Whatever Happened to the Inherent Equitable Powers of the Bankruptcy Court?

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Describing the inherent equitable powers of bankruptcy courts, the Supreme Court stated in *Pepper v. Litton* that "[t]hey have 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."[2] Recent decisions, however, reflect a trend by some courts to unnecessarily curb the bankruptcy courts' ability to take equitable actions in situations where the Bankruptcy Code expresses some limited intent, but is otherwise unclear or silent. This article examines the trend as well as the analysis that has been used to justify a limitation on the ability of bankruptcy courts to rely on their inherent equitable power to fill the inevitable gaps that arise in difficult and complex insolvency circumstances where the prudent exercise of equitable power is most needed.

Equitable Power Under §105(a)

Section 105(a) of the Code is the current codification of the inherent equitable power of the bankruptcy court and provides that "[t]he court may issue any order, process or judgment that is *necessary or appropriate* to carry out the provisions of this title [emphasis added]." With this seemingly comprehensive legislative provision, bankruptcy courts would appear to have the power to do potentially anything in the name of equity...or do they?

Prior to the enactment of the Code, the bankruptcy courts' equitable powers were codified in §2(a)(15) of the Bankruptcy Act, which gave bankruptcy courts the power to "[m]ake such orders...that may be *necessary* for the enforcement of the provisions of this Act... [emphasis added]."[3] Such equitable powers were historically coupled with other inherent powers to effectuate the provisions and goals of the Bankruptcy Act. For example, §2(a)(15) provided bankruptcy courts with the power to enjoin harassment by creditors and to protect the debtor's fresh start.[4] Section 105(a) of the Code expands upon its predecessor by authorizing bankruptcy courts to issue such orders that are "appropriate to carry out the provisions of this title."[5] Accordingly, bankruptcy courts are currently authorized to enter all orders that are "appropriate" regardless of whether such orders are also "necessary."

Since its enactment, *bankruptcy courts* have used §105(a) to, among many other things, extend the applicability of the automatic stay,[6] substantively consolidate cases,[7] partially discharge student loan debts[8] and prohibit serial bad-faith filings.[9] Perhaps the most discussed and controversial use of §105(a) has been the issuance of non-consensual third-party releases in mass-tort and securities-fraud cases. In these cases, bankruptcy courts have generally relied on the unique facts and circumstances present to issue injunctions that are not otherwise provided for in the Code.[10] In taking actions not

specifically authorized by the Code, bankruptcy courts have used the equitable powers granted to them in §105(a) to provide relief where Congress has been silent or to further the congressional intent behind certain provisions of the Code.

Equitable Applications of §105(a)

An example of the use of §105(a) to complement the Code is the Ninth Circuit's *In re Saxman* decision.[11] In *Saxman,* the Ninth Circuit held that a bankruptcy court may partially discharge that portion of a student loan debt that is deemed to be an undue hardship under §523(a)(8) of the Code using its equitable powers under §105(a).[12] Although §523(a)(8) does not explicitly permit the splitting of non-dischargeable student loan debt, the Ninth Circuit agreed with the Sixth Circuit that an "all-or-nothing" approach to the dischargeability of student loan obligations "thwarts the purpose of the Bankruptcy [Code]."[13] These courts have reasoned that, inasmuch as Congress granted the bankruptcy courts general equitable powers under §105(a), "it would contravene the bankruptcy court's equitable authority to construe [§523(a)(8)] as precluding bankruptcy courts from ordering partial discharges in appropriate cases."[14] Thus, where Congress has not expressly provided for the equitable division of debts for purposes of determining their non-dischargeability, bankruptcy courts have used their equitable powers under §105(a) to do so in appropriate cases.

Along similar lines, the Second Circuit has held that a bankruptcy court has the authority under §349 (a) and §105(a) to enjoin debtors from filing further petitions under the Code notwithstanding the explicit 180-day provision of §109(g).[15] Section 349(a) provides that "[u]nless the court, for cause, orders otherwise, the dismissal of a case under this title does not bar the discharge, in a later case under this title, of debts that were dischargeable in the case dismissed; nor does the dismissal of a case under this title prejudice the debtor with regard to the filing of a subsequent petition under this title, except as provided in §109(g) of this title."[16] In addition, §109(g) provides for a 180-day bar on future bankruptcy filings in certain circumstances. Even though Congress has provided for the preclusive effect of a dismissal in §§349(a) and 109(g), the Second Circuit held that the bankruptcy court had the authority under §105(a) to enjoin further bankruptcy filings by the debtor beyond 180 days.[17]

In essence, §105(a) has been the power that allows bankruptcy courts to fashion appropriate extraordinary relief notwithstanding other provisions of the Code providing for similar relief or where the Code is silent as to such relief.

The Curbing of the Bankruptcy Courts' Equitable Powers

Based on language from the Supreme Court's decision in *Norwest Bank Worthington v. Ahlers,*[18] some courts have determined that certain uses of §105(a) are beyond the scope of the bankruptcy courts' equitable powers. In *Ahlers,* the Supreme Court 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 equityholder's promise of "future labor, experience and expertise."[19] In its decision, the Supreme Court stated that "*whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.*"[20] Recent circuit court decisions curbing the use of §105(a) have latched on to the Supreme Court's statement in *Ahlers,* leaving bankruptcy judges and practitioners guessing what actions bankruptcy courts can and cannot take pursuant to their "equitable powers" under §105(a).

One particularly noteworthy case is the Seventh Circuit's decision in *In re Kmart Corp.*[21] In *Kmart,* the Seventh Circuit held that the bankruptcy court could not use §105(a) to issue "critical vendor orders" that permitted the immediate post-petition payment of pre-petition trade debts to certain favored creditors.[22] The Seventh Circuit cited the Supreme Court's decision in *Ahlers* for the proposition that §105(a) "does not create discretion to set aside the Code's rules about priority and distribution; the power conferred by §105(a) is one to implement rather than override."[23] The Seventh Circuit further stated that "[t]he fact that a bankruptcy proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and

fairness...."[24] The Seventh Circuit expressed its concern that the use of §105 in entering critical vendor orders would create an end-run around the priority scheme already provided in the Code.[25]

More recently, the Third Circuit's decision in *In re Combustion Engineering*[26] drew into question the bankruptcy courts' equitable powers under §105(a). One of the many issues the Third Circuit addressed in *Combustion Engineering* was whether "a non-debtor that contributes assets to a post-petition trust [can] take advantage of §105 of the Code to cleanse itself of non-derivative asbestos liability."[27] In this case, the bankruptcy court confirmed the debtor's reorganization plan, which included channeling injunctions under §105(a) for claims against certain non-debtor affiliates that contributed to the debtor's plan. In vacating the bankruptcy court's confirmation order, the Third Circuit relied on the Supreme Court's language in *Ahlers* that the bankruptcy courts' equitable powers "must and can only be exercised within the confines of the Code."[28] The Third Circuit also relied on another post-*Ahlers* decision limiting the bankruptcy courts' ability to use §105(a), *In re Lowenschuss,* in which the Ninth Circuit held that "[s]ection 105 does not authorize relief inconsistent with more specific law."[29] Based on this reasoning, the Third Circuit stated that "[t]he general grant of equitable power contained in §105(a) cannot trump specific provisions of the Code...."[30] Accordingly, the Third Circuit held that §105(a) could not be used to enter an injunction in contravention of either §524(e) or 524(g) of the Code.[31]

[I]t is now questionable whether bankruptcy courts can continue to use §105(a) to equitably discharge a portion of a debtor's student loan debts...

A Questionable Standard for Applying §105(a)

It is questionable whether the §105(a) injunction entered by the bankruptcy court in *Combustion Engineering* actually does rise to the level of "trumping" other more specific provisions of the Code. Admittedly, §524(g) does not provide bankruptcy courts with the authority to enter channeling injunctions for non-derivative claims against non-debtors,[32] nor does §524(e).[33] Indeed, if the language of §§524(e) and 524(g) is read carefully, it is clear that §524(e) only speaks to the effects of a "discharge of a debt *of the debtor*"[34] and §524(g) only permits injunctions for claims against third parties that are "*directly or indirectly liable*" for claims against the debtor.[35] The purpose of the §105 (a) injunction entered by the bankruptcy court in *Combustion Engineering,* however, was to enjoin *non-derivative* debts of *third parties* who were necessary to a successful reorganization of the debtor.[36] As a result of this flawed analysis (and the Ninth Circuit's similarly flawed analysis in *Lowenschuss*),[37] the Third Circuit held that the §105(a) injunction was invalid because, in essence, Congress has provided certain means to enter third-party injunctions. Specifically, the Third Circuit reasoned that §524(g) provides for third-party injunctions in limited circumstances and other types of third-party injunctions not specifically authorized by the Code may not be entered pursuant to §105 (a).[38] This is a classic use of the maxim "*expressio unius est exclsuio alterius*"—the expression that one thing is the exclusion of another.[39]

This limitation on the bankruptcy courts' ability to use §105(a) was also reflected in the Seventh Circuit's decision in *Kmart.* Based on the reasoning of *Ahlers,* the Seventh Circuit prohibited bankruptcy courts from using their equitable powers to authorize critical vendor orders.[40] Without the ability to resort to §105(a) and recognizing that the Code does not expressly provide for critical vendor payments, the Seventh Circuit struggled to find a section of the Code that would support such payments.[41] The Seventh Circuit dismissed other provisions that did not provide the authority for such payments and finally left the door open for the possibility that such payments might be authorized, if at all, under §363(b)(1).[42] However, the Seventh Circuit never addressed why a so-called direct departure from the priority scheme established by the Code would be authorized under §363(b)(1) but not under §105(a). Apparently, the authority to use property "other than in the ordinary course" is enough ammunition for the Seventh Circuit to permit bankruptcy courts to use §363(b)(1) to trump

sections of the Code that are otherwise directly on point. Instead of trying to find authority in Code provisions that clearly do not provide authority for critical vendor payments, the Seventh Circuit could have recognized that, where the Code is silent as to the allowance of critical vendor payments, an order authorizing such payments is at best an equitable remedy authorized in part by §105(a).[43] Nevertheless, the Seventh Circuit held that §105(a) was not applicable inasmuch as "the power conferred by §105(a) is one to implement rather than override."[44]

As such, even though the bankruptcy courts in *Combustion Engineering* and *Kmart* used their equitable authority under §105(a) to act where the Code expresses some limited intent but is otherwise unclear, the bankruptcy courts' actions in these cases have been deemed beyond the scope of the bankruptcy courts' equitable powers under §105(a). Accordingly, these decisions limit the bankruptcy courts' equitable power under §105(a) to situations where the Code is all but silent.

Conclusion

In light of the limitation on the bankruptcy courts' equitable powers under §105(a), as set forth in *Ahlers* and interpreted by the circuit courts in *Kmart* and *Combustion Engineering,* how does a bankruptcy court treat future situations that have historically been dealt with using its equitable powers under §105(a)? The bankruptcy courts' equitable uses of §105(a) in *Saxman* and *Casse* are no less a contravention of specific provisions of the Code than the §105(a) injunction in *Combustion Engineering.* In any event, it is now questionable whether bankruptcy courts can continue to use §105 (a) to equitably discharge a portion of a debtor's student loan debts or even to enjoin serial bad faith filers inasmuch as the Code already expresses some limited intent in §§523(a)(8) and 109(g), respectively.[45] Likewise, in complex insolvencies when the bankruptcy courts are often asked to act in situations where the Code expresses some limited intent but is otherwise unclear, bankruptcy courts regrettably may no longer have the authority to use §105(a) to ensure "that substance will not give way to form [and] technical considerations will not prevent substantial justice from being done."[46]

Footnotes

[1] Board Certified in Business Bankruptcy Law by the American Board of Certification. Return to article

[2] 308 U.S. 295, 305 (1939). Return to article

[3] 11 U.S.C. §2(a)(15) (1976) (repealed). Return to article

[4] *See U.S. v. Kras,* 409 U.S. 434, 448-49 (1973). Return to article

[5] 11 U.S.C. §105(a). Return to article

[6] *See, e.g., In re Metro Transp. Co.,* 64 B.R. 968 (Bankr. E.D. Pa. 1986). Return to article

[7] *See, e.g., In re Augie/Restivo Baking Co.,* 860 F.2d 515 (2d Cir. 1988). Return to article

[8] *See, e.g., In re Saxman,* 325 F.3d 1168 (9th Cir. 2003). Return to article

[9] *See, e.g., Casse v. Key Bank Nat'l. Ass'n.,* 198 F.3d 327 (2d Cir. 1999). Return to article

[10] *See, e.g., In re Drexel Burnham Lambert Group,* 960 F.2d 285 (2d. Cir. 1992); *In re A.H. Robins Co.,* 880 F.2d 694 (4th Cir. 1989); *In re Johns-Manville Corp.,* 36 B.R. 743 (Bankr. S.D.N.Y. 1984); *see, also, In re Combustion Eng'g. Inc.,* 295 B.R. 459, 489 (Bankr. D. Del. 2003), *rev'd.,* 391 F.3d

190, 236 (3d Cir. 2004). Return to article

[11] 325 F.3d 1168 (9th Cir. 2003). Return to article

[12] Section 523(a)(8) provides that student loan debts are generally non-dischargeable "unless excepting such debt from discharge...will impose an undue hardship on the debtor and the debtor's dependents." 11 U.S.C. §523(a)(8). Return to article

[13] *See Saxman,* 325 F.3d at 1174; *see, also, In re Hornsby,* 144 F.3d 433 (6th Cir. 1998). Return to article

[14] *See Saxman,* 325 F.3d at 1174. Return to article

[15] *See In re Casse,* 198 F.3d 327 (2d Cir. 1999). Return to article

[16] 11 U.S.C. §349(a). Certainly, §349(a) does not specifically address a debtor's ability to file serial petitions, it only addresses the effect of dismissal on the debtor's ability to obtain a subsequent discharge. *See Id.* Return to article

[17] 198 F.3d at 339. Return to article

[18] 485 U.S. 197 (1988). Return to article

[19] *Id.* at 206. Return to article

[20] *Id.* (emphasis added). Return to article

[21] 359 F.3d 866 (7th Cir. 2004). Return to article

[22] *Id.* at 871. Return to article

[23] *Id.* Return to article

[24] *Id.* (*citing In re Chicago, Milwaukee, St. Paul & Pacific R.R.,* 791 F.2d 524, 528 (7th Cir. 1986)). Return to article

[25] 359 F.3d at 871. Return to article

[26] 391 F.3d 190 (3d Cir. 2004). Return to article

[27] *Id.* at 202 (emphasis omitted). Return to article

[28] *Id.* at 236. Return to article

[29] *In re Lowenschuss,* 67 F.3d 1394, 1402 (9th Cir. 1995). Return to article

[30] *Combustion Eng'g.* at 236. Return to article

[31] Section 524(e) provides, in pertinent part, that "discharge of a *debt of the debtor* does not affect

the liability of any other entity on, or the property of any other entity for, such debt." 11 U.S.C. §524 (e) (emphasis added). Section 524(g) provides that, where certain requirements are met for the inclusion of the asbestos liabilities of the debtor in a trust under a reorganization plan, "an injunction may bar any action directed against a *third party...alleged to be directly or indirectly liable* for the conduct of, claims against or demands on the debtor." 11 U.S.C. §524(g) (emphasis added). Return to article

[32] *See* 11 U.S.C. §524(g). Return to article

[33] *See* 11 U.S.C. §524(e). Return to article

[34] *Id.* (emphasis added). Return to article

[35] 11 U.S.C. §524(g)(4)(A)(ii) (emphasis added). Return to article

[36] *In re Combustion Eng'g.,* 295 B.R. 459, 489 (Bankr. D. Del. 2003) (holding that §105(a) authorizes the bankruptcy court to enter an injunction against the independent claims against non-debtor third parties). Return to article

[37] *See* Warren, Jeffrey W., "Jurisdiction to Enjoin Claims Against Third Parties: Correcting a Flawed Analysis," *ABI Journal* (May 2000). Return to article

[38] *In re Combustion Eng'g.,* 391 F.3d at 233-38. Return to article

[39] *See Black's Law Dictionary,* 1717 (8th ed. 2004). Return to article

[40] *In re Kmart Corp.,* 359 F.2d at 871. Return to article

[41] *Id.* at 872. Return to article

[42] *Id.* Return to article

[43] *See, e.g., In re Tropical Sportswear Int'l. Corp.,* 320 B.R. 15 (Bankr. M.D. Fla. 2005). Return to article

[44] 359 F.3d at 871 (*citing Ahlers,* 485 U.S. at 206). Return to article

[45] Interestingly enough, unlike the *expressio unius est exclusio alterius* rationale of the *Combustion Engineering* court, one court that used its equitable powers under §105(a) to enjoin a serial bad faith filer from filing a further voluntary petition beyond the 180-day period authorized by §109(g) found that a specific grant of power bolsters the bankruptcy courts' authority under §105(a) to further Congressional intent: "[w]hen one considers that Congress intended §109(g) to give bankruptcy courts an additional weapon for use against serial filers, it is perverse to construe the section as striking from the courts' hands other sections of the Bankruptcy Code which may remedy the same problem." *See In re Casse,* 198 F.3d at 340. Return to article

[46] *See Pepper v. Litton,* 308 U.S. at 305. Return to article