

Legislating From the Bench - The Preferred Approach in Bankruptcy?

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Accusations of "judicial activism" have frequently been part of political discourse in the United States. Recently the issue has been framed by some as whether judges are "legislating from the bench." The debate is more prominently applied to the federal judiciary, particularly the United States Supreme Court with respect to issues of constitutional interpretation¹. On the other hand, federal bankruptcy judges are typically not targets in the debate². Criticism of the bankruptcy process seems mostly directed at legislation, not the courts³. Admittedly, one reason for less attention on the bankruptcy courts is the less familiar, specialized nature of bankruptcy, particularly chapter 11. However, if there were greater scrutiny, arguments that judges are "legislating from the bench" would not be convincing.

First, bankruptcy judges are vested with equitable powers. Therefore, by their very nature, the judges are empowered to both fashion equitable relief and consider the relative "equities" vis-à-vis the parties when deciding an issue. An example of equitable relief is substantive consolidation. Such relief is relatively extraordinary in nature. Substantive consolidation, if granted, can have a material impact on the rights of creditors: creditors of one debtor entity with significant assets may have to share their proceeds with creditors of a related debtor entity without assets, thereby diluting the return of the former and enhancing that of the latter. There is not an express provision in the Bankruptcy Code permitting substantive consolidation. Does that mean a bankruptcy court granting such relief would be legislating from the bench? The answer is no. Courts of equity, including bankruptcy courts, are vested with that authority.

Secondly, in many respects the legislation that bankruptcy judges have to work with - the Bankruptcy Code - is full of gaps that need to be filled and language to be interpreted. For instance, section 363(b)(1) requires notice and a hearing in connection with a debtor's use, sale or lease of property of the bankruptcy estate "other than in the ordinary course of business." Where do you draw the line between ordinary course and outside the ordinary course transactions? The line is clear in some situations such as the sale of substantially all of a debtor's assets. In other cases, it is not: what about the payment of a finder's fee to a leasing agent in connection with a debtor's entry into a new commercial lease? A bankruptcy judge must look beyond the words "ordinary course of business." An approach that courts have developed is application of the so-called "horizontal" and "vertical" tests⁴. Would a bankruptcy judge be improperly legislating from the bench since these tests are not expressly found in a federal statute? However one may label it, the thoughtful observer will recognize that bankruptcy courts cannot effectively adjudicate matters without adopting these kind of reasonable and practical approaches. In fact, the Bankruptcy Code specifically vests bankruptcy judges with the power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." See 11 U.S.C. 105(a). Thus, bankruptcy courts have been

expressly empowered by the legislative branch to "fill in the gaps." In reality, they have no choice but to exercise that power.

Thirdly, as with virtually any statutory framework, the Bankruptcy Code is laden with ambiguities and seemingly conflicting provisions. Often, judges can not limit their focus to the language in question. Rather, they must look at the Bankruptcy Code in its entirety and consider its underlying policies. One example of a statute that is not exactly a model of clarity is the new provision under the recently enacted Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 addressing a debtor's key employee retention program ("KERP")⁵. New section 503(c)(1) prohibits allowance (as an administrative claim) or payment of a transfer to (or a obligation incurred for the benefit of) an insider "for the purpose of inducing such person to remain with the debtor's business," absent a finding by the court based on an evidentiary record that -

- A. the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation;
- B. the services provided by the person are essential to the survival of the business; and
- C. either -
 - i. the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to non-management employees for any purpose during the calendar year in which the transfer is made or the obligation is incurred; or
 - ii. if no such similar transfers were made to, or obligations were incurred for the benefit of, such non-management employees during such calendar year, the amount of the transfer or obligation is not greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made or obligation is incurred.

Even the most vocal critics of judicial activism would have to concede that this complicated provision is subject to varying interpretations. Should a bankruptcy judge - in the interest of judicial restraint - feel compelled to apply this "KERP" provision in a manner that is unfavorable to the debtor seeking to retain key employees, notwithstanding that it might result in the exodus of key employees and possibly the downfall of the company? Even if there is no creditor opposition? Would that be in the interest of the other constituencies in the case? There is room for argument on generally how strictly statutes should be constructed. However, with this particular statute, one thing is clear: it is highly unlikely that in enacting this legislation, Congress truly understood its potential ramifications. Does that mean that bankruptcy judges cannot be sensitive to the possible outcomes of certain interpretations of complicated statutes? The answer should be no.

Finally, chapter 11 cases by their nature can involve extremely complicated transactions among different constituencies with varied levels of sophistication. New issues will arise in any given case, and even more common issues can present a new twist under a different set of facts. Even the casual observer became aware through the financial press of the tremendous complexity of the Enron bankruptcy: Enron was one of the ten largest U.S. companies with \$100 billion in market capitalization at its peak. The Bankruptcy Code was enacted in 1978. Could the drafters of that legislation - in between the OPEC-led energy shocks of that era, and before 401(k) plans and financial derivative products - have conceived of the kinds of issues faced by the bankruptcy court in Enron? How about issues in the Worldcom cases, filed nearly twenty years after the court-ordered break up of AT&T and the "Baby Bells" and following the revolutionary transformation of the telecommunications industry in the 1990's?

The point of all this is bankruptcy judges are often faced, even in cases not nearly so large and complex as in Enron or Worldcom, with increasingly sophisticated parties represented by experienced counsel presenting a panoply of business, financial and legal issues. A judge can hardly afford to view him or herself as locked in a straight jacket within a limited statutory framework while keeping up with the demands of adjudicating a constant stream of disputes and administering a case to its conclusion. First, a bankruptcy judge would be misguided to the extent the court ignored the fact that it was a court of equity and expressly is vested under section 105 of the Bankruptcy Code with the power to grant relief "necessary or appropriate to carry out the provisions of this title." Additionally, such a limited view will decrease the probability of success in a chapter 11 case. These cases can be high drama among highly sophisticated parties. Various legal disciplines can be implicated, including tax, corporate, mergers and acquisitions, antitrust, real estate, securities and energy law. The Bankruptcy Code can be viewed as a framework or landscape within which commercial battles take place. By no means is that description intended to belittle legislation enacted by Congress. Rather, this popular characterization reflects that this particular statutory framework was not intended to be all encompassing like, for example, the Internal Revenue Code. Moreover, to breathe life into this statutory overlay, by necessary implication other disciplines have to be applied by the presiding judge, including corporate law and mergers and acquisitions (Section 363), finance and transactions (Section 364), and real property law (Sections 365 and 541). Further, the diverse universe of companies in terms of size, industry and complexity that are drawn to file for bankruptcy under the statute inevitably means bankruptcy courts and professionals are required to look beyond the four corners of the Bankruptcy Code in order to make the chapter 11 process workable.

In summary, whatever merit there may be to the view that "legislating from the bench" has become too prevalent, the argument really does not apply in the bankruptcy context. The Bankruptcy Code was designed to invite judicial "activism" at every step of the way to allow the process to work.

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A recent example of this criticism followed a Supreme Court opinion addressing governmental power of eminent domain. Kelo v. New London, 125 S. Ct. 2655 (2005).

Bankruptcy judges, in contrast to judges in other federal courts, are not recognized as Article III judges. Northern Pipeline v. Marathon Pipeline, 458 U.S. 50 (1982).

An exception is Professor Lynn LoPucki, a strident critic of the bankruptcy courts in Delaware and the South District of New York.

The Third Circuit Court of Appeals described that approach in In re Roth American, 975 F.2d 949 (3rd Cir. 1992), affirming the lower courts.

Most of this legislation, including the KERP provisions, became effective on October 17, 2005.