II. The Bankruptcy System

A. Bankruptcy as a Framework

Bankruptcy is a system of federal law, enacted by Congress pursuant to a constitutional authorization. In an important sense, however, bankruptcy is only a framework for modifying rights established by other law. Often that other law is state law, but it does not have to be state law; it could be other nonbankruptcy federal law, or it could be foreign law.

For example, bankruptcy deals with property of the debtor, but what is property of the debtor? You really cannot answer that question from federal law alone; you have to look to state (nonbankruptcy) law. In the same vein, bankruptcy pays claims against the debtor, but the question of what counts as a claim is largely a matter of nonbankruptcy law.

Among these and many other fields of relevant nonbankruptcy law, a couple demand special attention. Specifically, a creditor outside of bankruptcy may have a security interest, such as a mortgage, giving it first priority in some property of the debtor in the event the debtor does not pay his debt. Security interests that are valid under nonbankruptcy law will be respected in bankruptcy. This rule means that good bankruptcy lawyers are also proficient in their respective state laws of security interests.

For a different sort of example, lots of debtors go into bankruptcy owing taxes due under federal law. The federal government as a tax collector may be a creditor of the estate. The tax collector gets some special advantages in bankruptcy law, and he also gets to carry over some special rights that he enjoys outside of bankruptcy law.

B. The Bankruptcy Court

In addition to creating a bankruptcy procedure, Congress created a system of bankruptcy courts, staffed by bankruptcy judges. The bankruptcy courts operate under the authority of the federal district court, but until recently, few people noticed; the bankruptcy judge did the judging, and the district courts got involved, if at all, only to review the work of the bankruptcy courts. In some parts of the country, bankruptcy court decisions are appealed to the federal district court; in other parts of the country, they are appealed to a Bankruptcy Appellate Panel (BAP), which is staffed by bankruptcy judges from around the federal judicial circuit. Sometimes parties appeal bankruptcy matters up to the circuit courts of appeals, and sometimes even to the highest court in the land: The U.S. Supreme Court typically hears fewer than a half-dozen bankruptcy cases a year.

The bankruptcy judge operates in the shadow of the district judge because of the Constitution — in particular, because of what the Constitution says about jurisdiction. The Constitution says that the judicial power of the U.S. may be exercised only by a judge who serves during good behavior — *i.e.*, a lifetime appointee. The bankruptcy judge is not a lifetime appointee; she serves for a term of 14 years, after which she may be reappointed.

Moreover, bankruptcy judges, unlike district judges, are not nominated by the President and approved by the Senate. Rather, as a result of a political compromise, they are appointed by the circuit courts of appeals. Most observers would agree that the bankruptcy bench is relatively free of patronage and partisanship — probably a good deal more so than the district and appellate courts themselves.

Finally, a word on the role of the judge in the context of the system: The bankruptcy judge settles disputes, but most matters in bankruptcy are not in dispute. The debtor files his petition; maybe he transfers some assets (or pays some money) to the trustee. Sooner or later, he gets a discharge. Consequently, a lot of bankruptcy work is more bureaucratic than judicial. Not surprisingly, then, some of the most important players in the system are the clerks of the bankruptcy courts. The bankruptcy clerks usually have big enough staffs with lots of storage space for paper or, increasingly, bits and bytes.

C. Trustees (and the DIP)

Aside from the judge, the next most visible player in the system is the "trustee." Do not confuse the trustee (where necessary for clarification, the "case" trustee, "private" trustee or "chapter 7" trustee) with the U.S. Trustee.

The trustee is the person who takes charge of the assets of the debtor in chapter 7 and turns them into cash to distribute to creditors. She also has the power to investigate the debtor and to object to his discharge. The trustee examines documents filed by the debtor and the register of claims. She then challenges claims that she thinks are invalid [§ 704].[2]

The trustee is not a government employee but rather a private person who works for a fee, typically a function of the size of the case (with a minimum fee in no-asset cases, of which there are plen-

2 Citations are to title 11 of the U.S. Code unless otherwise specified.

ty) [§§ 321-322, 326]. The trustee may be a lawyer, but not always. Lawyer-trustees often maintain a law practice in addition to their trustee work. Trustees may, with court approval, hire attorneys or accountants [§ 327]. These hired professionals get paid (but only after court approval) out of the assets in the case.

The U.S. Trustee is a government employee; in fact, the Office of the U.S. Trustee is an arm of the Department of Justice. He appoints and supervises "case" trustees, and also monitors cases [28 U.S.C. § 586].

If you had just read the Code, you would think that the case trustee is elected by creditors. Indeed, the Code says that creditors may elect the trustee, but in practice, it does not work that way. Rather, the U.S. Trustee appoints an "interim" trustee who serves until there is a creditor election. Creditors, however, almost never go to the trouble of staging an election, so the interim trustee stays in place [§§ 701-702].

Aside from the case trustee, districts also maintain one or more "chapter 13" trustees. The chapter 13 trustee, like the "case" trustee, is a private person who works for fees that come out of the debtors' assets. The chapter 13 trustee operates more like a bureaucratic office, however. She has the job of collecting earnings from debtors and distributing them to creditors. The chapter 12 trustee works like the chapter 13 trustee, but on a smaller scale (the chapter 12 trustee and the chapter 13 trustee may in fact be the same person).

From all of these, we can distinguish the debtor in possession (DIP) in a case under chapter 11. There is always a trustee in chapter 7 or 13, but the rule in chapter 11 is that no trustee is appointed unless the court orders it. Absent a court order, the debtor remains in possession as a DIP, with the powers and responsibilities of a trustee [§ 1107(b)]. As a result, the business debtor's management team usually retains control in a chapter 11 case. Understanding the DIP is central to understanding chapter 11. The point is more fully developed in section VIII.B.

It might seem strange to the nonbankruptcy expert that existing debtor management retains control in a chapter 11. Yet chapter 11 provides a check on this control by mandating the participation of a committee of (unsecured) creditors [§§ 1102-1103]. Reading the statute, you would think that the creditors' committee plays a central role in the case — and sometimes it does, particularly in larger cases. The committee may even (with the approval of the court) retain counsel and investment advisers.

In smaller cases, it is tough to get anybody to serve on committees because of the relatively small amounts of money involved. The Code provides for committees in chapter 7 cases, but there is no provision to pay their lawyers or bankers, so they tend to be informal where they exist at all [§ 705].