PART 1 – AN OVERVIEW OF THE BANKRUPTCY SYSTEM

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I. HISTORY OF THE BANKRUPTCY CODE

A. ANCIENT FOUNDATIONS

> If a man incurs a debt and Adad inundates his field or a flood has carried away [the soil] or else [if] corn is not raised on the field through lack of water, in that year he shall not render [any] corn to [his] creditor; he shall blot out [the terms inscribed on] his tablet and shall not pay interest for that year.

This provision for debt relief is found in the Code of Hammurabi, the written law that governed Babylonia during the eighteenth century B.C.E. During this time, failure to pay a debt could lead to dire consequences, including slavery or even death for commercial wrongdoing. Certain circumstances beyond a debtor's control could afford some relief. Many years later when the Old Testament was being written, a further provision granting discharge was formalized into Jewish law. The fifteenth chapter of Deuteronomy says there shall be a release of debts every seventh year.

When one carefully reviews the Bible, there are other provisions which deal not only with discharge of debts, but with a sophisticated concept of distribution. *See* 2 *Kings* 4. Today's bankruptcy laws incorporate the same concepts of discharge and distribution found in ancient law.

In the Middle Ages, forgiveness was not a part of the commercial lexicon, and debtors were not treated with equanimity. Nevertheless, rules concerning distribution governed commercial transactions. In Celtic Ireland, the creditor blocked the debtor's doorway, and in medieval Venice, a merchant's bench was broken to prevent trading (*banca rotta* or *banca rupta*, or bankruptcy). The broken bench was meant to protect honest businessmen from dealing with one who did not pay debts.

In Great Britain, those who did not pay their debts were assumed to be frauds and cheats. The Statute of Elizabeth was enacted to prevent debtors from fleeing from their creditors. Once caught, the "proverbial 'pound of flesh'" could be taken. *See* William Shakespeare, *The Merchant of Venice*. Harsh though it was, a system for distribution was developing.

B. AMERICAN FOUNDATIONS

In the New World, the laws of England, including debtor's prison with all of its harshness, were taking their place. When our Founding Fathers assembled to draft the Constitution, they determined that debtor/creditor law should be established by the central government. Thus, with little debate, the Constitutional Convention included Article 1, Section 8, clause 4 in the Constitution, which granted Congress the power "to establish . . . uniform Laws on the subject of Bankruptcies throughout the United

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[1] Substantial portions of this text were drafted by Hon. William H. Gindin, Simon Kimmelman, Esq., and Magdalena Schardt, Esq. for publication in the 1994 Supplement to the *New Jersey Bankruptcy Law Manual*.

States." The only dissent came from Roger Sherman of Connecticut, who thought a federal law concerning bankruptcy could lead to the death penalty as a creditor's remedy.

It was not until 1800 that Congress passed, and the President signed, a bankruptcy law. In the meantime, Robert Morris, a Philadelphia merchant, one of the richest men in Colonial America, and considered to be "The Financier of the Revolution," spent three years in debtor's prison in Philadelphia. His imprisonment was one of the driving forces for the 1800 Act. James Wilson, a Philadelphia lawyer and sitting Associate Justice of the United States Supreme Court, fled one jurisdiction to take up residence in another state in order to avoid such harsh treatment. He was imprisoned in Philadelphia, then again in Burlington, New Jersey, and again in New Castle, Delaware. He fled to North Carolina to avoid his creditors, yet was imprisoned there again.

The original bankruptcy law bore little resemblance to what we know as modern bankruptcy law. It was a creditor's remedy that applied only to business people. Voluntary petitions were not allowed, but they were often used by friendly creditors to accommodate a debtor. Discharge was available only through the largesse of the creditors, and the law was limited in its usefulness. The statute was scheduled to expire by its own terms in 1805, but general dissatisfaction led Congress to repeal it in November of 1803.

In spite of the economic vicissitudes of the early 19th century, no session of the legislature was able successfully to pass a bankruptcy bill. The conflicts were insurmountable: some wanted a broad based bill, believing that state insolvency laws were unconstitutional; others wanted a bill limited to traders. Still others wanted no bill at all. Finally, after the Panic of 1837, the cry for relief became so great that Congress revisited the subject. In 1841, Congress passed a bill that permitted relief for debtors who were not guilty of fraud. Voluntary petitions were also permitted. The Act of 1841 authorized the appointment of an "assignee" in whom was vested all of the bankrupt's property. After more than 33,000 discharges and one year of operation, Congress repealed the statute. The law had done its work.

In the aftermath of the Civil War, Congress again considered bankruptcy an appropriate subject for legislation. Northern creditors of southern debtors remembered that bankruptcy was still essentially a creditor's remedy. If a bankruptcy law could control the land owned by southerners, northern creditors believed there would be some chance that they could collect from southern debtors. A national law was passed in 1867 with the hope that subsequent amendments to the statute would broaden its base. Generous state exemptions were contained within the Bankruptcy Act and debtors became entitled to discharge as a matter of right provided no improprieties had taken place. It is interesting to note that for the first time, large numbers of voluntary petitions were filed.

The operation of the Act of 1867 was taking place in an era when the "carpet baggers" from the North were corrupting the judicial system of the South in increasing numbers and resentment was rampant. Corruption led Congress to repeal that act in 1873.

In 1898, a comprehensive Bankruptcy Act was finally passed, which put into place the roots of the system currently in effect. It was enacted on the heels of the Panic of 1893 and became a necessary part of the body of law that increasingly regulated economic life. While no repeal of the Bankruptcy Act of 1898 was ever seriously considered, the Great Depression stimulated the need for further refinements in a series of amendments known as the Chandler Act of 1938.

These amendments led to codification of the provisions granting automatic discharge, voluntary bankruptcies, and availability to individual debtors. Within the framework of the Bankruptcy Act of

1898, the concepts of fresh start and one bankruptcy court as a court of equity became established in American jurisprudence.

C. BANKRUPTCY REFORM ACT OF 1978

The Bankruptcy Act of 1898 operated continuously for more than 80 years. During the 1970s, a complete revision of the Bankruptcy Act was undertaken. In 1978, the Bankruptcy Reform Act of 1978 was signed and Congress enacted the Bankruptcy Code into law. The Code is constantly evolving and various amendments have been periodically made to it.

The Code originally granted bankruptcy courts pervasive jurisdiction over all matters pertaining to bankruptcy cases and disputed matters arising in pending bankruptcy cases. As a result of Supreme Court limitations on the jurisdiction of courts established under Article I of the Constitution. *See Northern Pipeline Constr. Co. v. Marathon Pipeline Co.*, 458 U.S. 50, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982), a major change was enacted in 1984 in the Bankruptcy Amendments and Federal Judgeship Act of 1984 (BAFJA). The primary difference between the Bankruptcy Reform Act of 1978 and BAFJA related to bankruptcy court's exercise of jurisdiction. Under the 1978 Act, although bankruptcy jurisdiction was vested in the United States district court (an Article III court), it was required to be exercised by the bankruptcy court (an Article I court). Under BAFJA, the district court is granted jurisdiction which it may, but need not, refer to the bankruptcy court and the district court maintains control over the reference of cases to the bankruptcy court.

D. 1986 AND 1994 AMENDMENTS TO THE BANKRUPTCY CODE

In 1986, the Bankruptcy Judges, United States Trustee and Family Farmer Bankruptcy Act was enacted, the primary purpose of which was to make the United States Trustee system permanent and nationwide (although a few judicial districts elected to opt out).

The Bankruptcy Reform Act of 1994 made numerous unrelated changes to the Code. It permitted jury trials to be conducted by bankruptcy courts if the parties expressly consent and the district court specifically designates that the bankruptcy court may exercise such jurisdiction. Several provisions were added to Chapter 11 to permit an expedited and less expensive procedure for reorganizing small businesses. The Bankruptcy Reform Act of 1994 established a National Bankruptcy Review Commission charged with studying the Code and developing ways to improve upon it.

E. THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) represents the most sweeping change of American bankruptcy law since the Bankruptcy Reform Act of 1978. Although its legislative history spans almost a decade, the legislation was signed into law on April 20, 2005, and is generally effective as to cases filed on or after October 17, 2005. The stated purpose of the BAPCPA is to "improve bankruptcy law and practice by restoring personal responsibility and integrity in the bankruptcy system and ensure that the system is fair for both debtors and creditors." Underlying the reform legislation are the dual premises that debtors who are capable of repaying at least a portion of their debt should do so, and that the prior bankruptcy laws, either as written or as interpreted by the courts, were inadequate to compel debtors capable of paying some or all of their debts to do so. Among the major reforms implemented by the BAPCPA are mandatory credit counseling for individual debtors in order to be eligible to file a bankruptcy petition and completion of a financial management course in order to obtain a discharge, a presumption of abuse when a Chapter 7 bankruptcy debtor with primarily