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LAWYERS, JUDGES, AND UNWRITTEN RULES

Bruce A. Markell*

INTRODUCTION

Professor Douglas Baird’s *The Fraudulent Conveyance Origins of Chapter 11: An Essay on the Unwritten Law of Corporate Reorganizations* boldly reconceptualizes the role of the bankruptcy judge in corporate reorganizations. He sees the judge not as a neutral arbiter of dispute brought before her, but as a “referee” whose “job . . . is to police . . . negotiations [over the sensible capital structure of a firm in reorganization] and make sure that they are done according to Hoyle.” But unlike Hoyle, the rules to be enforced are not all written. Time and tradition have produced unwritten rules with respect to the conduct of a reorganization. Professor Baird’s article is a start at identifying and contextualizing these rules.

I agree that unwritten rules exist. I differ with Professor Baird as to their provenance and their enforcement.

As with all things, what is seen depends on perspective, and my perspective is different than Professor Baird’s. A famous exchange with the philosopher Ludwig Wittgenstein illustrates this point, as recounted by his former student and later his literary executor, Professor Elizabeth Anscombe:

[Wittgenstein] once greeted me with the question: ‘Why do people say that it was natural to think that the sun went round the earth rather than that the earth turned on its axis?’ I replied: ‘I suppose, because it looked as if the sun went round the earth.’ ‘Well,’ he asked, ‘what would it have looked like if it had looked as if the earth turned on its axis?’

After working it out, the conclusion is both perspectives can explain the sun’s motion; identical conclusions often lie at end of disparate assumptions. Against this background, although I agree with much of Professor Baird’s conclusions, we differ on what has shaped both the current set of unwritten rules and the role of the judge in their application.

* Professor of Bankruptcy Law and Practice, Northwestern Pritzker School of Law.
2 Id. at 717.
3 G.E.M. ANSCOMBE, AN INTRODUCTION TO WITTGENSTEIN’S TRACTATUS 151 (2nd ed. 1959) (emphasis omitted).
In this short response, I want to first sketch out my understanding of the role of fraud in avoiding transactions, an understanding that includes examination of the statute of 13 Eliz., but starts much earlier. My view of this history has a different take than Professor Baird; I see more the hand of adroit lawyers maneuvering judges to a desired result, and less of an understanding between bench and bar as to the rules of reorganization. I then want to assess Professor Baird’s perception of the role of the bankruptcy judge in corporate reorganizations. His metaphor is enforcement according to Hoyle; I offer a counternarrative based on the Marquess of Queensbury’s rules for boxing.

I. THE DEVELOPMENT OF FRAUDULENT TRANSFER LAW

Professor Baird spends much time carefully tracing a plausible development of courts’ reactions to what we now call fraudulent transfers. His analysis starts with the Statute of 13 Eliz., c. 5, a 1571 statute that I agree is a watershed development in fraudulent transfer law, especially as framed and applied by Edward Coke in his report of *Twyne’s Case*. The operative words of that statute—condemning transfers made with the actual intent to “hinder, delay or defraud”—still appear in statutes today.

But long before the reign of Elizabeth I, Roman law had recognized as a nominate tort an action *fraus creditorum* similar in purpose and effect to the Statute of Elizabeth. And early English law acknowledged this. As Professor Glenn noted, “[t]he very terms, ‘in fraud of creditors,’ and ‘with intent to defraud’ them, as appearing in Roman law, found their way, with monotonous regularity, into English statutes long before the Act of Elizabeth was drafted.” *Twyne’s Case* is thus an important waystation in the development of fraudulent transfer law, not the origin.

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8 GLENN, supra note 7, at 83 (footnote omitted); see also Frank R. Kennedy, *Involuntary Fraudulent Transfers*, 9 CARDozo L. REV. 531, 536 (1987) (“English legislation directed at such transfers [that] had been enacted by Parliament during the preceding two centuries.”); Radin, *Fraudulent Conveyances in California*, supra note 7, at 1–2 (noting that the 1571 Statute of 13 Elizabeth “reenacted many of the provisions and repeated many of the words of statutes of Henry VIII and Edward III . . . . ”).
Even the concept of “badges of fraud” was not original to Twyne’s Case. As Professor Constantin Willems noted in his recent article, Coke, Collusion, and Conveyances: Unearthing the Roots of Twyne’s Case, another report of Twyne’s Case indicates that, in discussing badges of fraud, there was a prior “external influence,” as evidenced by the judges’ statement that Twyne’s Case had all the badges of fraud, “as Linwoode notes.” As Professor Willems points out, this refers to William Lyndwood (1375–1446), an English canonist who was most renowned as the author of the famous Provinciale seu Constitutiones Angliae. After studying Lyndwood’s work and the various reports of Twyne’s case, Professor Willems states that:

We can therefore conclude that Coke’s reasoning [and uses of badges of fraud] coincides largely with what ‘Linwoode notes’: there are also six presumptions, of which three are identical, two are similar, and one which arguably may be reduced to the same general rule.

The status of Twyne’s Case as the origin of fraudulent conveyance law was also questioned over a century and a half later by none other than Lord Mansfield. In 1776, he had a case before him that today we might call a case of a spendthrift trust. A lord had entered into a marriage settlement with his betrothed. The settlement was worth some £10,000 of property, but this property was transferred to a trust for lord and his new wife to possess and use. Under the terms of the trust, upon the lord’s death, any residue of the trust res was to pass to his new spouse and her heirs.

A pre-marriage creditor of the lord saw the lord’s possession and use of property without title as a fraud. He levied upon the trust property under the Statute of 13 Elizabeth, and the trustees filed suit to reclaim the property.

Lord Mansfield ruled for the lord and against the creditor. He began his judgment, however, with a strong statement regarding the relationship between the statute and the common law.
The principles and rules of the common law, as now universally known and understood, are so strong against fraud in every shape, that the common law would have attained every end proposed by the statutes 13 El. c. 5, and 27 El. c. 4. The former of these statutes relates to creditors only; the latter to purchasers. These statutes cannot receive too liberal a construction, or be too much extended in suppression of fraud.17

Whether Lord Mansfield was correct about how the common law might have evolved without the Statute of 13 Elizabeth is beside the point. The point is that principles and norms underlying fraudulent transfer law are ancient, enduring, and malleable.18 Actions which harm one while enriching another, done without justification, have raised hackles throughout history. And when hackles are raised, lawyers arrive.

Lawyers were already present documenting compositions and settlements for distressed debtors long before reorganization law emerged in the late Nineteenth Century. My sense is that such practices and devices proved inadequate to address the advent of limited liability and the larger enterprises limited liability facilitated—such as railroads. In a sense, lawyers were called upon to respond to the significant externalities such large firm failures imposed on society, such as loss of jobs and misuse of resources.

Lawyers and finance professionals then looked for legal tools to address this old problem of divvying up the assets of a failed enterprise, which railroads, among others, presented in virulent form. Professor Baird sketches his interpretation of how lawyers found and used fraudulent conveyance law to address these issues. I cannot quibble too much with his exposition, but I think the orientation is skewed. The professionals involved could not make existing


17 Cadogan v. Kennett, 2 Cowp. 433, 434, 98 Eng. Rep. 1171, 1172 (K.B. 1776). Lord Mansfield also indicated that a valid consideration would not immunize a transaction from attack under the statute. As he stated:

I have known several cases where persons have given a fair and full price for goods, and where the possession was actually changed; yet being done for the purpose of defeating creditors, the transaction has been held fraudulent, and therefore void.

Id.

18 That the simple injunction against transfers made with the intent to hinder, delay or defraud could spawn much litigation is shown by the fact that, at the beginning of the twentieth century, there were no fewer than five complete treatises devoted almost exclusively to the subject of fraudulent transfers. See, e.g., Henry W. May, The Law of Fraudulent and Voluntary Conveyances (W. Douglas Edwards, ed., 3d Am. ed. 1908); Frederick S. Wait, Fraudulent Conveyances and Creditors’ Bills (1884); Melville M. Bigelow, The Law of Fraud (1877); Orlando F. Bump, Fraudulent Conveyances (1872); William Roberts, A Treatise on the Construction of the Statutes Relating to Voluntary and Fraudulent Conveyances (3d Am. ed. 1845).
devices work; the quantity and dispersion of stakeholders was too challenging. So lawyers did what lawyers often do: they suggested new uses for existing law; that is, they saw fraudulent conveyance law as a possible framework for creditor recoveries. That such laws came to be the intellectual foundation of reorganization law is likely more a testament to the cleverness and insight of lawyers who had to solve clients’ problems, rather than a union of lawyers and judges trying to preserve businesses.

Indeed, courts’ reaction to the application of fraudulent conveyance law was to link its use to a “fair” result for all, by taking lawyers’ suggestion that the issue was little more than one of allocation of value to all stakeholders, including shareholders. When value was insufficient, someone had to lose, and courts, especially through cases such as Northern Pacific Railway Co. v. Boyd, used equitable principles inherent in fraudulent conveyance law to distribute those losses. As I once wrote:

But if reorganization extended the “value of the road” to creditors on “equitable terms,” could plan proponents exclude dissenting creditors? Equity provided no firm answer. The Court’s solution sounded in waiver and estoppel: “If [the creditor] declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it.” In other words, upon declining a fair offer, the creditor was estopped from challenging the reorganization. Thereafter, the only recourse would be to sue to collect from the execution-proof former shell.

Boyd thus stands for two closely aligned principles. First, continued shareholder participation in the reorganized debtor creates a presumption of collusion sufficient to permit successor liability. The Court called this presumption a “fixed principle” that operates regardless of the estimated value of the debtor’s property. Second, reorganization managers could dispel this presumption by promulgating a fair offer to all creditors. So long as a fair offer made any existing value available to all participants, courts would respect the reorganization and its effect on unsecured creditors. Boyd thus created a procedural device to avoid judicial entanglement in substantive evaluations of value.

Reorganization professionals thus took creditors’ fraudulent conveyance attack, and turned it against its promoters. They argued that fairness lay in the process,

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20 Markell, Owners, supra note 19, at 81.
not the result. This was a legal masterstroke. Process was easier to evaluate than result, and more in line with the types of procedural disputes courts were accustomed to resolve. That fraudulent conveyance law was used for this result, I contend, owes more to the cleverness and craft of lawyers, and less to the vague principles of fraudulent conveyance law and its protean prohibition against transfers made with the intent to hinder, delay and defraud. Put another way, fraudulent transfer law was more about directions than destinations, more about suggestions that solutions.

II. JUDGES AND MODERN REORGANIZATION

With fraudulent conveyance law as the cauldron in which solutions were brewed, Professor Baird then traces the enhanced role of bankruptcy judges to the efforts of William O. Douglas and Jerome Franks, New Deal warriors with expanded ideas of what reorganization should be. One of their main tools was disclosure. As Professor Baird frames the issue:

Douglas and Frank both believed that bankruptcy judges should be broadly empowered—whether by designating votes, subordinating claims, disallowing claims, or otherwise sanctioning the parties—to do what was necessary to ensure that parties bargained in good faith. The judge had to protect the integrity of the process. To do this, judges had to know what was going on. Hence, disclosure was the first obligation of participants in the reorganization process, but only the first.21

Disclosure helped to ensure a fair process; after all, as the saying goes, “sunlight is the best disinfectant.” But Professor Baird does not emphasize that disclosure was sold not as a tool for the judge, but as an aid to creditor enfranchisement. Here I return to the Wittgenstein example that opened this short piece. Both Professor Baird and I agree that disclosure is critical, but different results arise for current problems depending on your perspective as to why disclosure is necessary.22

One way in which this difference can be seen is by examining the disclosure justification as used with respect to elements thought necessary to a fair reorganization. An example is feasibility, found in § 1129(a)(11). The financial viability of a debtor is critical to a successful reorganization. Yet this information is under the parties’ control, and often there is incentive to fudge or

21 Baird, supra note 1, at 711.
22 There is a separate issue as to whether disclosure is effective for either purpose. As to creditor voting, see Brian L. Betker, et al., “Warm with Sunny Skies”: Disclosure Statement Forecasts, 73 AM. BANKR. L.J. 809 (1999).
enhance the data in ways intended to mislead or fool the bankruptcy judge. If the judge were a referee in Professor Baird’s view, that referee would have access and insights into how the feasibility determination was made. But incentives exist to conceal from the judge the reasons for collusive agreement on feasibility. As Harvey Miller, one of the great reorganization lawyers of our time, put it:

> Because Chapter 11 provides no role for the court to participate in the formulation of a plan and only gives the court a limited ability to determine the feasibility of a plan, no court, including the Delaware Bankruptcy Court, can be faulted for ‘reorganized’ debtors’ recidivism. The real problem lies not in the Delaware Bankruptcy Court, but in the conference rooms across the country where the debtors and creditors create and agree to reorganization plans. In those conference rooms, a bankruptcy judge has no control or influence, and the parties themselves may bind each other to dubious reorganization plans. Despite the debtor’s lack of commensurate bargaining leverage, once the debtor and the creditors’ committee have committed to a plan, a bankruptcy court will usually defer to the professed expertise of the parties’ financial advisors, investment bankers, and other plan advocates, and confirm the proposed plan.23

The point is that incentives exist for reorganization professionals not to be candid with the judge on all issues critical to the reorganization.24 These incentives can arise in many ways. They could arise from strategic considerations, such as suppressing issues that would scuttle a deal. As Harvey Miller notes, issues such as feasibility are often the subject of a bargaining

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24 An example in which a court found a lack of candor is *In re Las Vegas Monorail Co.*, 462 B.R. 795, 804 n.14 (Bankr. D. Nev. 2011):

> [T]he court states that it specifically finds Mr. Kvarda’s [debtor’s finance professional] and Mr. Myles’s [debtor’s president] testimony on the upside scenarios to be not credible. The strongest testimony on this point came after a long break during which counsel was able to confer with both witnesses, and to frame tendentious questions. With due respect to the witnesses, their responses appeared rehearsed. Further, neither witness withdrew or recanted any of their earlier testimony on the ephemeral nature of the upside scenarios, thus creating uncertainty as to their exact testimony. As stated above, the court credits the earlier testimony given before they were recalled.

> Lastly, one will exhaust one’s patience counting the disclaimers in the amended disclosure statement and in Mr. Kvarda’s and Mr. Myles’ declarations as to the accuracy of the information given. While the court understands and acknowledges that no witness is, or can be, a guarantor of forward-looking information or projections, the level of disassociation exhibited by these witnesses was beyond reasonable or what this court has seen in the past.

> For purposes of full disclosure, I was the trial judge in the Las Vegas Monorail case.
process that not only excludes a judge’s participation, but is intentionally structured to keep the issue from the court until it is too late—or, in the lingo of some, after the reorganization train has left the station.

An aligned problem centers on whether judges themselves view their role as good faith governors. Many do not. Those who do not view their role as an active participant thus participate less than optimally for enforcement of the norms Professor Baird describes. Despite the broad powers given to bankruptcy judges in § 105(d) of the Code, these judges take seriously the shift in 1978 away from the participatory referee model prevalent under the 1898 Bankruptcy Act to a traditional judicial model in which judges exist to resolve disputes, not monitor and guide a process. As noted in the legislative history, the 1978 revisions:

[R]emove[d] many of the supervisory functions from the judge in the first instance, transfer[ed] most of them to the trustee and to the United States trustee, and involve[d] the judge only when a dispute arises. Because the judge no longer will have to take an active role in managing bankruptcy cases, the bankruptcy court should become a forum that is fair in fact and in appearance as well.25

Whether this change ever took hold can (and has been) debated,26 but the disparate approaches to chapter 11 case management belie any overarching role of the bankruptcy judge as a monitor of the bankruptcy process. As a result, those reorganizations which fall to more passive judges will result in the judges themselves lessening their participation in the non-courtroom aspects of reorganization.

A final basis for a lack of candor in the process is perhaps itself an unwritten rule, or maybe even one that may not be spoken. Many reorganization professionals disdain bankruptcy judges as low-level functionaries who are not partners in the reorganization process, but potential roadblocks to a deal. I have heard professionals mumble and grumble that they cannot understand why a person who is paid less than their lowest associate and who went to an inferior law school (and may never have been a corporate restructuring lawyer) has the right or ability to scupper their deal.27 This view can, and probably does, lead to perverse strategies regarding venue and judge-shopping. It certainly is inimical to constructing an image of the bankruptcy judge as referee. Phrased differently, a bankruptcy judge’s ability to police the rules of reorganization, whether written

27 This usually comes from a partner whose hourly billing rate is more than 220 times the minimum wage.
or unwritten, correlates strongly with the respect given to that judge, and bankruptcy judges in general.

**CONCLUSION**

Professor Baird’s article highlights an important area of reorganization practice—the unwritten norms and rules of a complex process. In it, however, he sketches a view of and role for judges that does not, for me at least, ring true. After describing reorganization as involving many unwritten rules for negotiation and result, he describes the “job of the bankruptcy judge” as one of “polic[ing] these negotiations and mak[ing] sure that they are done according to Hoyle.”

I am not sure Hoyle is the right metaphor. Hoyle, who wrote the rulebook for the game of whist, is more associated with enforcing known and written rules for a game, something quite different from monitoring adherence to unwritten rules to ensure a result.

I think the better analogy might be to the Marquess of Queensberry rules for boxing. These rules, which sought to refine bare-knuckle fights into something for a broader audience, set twelve rules for a fisticuffs match. If the match met the new rules, it was legitimate; if not, it was not. The rules were simple, and were enforced on-the-go by referees. Rule 1, for example, set the boundaries of the playing field: “To be a fair stand-up boxing match in a 24-foot ring, or as near that size as practicable.” Rule 2 set the permissible style of engagement: “no wrestling . . . allowed.” These rules did not specify the bounds of practicality or attempt a definition of “wrestling.”

But perhaps the rule more relevant to reorganizations, though, is Rule 11: “That no shoes or boots with spikes or sprigs [wire nails] be allowed.” If present, a referee could disqualify a boxer. Now that’s a metaphor for judges’ role in reorganizations.

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28 Baird, supra note 1, at 717.
30 Id.
31 Id.
32 Id.