Supreme Court Clarifies Scope of Bankruptcy Court Authority, Allows Court Adjudication of '*Stern* Claims' if Parties Consent

Skadden

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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Mark A. McDermott
New York
212.735.2290
mark.mcdermott@skadden.com

George A. Zimmerman
New York
212.735.2047
george.zimmerman@skadden.com

Julie E. Cohen
New York
212.735.2431
julie.cohen@skadden.com

Evan A. Hill
New York
212.735.3528
evan.hill@skadden.com

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

On May 26, 2015, the U.S. Supreme Court issued its ruling in *Wellness International Network, Ltd., et al. v. Sharif*.[1] The *Wellness* decision clarifies one of the most significant open issues created four years ago by the Court's highly controversial decision in *Stern v. Marshall*.[2] Specifically, the Court in *Wellness* strengthened the scope of bankruptcy court authority by ruling that a bankruptcy judge may hear and finally determine so-called "*Stern* claims" — claims that bankruptcy judges are constitutionally prohibited from finally determining despite specific statutory authorization to do so — as long as the parties to the proceeding knowingly and voluntarily consent.

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Some background is necessary for a full understanding of *Wellness* and its implications for bankruptcy litigation. The statutes governing bankruptcy court jurisdiction and authority create three groups of bankruptcy-related matters. The first is comprised of "cases under title 11."[3] That phrase refers to the bankruptcy case of a debtor, *i.e.*, the process by which a debtor is either liquidated or reorganized and provided a fresh start. That basic category of matters is not implicated by *Stern* or *Wellness*.

However, these decisions have implications for the second and third categories of bankruptcy matters. These two categories are referred to as "core" proceedings and "non-core" proceedings. Core proceedings are those that either "arise under title 11" or that "arise in a case" under Title 11.[4] Put simply, these are proceedings that are creations of the Bankruptcy Code or that would otherwise largely exist only in bankruptcy.[5] The Bankruptcy Code contains a nonexclusive list of 16 types of proceedings that are core.[6] For example, in a Chapter 11 case, a hearing to consider confirmation of a debtor's plan of reorganization is core.[7] So are actions to recover preferences and matters related to a debtor's discharge.[8]

Non-core matters, on the other hand, are those that could exist outside of bankruptcy but that nonetheless have some effect on the bankruptcy. A common example is a debtor who has a state law claim against a creditor or some other party for breach of contract, or a claim by a litigation trust against former officers and directors for breach of fiduciary duty. Such claims are not creations of federal bankruptcy law. Rather, they are a product of state law. However, they clearly may augment a bankruptcy estate and hence, creditors' recoveries. For this reason, non-core matters are "related to" the bankruptcy and therefore are often referred to as "related to" proceedings.[9]

Critically for the *Stern* and *Wellness* decisions, bankruptcy judges can hear and enter final orders in core matters.[10] However, with respect to non-core matters, a bankruptcy judge may only "submit proposed findings of fact and conclusions of law to the district court," with any final order or judgment entered by the district court, not the bankruptcy

[1] 575 U.S. ___ (2015), No. 13-935

[2] 564 U.S. ___ (2011), 131 S.Ct. 2594

[3] 28 U.S.C. §§ 157(a), 1334(a)

[4] 28 U.S.C. §§ 157(b)(1), 1334(b)

[5] *In re Fairfield Sentry Ltd.*, 2011 WL 4359937 at *4 (S.D.N.Y. Sept. 19, 2011)

[6] 28 U.S.C. § 157(b)(2)

[7] 28 U.S.C. § 157(b)(2)(L)

[8] 28 U.S.C. § 157(b)(2)(F) and (J)

[9] *Stern*, at [11] ("The terms 'non-core' and 'related' are synonymous") (quoting Collier on Bankruptcy para. 3.02[2], p. 3-26, n. 5 (16th ed. 2010))

[10] 28 U.S.C. § 157(b)(1)

court.[11] However, if all parties to a non-core proceeding consent, the bankruptcy judge may enter a final judgment in the non-core proceeding.[12]

The Supreme Court seemingly upended these matters in *Stern*. In that case, a debtor filed a state law counterclaim against a creditor. The bankruptcy jurisdiction statutes specifically designate such claims as core, which a bankruptcy judge may finally determine. However, the Supreme Court in *Stern* held that bankruptcy judges nonetheless were constitutionally prohibited from entering final judgments on such matters, *i.e.*, state law breach of contract or tort claims that do not "stem from the bankruptcy itself" or "necessarily" resolve a creditor's proof of claim. Rather, such matters are reserved solely for Article III judges, *i.e.,* federal district court judges.

While *Stern* dealt with only one narrow class of core matters, the ruling called into question bankruptcy judges' authority to finally determine other matters statutorily designated as core. State law-based fraudulent transfer actions are one significant class of such matters, with bankruptcy litigants and courts having understood for decades that such matters are the virtually exclusive province of bankruptcy judges. *Stern* also begged — but did not answer — the question whether litigants could consent to a bankruptcy court's determination of such matters. Indeed, the decision raised the question whether bankruptcy courts could hear such matters at all, even if only to submit proposed findings and recommendations to a district court. The bankruptcy jurisdiction statutes provide for proposed findings and recommendations only in connection with non-core matters, not core matters. Accordingly, if a bankruptcy judge cannot make proposed recommendations with respect to *Stern* claims like fraudulent transfer actions, and if the judge cannot constitutionally enter a final order on such matters, then bankruptcy judges presumably are powerless to entertain such actions at all.

The Supreme Court's first opportunity to resolve these questions was presented in a case that the Court decided last year: *Executive Benefits Insurance Agency v. Arkison (In re Bellingham Insurance Agency, Inc.)*.[13] *Bellingham* involved a fraudulent transfer action. The U.S. Court of Appeals for the Ninth Circuit held, as foreshadowed by *Stern*, that bankruptcy judges are constitutionally precluded from entering final judgments in such actions, despite their designation as core proceedings under the Bankruptcy Code.[14] But the Ninth Circuit nonetheless ruled against the defendant, finding that the defendant had impliedly consented to the bankruptcy court's final adjudication of the matter by failing to challenge the court's authority until the matter was on appeal.

On appeal, the Supreme Court chose not to address whether parties can consent to bankruptcy adjudication of *Stern* claims — much to the disappointment of bankruptcy judges and practitioners. However, the Court did decide that bankruptcy judges may treat such claims as if they are non-core matters, meaning that bankruptcy judges may issue proposed findings of fact and conclusions of law subject to *de novo* review and the entry of a final judgment by the district court. Because litigants can consent to entry of final orders in non-core matters, an implication of the Court's *Bellingham* ruling is that *Stern* claims also may be finally adjudicated by a bankruptcy judge if the parties consent. But when the Supreme Court avoided the issue, bankruptcy judges and practitioners were left wondering.

The Court finally addressed the matter in *Wellness*. Sharif was an individual Chapter 7 debtor. Wellness International Network, one of Sharif's creditors, objected to the discharge of Sharif's debts because Sharif had allegedly concealed property by claiming that significant assets were not owned by him personally but instead were owned by a trust that Sharif administered on behalf of family members. In a five-count adversary proceeding, Wellness objected to the discharge of Sharif's debts and sought a declaratory judgment that the trust was in fact Sharif's alter ego and that the trust's assets should therefore be treated as part of Sharif's bankruptcy estate. The bankruptcy court granted the relief requested after Sharif defaulted, ruling that the assets supposedly held in trust were in fact property of Sharif's bankruptcy estate.

On appeal, the Court of Appeals for the Seventh Circuit determined that the claim by Wellness with respect to the scope of Sharif's assets was a *Stern* claim and that the bankruptcy court therefore lacked constitutional authority to enter a final judgment as to whether the trust property should be included in Sharif's bankruptcy estate. It also ruled that parties could not consent to final adjudication of such matters by a bankruptcy court. The court reasoned that vesting such authority in bankruptcy judges, who do not have the lifetime tenure and related protections of full, Article III district court judges, violated the Constitution's requirement of separation of powers. The Supreme Court reversed the ruling of the Seventh Circuit, holding that parties can indeed consent to final adjudication of *Stern* claims by a bankruptcy judge. Moreover, such consent need not be express, but it must be knowing and voluntary.

The Supreme Court's decisions in *Wellness* and *Bellingham* together resolve much of the uncertainty created by *Stern*. *Stern* did not, as many feared, completely divest bankruptcy judges of authority to consider statutory core matters, such as fraudulent transfer claims, that raise constitutional concerns. Instead,

[11] 28 U.S.C. § 157(c)(1)

[12] 28 U.S.C. § 157(c)(2)

[13] 573 U.S. ___ (2014), No. 12-1200

[14] 702 F.3d 553 (9th Cir. 2012)

bankruptcy judges are free to treat them like non-core matters: They can issue proposed findings and recommendations or, with the parties' consent, they can enter final rulings. Further clarity is provided by proposed changes to the bankruptcy rules that require parties to expressly state whether they consent to final adjudication of a matter by a bankruptcy court, without regard to the core/non-core distinction.[15] The Court repeated in *Wellness* its refrain from *Stern* that the narrow decision in *Stern* "did not change all that much." This refrain was viewed skeptically by bankruptcy judges and practitioners in the immediate wake of *Stern*, but it now has far greater legitimacy in the wake of *Wellness*.

[15] Report of the Judicial Conference, Committee on Rules of Practice and Procedure, pp. 6, 7, 9. (Sept. 2013).