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ALERT

Business Reorganization & Financial Restructuring | March 2014

U.S. Supreme Court Clarifies Limits of Bankruptcy Judge's Equitable Authority Under Section 105(A)

On March 4, 2014, a unanimous United States Supreme Court decided *Law v. Siegel*[1] and clarified that exercising statutory or inherent powers, a bankruptcy court may not contravene specific statutory authority. *Law* will likely have broad implications for business bankruptcy cases even though it directly involved the exercise of a bankruptcy judge's authority under section 105(a) to create a pragmatic solution to the actions of a bad actor in a consumer bankruptcy case.

In *Law*, a Chapter 7 trustee had succeeded in obtaining a determination that a second mortgage on the debtor's homestead property was a fiction designed to preserve the debtor's equity in his residence beyond what he was able to exempt under the Code. After this determination, the Bankruptcy Court permitted the trustee to "surcharge" the entirety of the debtor's $75,000 homestead exemption to pay for the attorney's fees incurred by the trustee in the litigation, because the debtor had caused the expense and protraction of the litigation by apparently submitting ghost-written pleadings for the non-existent second lien lender.

The Bankruptcy Appellate Panel for the Ninth Circuit and the Ninth Circuit Court of Appeals affirmed the Bankruptcy Court's decision to permit the surcharge, based largely on the authority of an earlier Ninth Circuit decision, *Latman v. Burdette (In re Latman),*[2] which had approved a surcharge of exempt property to prevent a debtor from retaining property in excess of the applicable exemption statute.

[1] *Law v. Siegel*, 571 U.S. ___ (Mar. 4, 2014).
[2] *Latman v. Burdette (In re Latman)*, 366 F.3d 774 (9th Cir. 2004).

In the opinion written by Justice Scalia, the *Law* Court determined that the bankruptcy Judge had exceeded its authority under section 105(a) and any inherent powers it *may* possess by imposing the sanction of a surcharge against exempt property. The Court examined section 105(a) which states, in pertinent part, that a bankruptcy court has statutory authority to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of" the Code.[3] Simply stated, because the "Code's meticulous – not to say mind-numbingly detailed – enumeration of exemptions and exceptions" did not contain an exception that would permit the denial of an exemption for bad-faith conduct, the Bankruptcy Court was powerless to issue such a sanction.

Perhaps, most notably, the opinion re-cast and clarified the Court's decision in *Marrama v. Citizens Bank of Massachusetts*[4] which had led to a resurgence in attempts by practitioners to convince courts to use equitable powers to prevent abuses of the bankruptcy system. In *Marrama*, the Court had held that "the broad authority granted to bankruptcy judges to take any action that is necessary or appropriate to 'prevent an abuse of process' described in § 105(a) of the Code, [was] surely adequate to authorize an immediate denial of a motion to convert filed under § 706" even where such denial was not expressly authorized by the Code.[5] The *Law* Court noted that "[a]t most, *Marrama*'s dictum suggests that in some circumstances a bankruptcy court may be authorized to dispense with futile procedural niceties in order to reach more expeditiously an end result required by the Code. *Marrama* most certainly did not endorse, even in dictum, the view that equitable considerations permit a bankruptcy court to contravene express provisions of the Code."

Before *Law*'s limiting statements, some commentators had believed *Marrama* signaled expansion of the inherent equitable powers of bankruptcy judges that the Supreme Court originally recognized in *Pepper v. Litton*.[6] In *Pepper*, the Court noted that the inherent equitable power of the bankruptcy courts "ha[s] been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done."[7] After *Pepper*, however, a number of other pronouncements made it clear that if equitable authority existed in the bankruptcy courts, such authority was extremely limited. In *Norwest Bank Worthington v. Ahlers*[8], the Court had held that a bankruptcy court cannot use its general equitable powers to confirm a reorganization plan in contravention of the absolute priority rule based on an equity holder's promise of "future labor, experience, and expertise."[9] In *Ahlers,* the Court had noted "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."[10] After *Law*, it is clear that *Marrama* did not signal a retrenchment from *Ahlers* in favor of the views expressed in *Pepper*.

It bears noting that the majority in *Marrama* expressly reasoned that nothing in the text of either "§ 706 or § 1307(c) limits a court's authority to take appropriate action in response to fraudulent conduct by the atypical litigant who has demonstrated that he is not entitled to the relief available to the typical debtor."[11] And the dissent, which was joined by Chief Justice Roberts and Justices Scalia and Thomas,

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[3] 11 U.S.C. § 105(a).
[4] *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365 (2007).
[5] *Id*. at 375.
[6] *Pepper v. Litton*, 308 U.S. 295 (1939.)
[7] *Id*. at 305.
[8] *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988).
[9] *Id*. at 206.
[10] *Id*.
[11] *Id. Marrama v. Citizens Bank of Mass*, 549 U.S. at 366.

noted consistently with *Law*, that although bankruptcy courts can, and have, "crafted various remedies for a range of bad-faith conduct" pursuant to section 105(a), "… whatever steps a bankruptcy court may take pursuant to § 105(a) or its general equitable powers, a bankruptcy court cannot contravene the provisions of the Code."[12]

It appears likely that many of the pragmatic equitable solutions created by resort to section 105(a) and reliance on *Marrama* in recent years may no longer be permissible after *Law*. Clearly, surcharges of exempt assets are no longer permissible per the holding in *Law*, unless authorized by the state exemptions statute upon which the exemption is based, but other equitable remedies routinely employed by the bankruptcy courts may also no longer be available. For example, bankruptcy courts routinely have denied dismissal as a matter of right under section 1307(b), where evidence of bad-faith conduct is present, and have instead required conversion to Chapter 7 even though the Code does not specifically authorize such conversion.[13] *Law* may provide new grounds to resist efforts to obtain bankruptcy-specific equitable remedies, such as equitable disallowance of claims, substantive consolidation, and imposition of the automatic stay as to non-debtors. Further, litigants may use *Law* to seek denial of requests in business bankruptcy cases for actions based on section 105(a) and "the doctrine of necessity" where the relief would otherwise run afoul of the treatment provisions of the Code.[14] And, it may be harder to obtain expanded discharge or channeling injunctions under section 105(a) that exceed the scope of sections 524(e) or (g) of the Code.[15]

The *Law* decision is only one of several recent limitations imposed on bankruptcy judges. The Bankruptcy Abuse and Prevention and Consumer Protection Act (BAPCPA) of 2005[16] congressionally limited judicial discretion of bankruptcy judges. BAPCPA removed the authority of a bankruptcy judge to extend the exclusivity period under section 1121 and the timeframe to assume or reject a lease under section 365(d)(4), and limited a bankruptcy judge's discretion in approving key employee retention plans under section 503(c). In *Stern v. Marshall*[17] the Supreme Court determined that absent consent, bankruptcy courts lack constitutional authority to enter final judgments on state law counterclaims that are not resolved entirely through the claims allowance or disallowance process, even though Congress purportedly granted such authority in 28 U.S.C. section 157(b)(2)(C). The Court is now set to determine *Executive Benefits Insurance Agency v. Arkison*[18] which may further impair the authority bankruptcy judges have relied upon to determine business bankruptcy cases expeditiously. In *Executive Benefits*, the Court will decide a split of authority that has developed since Stern, as to whether a party may or may not waive consent or waive objection to the limited Constitutional authority of an Article I bankruptcy court. Seen in the context of this trend toward limiting bankruptcy court power, the *Law* decision sends an additional clear message as to the limits of the authority of bankruptcy judges.

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[12] *Id.* at 383.

[13] See, e.g., *Jacobsen v. Moser* (In re Jacobsen), 609 F.3d 647, 652 (5th Cir. 2010), *Rosson v. Fitzgerald* (In re Rosson), 545 F.3d 764 (9th Cir. 2008).

[14] *In re Kmart Corp*, 359 F.3d 866 (7th Cir. 2004) (reversing order permitting payment of critical vendors based on the "doctrine of necessity" and expressly noting at 528 that "[a] 'doctrine of necessity' is just a fancy name for a power to depart from the Code.").

[15] *See*, *In re Combustion Engineering*, 391 F.3d 190 (3d Cir. 2004) (vacating confirmation order providing for a channeling injunction under section 105(a) and noting consistently with *Law* that "[t]he general grant of equitable power contained in § 105(a) cannot trump specific provisions of the Bankruptcy Code.").

[16] Pub. L. No. 109-8.

[17] *Stern v. Marshall*, 564 U.S. 2 (2011).

[18] *See*, *Executive Benefits Insurance Agency v. Arkison* (*In re Bellingham Ins. Agency, Inc.*), 702 F.3d 553 (9th Cir. 2012), cert. granted 133 S.Ct. 2880 (2013) (No. 12-1200) argued January 14, 2014.

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