the debtor a discharge of his debts and a fresh start.

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The Bankruptcy Act allows the debtor to retain such assets as are exempt from the claims of creditors under the law of the state in which he resides.

The other broad objective of proceedings under the Bankruptcy Act is rehabilitation rather than liquidation. Rehabilitation is a concept generally more applicable to a business enterprise and the term more commonly used is reorganization. There are various kinds of reorganization or rehabilitation proceedings available to individuals in business, partnerships and corporations. For the smaller business, the Bankruptcy Act provides a simple kind of reorganization known as an arrangement proceeding under Chapter XI. An arrangement is basically a judicially supervised settlement or extension of the debtor's unsecured debts. It does not deal with secured debt except to hold up its enforcement during the reorganization proceeding. There is also a more complicated and comprehensive reorganization for large corporations, usually where the public interest is involved, under Chapter X of the Bankruptcy Act. In that kind of proceeding, the plan may affect shareholders, as well as all classes of debt. A specialized reorganization proceeding is available under Chapter XII for non-corporate real estate businesses. A so-called wage earner proceeding under Chapter XIII is also provided for those individuals who are employed and not in business and who would prefer to pay their debts from future earnings over a period of time rather than undergo a liquidation of their assets. The wage earner proceeding is more common in some parts of the United States than others.

For the most part, in smaller cases, non-bankruptcy methods for dealing with insolvency problems are still occasionally employed. The composition or extension is a form of out-of-court agreement between the debtor and creditors for the purpose of settling or extending the debtor's obligations. The chief difficulty with this device is that it requires, to be successful, the consent of most, if not all, of the creditors. But it is an inexpensive way, if it is feasible, of keeping a debtor in business. Where a debtor, such as a corporation, has no need of a discharge from its debts and the creditors do not object to the procedure, a liquidation may be accomplished by a general assignment for the benefit of the creditors. This is simply an agreement whereby the debtor transfers all of his non-exempt assets to an assignee or trustee representing creditors to enable the assignee or trustee to liquidate the assets and, after paying expenses and certain priorities as provided by law, to distribute the balance on a pro rata basis among the creditors. In many states the general assignment is regulated by statute and is made subject to the control of the state court. However, the principal method for dealing with financially distressed individuals and businesses still remains those proceedings provided under the Federal Bankruptcy Act.

Bankruptcy proceedings are conducted and administered in the federal courts and this includes the vast number of individual cases in which there is

generally no controversy or dispute to be resolved by the judge. Nevertheless, no administrative agency or executive department has any responsibility for the administration of American bankruptcy law. Congress has created, to assist the federal courts in the administration of the Bankruptcy Act, the so-called referee system. Referees-in-Bankruptcy, who are now called Bankruptcy Judges, are appointed by the federal judges in each district for periods of six years and they exercise all the jurisdiction granted to the federal courts under the Bankruptcy Act. Appeals from decisions of the bankruptcy courts go to the federal courts.

An ordinary, or liquidating, bankruptcy may be voluntary on the part of the debtor or involuntary in the sense that it may be initiated by the creditors. If the proceeding is commenced by the creditors, then certain requirements must be met. Usually three or more creditors must join the application and they must establish an act of bankruptcy, which is commonly some prescribed conduct on the part of the debtor detrimental to the interests of creditors. Some reorganization proceedings may be voluntary only while others of a more complicated nature may be either voluntary or involuntary.

In a liquidating bankruptcy a trustee may be elected by the creditors, but, if this does not occur, then he is appointed by the court. In some reorganization proceedings the debtor remains in possession of his assets during the case, subject to the control of the court; while in the more complicated proceedings, the court will appoint a trustee to take charge of the assets and to operate the business. In any case in which a trustee is appointed it is his responsibility to carry out the purpose of the proceeding and to report to the court. In almost all bankruptcy cases, the debtor and creditors are represented by attorneys. Lawyers play an active role in bankruptcy proceedings.

Generally speaking, the filing of a bankruptcy case acts as a shelter over the assets of the debtor, and all action by creditors against the debtor and the assets is automatically stayed or enjoined, with some limited exceptions. The creditors, the trustee and the court are granted rather elaborate powers to investigate the acts, conduct and financial affairs of the debtor. The Bankruptcy Act also empowers the trustee to recover for the creditors certain kinds of preferential transfers made within four months of the commencement of the case if at that time the debtor was insolvent and the transferee had reasonable cause to believe the debtor was insolvent. The purpose of such recovery is to achieve equality of distribution among the creditors. Insolvency is defined as an insufficiency of assets at a fair valuation to pay the liabilities.

An individual residing in the United States or having his principal place of business there is subject to the provisions of the Bankruptcy Act. He may also come under the Act even though he is an alien and resides in and has his business in a foreign country if he has some property in the United States. There is one court decision which appears to say that in such case if the

creditors are also all foreigners the court may dismiss the case as inappropriate for the United States courts.

A foreign corporation may be the subject of an American bankruptcy proceeding if it has some property in the United States. The definitions of property are very liberal and may include bank accounts as well as an interest in stock certificates situated in the United States.

This has been intended as a general overview of American bankruptcy law. Much detail has been omitted. It is a very complicated area of legal practice and one in which lawyers become specialists. The general practicing attorney usually has little knowledge of the subject and will often consult an expert.