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Chapter 11 Litigation Strategies After The Supreme Court's Decision in *Stern v. Marshall*

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On June 23, 2011, the United States Supreme Court issued its highly controversial decision in *Stern v. Marshall*.[1] The Court ruled in *Stern* that a bankruptcy judge could not constitutionally enter a final ruling on a debtor's state law "core" counterclaim against a litigant that filed a proof of claim against the debtor's bankruptcy estate unless the debtor's counterclaim "stems from the bankruptcy itself" or adjudication of the debtor's counterclaim "necessarily" would resolve the creditor's proof of claim. Prior to *Stern*, bankruptcy judges and practitioners had long understood such disputes to be the proper domain of the bankruptcy courts.

Although the Court's holding focused on one relatively narrow aspect of bankruptcy judges' authority, other courts around the country have struggled with the meaning of the decision and its implications. Since *Stern* was decided, courts have issued more than 70 published and unpublished rulings that cite to it. This initial volume of court rulings and their disparate outcomes make clear that the ramifications of the Court's ruling potentially are far ranging. Moreover, litigants are using the decision to call into question bankruptcy judges' authority to hear and determine a myriad of matters that they historically have handled without any previous legitimate question that they could do so.

As a result, *Stern* will affect reorganization and bankruptcy litigation strategies of both companies attempting to reorganize their affairs, and litigation trustees with the authority under Chapter 11 plans to pursue estate claims post-confirmation. It also will affect the strategies of lenders, hedge funds, equity sponsors, directors and officers, and others who become involved in bankruptcy cases and related litigation. This is especially true of fraudulent transfer and fiduciary duty litigation, two of the most common types of litigation commenced in bankruptcy courts.

This memorandum provides an overview of *Stern* and this initial wave of bankruptcy court reactions. It also provides an overview of certain of the issues and strategies that reorganizing debtors, litigation trustees and commercial litigants now may need to consider in light of the uncertainty and confusion that *Stern* has engendered.

1. Background: bankruptcy court jurisdiction and authority

a. Core and non-core matters

The statutes governing bankruptcy court jurisdiction and authority create three groups of bankruptcy-related matters. The first is comprised of "cases under title 11."[2] That phrase refers to the bankruptcy case of a debtor: the process by which a debtor is either liquidated or reorganized. That basic category of matters is not implicated by *Stern* and its progeny.

However, the second and third categories of bankruptcy matters are implicated by *Stern*. These matters are referred to as "core" and "non-core" proceedings. Core proceedings

1 131 S.Ct. 2594 (2011).

2 28 U.S.C. §§ 157(a), 1334(a).

are those that either "arise under title 11" or that "arise in a case" under title 11.[3] The Bankruptcy Code contains a nonexclusive list of 16 types of proceedings that are core.[4] For example, in a Chapter 11 case, a hearing to consider confirmation of a debtor's plan of reorganization is core.[5] So are actions to recover preferences, fraudulent conveyances and matters related to a debtor's discharge.[6]

Non-core matters are those that could exist outside of bankruptcy, but that nonetheless have some effect on the bankruptcy.[7] Common examples include a debtor who has a state law claim against a creditor or some other party for breach of contract, or a litigation trust with a claim 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.[8]

b. Allocation of authority between federal district judges and bankruptcy judges

District courts have original "and exclusive" jurisdiction over "cases under title 11," *i.e.*, the first category of bankruptcy matters referred to above.[9] With respect to core and non-core matters, however, district courts have original, "but not exclusive" jurisdiction.[10] The district courts, by local rules, have referred all bankruptcy matters to the bankruptcy judges of their respective districts.[11] While most core and non-core matters are considered by bankruptcy judges, there is no requirement that they do so. It is, therefore, possible that a particular core or non-core matter may be addressed by a nonbankruptcy court.

Bankruptcy judges can hear and enter final orders in core matters.[12] 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 after *de novo* review.[13] Notwithstanding this general rule, however, if all parties to a non-core proceeding consent, the bankruptcy judge may enter a final judgment in the non-core proceeding.[14]

2. The issues and holding in *Stern* and related decisions of the Supreme Court

a. Overview of *Stern*

The issue in *Stern* concerned one of the 16 categories of matters that are listed as core claims in the Bankruptcy Code: those involving "counterclaims by the estate against persons filing claims against the estate."[15] For example, assume that an equity sponsor files claims against a debtor for a loan it

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3 28 U.S.C. §§ 157(b)(1), 1334(b).

4 28 U.S.C. § 157(b)(2).

5 28 U.S.C. § 157(b)(2)(L).

6 28 U.S.C. § 157(b)(2)(F), (H), and (J).

7 *In re Salander O'Reilly Galleries*, 2011 WL 2837494, at *5 (Bankr. S.D.N.Y. July 18, 2011).

8 *Stern*, 131 S. Ct. at 2605 ("The terms 'non-core' and 'related' are synonymous") (quoting Collier on Bankruptcy, para. 3.02[2], p. 3-26, n. 5 (16th ed. 2010)).

9 28 U.S.C. § 1334(a).

10 28 U.S.C. § 1334(b).

11 28 U.S.C. § 157(a).

12 28 U.S.C. § 157(b)(1).

13 28 U.S.C. § 157(c)(1).

14 28 U.S.C. § 157(c)(2).

15 28 U.S.C. § 157(b)(C).

made to the debtor prefiling. If a litigation trustee established under the debtor's plan sues the sponsor as an alleged alter ego of the debtor, thereby attempting to hold the sponsor liable for the claims of the debtor's creditors, that suit would constitute a counterclaim against the equity sponsor.

Prior to *Stern*, there was never any question that such proceedings were core; that bankruptcy judges had jurisdiction over such proceedings; and that bankruptcy judges could enter final judgments on a debtor's counterclaim in such proceedings. *Stern* changed all that. In *Stern*, a creditor filed a proof of claim in a debtor's case alleging that the debtor had defamed the creditor prepetition. The debtor then sued the creditor in bankruptcy court, alleging that the creditor had committed a separate tort against the debtor. The debtor's suit was a counterclaim as contemplated by the Bankruptcy Code.

While the Supreme Court said that there was no question that the debtor's counterclaim against the creditor constituted a core proceeding as defined by the statute,[16] it nonetheless found the statute to be unconstitutional. According to the Supreme Court, bankruptcy judges do not have the power under the Constitution to enter final orders on a debtor's state law counterclaim unless the debtor's counterclaim "stems from the bankruptcy itself" or adjudication of the debtor's counterclaim "necessarily" would resolve the creditor's proof of claim.[17]

The Supreme Court ruled that the debtor's tort claim in *Stern* did not "stem from the bankruptcy itself" because it was a state law tort claim. Moreover, resolution of the debtor's claim would not "necessarily" resolve the creditor's separate defamation claim. Accordingly, the bankruptcy court had no constitutional authority to enter a final order on the debtor's counterclaim.

b. The Supreme Court's pre-*Stern* decisions

The Supreme Court has rendered a handful of other rulings that, taken together with *Stern*, suggest that bankruptcy judges' authority to enter final rulings in other categories of core proceedings also may be in doubt. For example, the Supreme Court has ruled that bankruptcy judges may not enter final orders in straightforward, state law breach of contract claims brought by a debtor against a nondebtor.[18] More importantly, the Supreme Court has ruled (i) that defendants in fraudulent transfer and preference litigation have a constitutional right to a jury trial, and (ii) where such a right exists, Congress cannot assign adjudication of such litigation to a so-called "non-Article III court," *i.e.*, a court other than a federal district court, at least so long as the defendants have not appeared in the bankruptcy proceedings by submitting a proof of claim.[19]

In the fraudulent transfer and preference decisions, the Supreme Court explained that such actions effectively are private lawsuits that seek recovery of damages, and that, under the Constitution, defendants in such actions are entitled to certain basic, constitutional protections, including the right to a trial by jury. A possible implication of this reasoning, when combined with *Stern*'s ruling that bankruptcy judges have no constitutional authority to enter final rulings on a debtor's state law counterclaim, is that bankruptcy judges also may be foreclosed from entering final orders in fraudulent transfer and preference actions, at least where the defendants have not filed proofs of claim.

In this respect, among others, *Stern* has been a shock to the bankruptcy system. Debtors, creditors' committees and litigation trustees have pursued fraudulent transfer litigation in bankruptcy courts for

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16 *Stern*, 131 S. Ct. at 2608.

17 *Id.* at 2620.

18 *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982).

19 *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989); *Langenkamp v. Culp*, 498 U.S. 42 (1990).

years, with no question about the propriety of doing so.[20] Bankruptcy judges and litigants now must reconsider this fundamental assumption in light of *Stern*.

3. Selected questions and bankruptcy litigation and related strategies post-*Stern*

a. Does Stern implicate subject matter jurisdiction?

A significant threshold question arises after *Stern* as to whether or not the decision implicates bankruptcy courts' subject matter jurisdiction. The phrase "subject matter jurisdiction" refers to a court's authority to hear and determine a particular matter. Whether a court can do so is a function of whether it has been specifically empowered to do so by the Constitution and, more specifically, by statute.[21] Without an explicit grant of subject matter jurisdiction, a court has no power to act at all.[22] Moreover, parties cannot create subject matter jurisdiction by agreement among themselves.[23] Orders entered by a court without subject matter jurisdiction are void *ab initio* — they have no effect — and a court's lack of subject matter jurisdiction can be raised at any time, even after a matter has been fully litigated to judgment.[24]

Most bankruptcy courts post-*Stern* have said, with little or no analysis, that they do not believe that the decision implicates bankruptcy courts' subject matter jurisdiction.[25] However, a small number of bankruptcy judges have carefully analyzed the issue — and they have arrived at different conclusions. The issue can be illustrated in the context of fraudulent transfer litigation. The Bankruptcy Code specifically says that such actions are core proceedings.[26] Accordingly, bankruptcy judges should be able to enter final orders in such proceedings. Indeed, the issue has arisen in several such litigations since *Stern*.

However, because *Stern* and the other Supreme Court decisions discussed above collectively cast doubt on bankruptcy judges' ability to enter final orders in private lawsuits by a debtor's estate that seek recovery of damages, most bankruptcy judges have ruled post-*Stern* that they can still hear fraudulent transfer litigation — but they must proceed as if such litigation is a non-core matter.[27] The litigants' consent, therefore, is required before a bankruptcy court may actually enter a final ruling in

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20 *In re Safety Harbor Resort and Spa*, 2011 WL 3849639, at *10-11 (Bankr. M.D. Fla. Aug. 30, 2011) ("[T]his Court is not aware of a single case during the twenty years preceding *Stern* challenging a bankruptcy court's authority to enter final judgments in fraudulent conveyance actions.").

21 *See, e.g.*, *Kontrick v. Ryan*, 540 U.S. 443 (2004); *Moore v. Olson*, 368 F.3d 858 (7th Cir. 2004).

22 *Arbaugh v. Y & H Corp.*, 546 U.S. 500, 510-14 (2006).

23 *Id.*

24 *Kontrick v. Ryan*, 540 U.S. 443, 454-55 (2004). However, a party must raise subject matter jurisdiction before a judgment becomes final, *i.e.*, before all appeal rights have been exhausted or expired.

25 *See, e.g., In re Coudert Brothers LLP*, 2011 U.S. Dist. LEXIS 110425 at *28 (S.D.N.Y. Sept. 23, 2011); *In re Bearingpoint, Inc.*, 2011 WL 2709295, at *8, n. 37 (Bankr. S.D.N.Y. July 11, 2011); *In re Fairchild Corp.*, 2011 WL 3267764, at *5, n. 14 (Bankr. D. Del. July 29, 2011); *In re Clark*, 2011 WL 3294040 at *5, n. 16 (Bankr. D. Idaho July 29, 2011); *In re Teleservices Grp., Inc.*, 2011 WL 3610050, at *1, n.3 (Bankr. W.D. Mich. Aug. 17, 2011); *In re Heller Ehrman LLP*, 2011 WL 3878347, at *3, n.4 (Bankr. N.D. Cal. Aug. 30, 2011); *In re Oxford Expositions, LLC*, 2011 WL 4054872, at *7 (Bankr. N.D. Miss. Sept. 12, 2011) ("There are some students of bankruptcy lore who are concerned that *Stern* implicates the subject matter jurisdiction of the bankruptcy courts. This court does not believe that is the case at all.").

26 28 U.S.C. § 157(b)(2)(H).

27 *See, e.g.*, *In re Coudert Brothers LLP*, 2011 U.S. Dist. LEXIS 110425 (S.D.N.Y. Sept. 23, 2011); *In re Crescent Resources,* 2011 WL 3022554 (Bankr. W.D. Tex. July 22, 2011); *In re MUHS*, 2011 WL 3421546 (Bankr. S.D. Tex. Aug. 2, 2011); *In re Canopy Financial, Inc.,* 2011 U.S. Dist. LEXIS 99804 (N.D. Ill. Sept. 1, 2011); *Kelley v. JPMorgan Chase & Co.*, 2011 WL 4403289 (D. Minn. Sept. 21, 2011); *see also In re Heller Ehrman LLP*, 2011 WL 4542512 (Bankr. N.D. Cal. Sept. 28, 2011) (bankruptcy courts have core jurisdiction over fraudulent transfer actions and can enter final orders regardless of parties' consent).

the matter.[28] Absent such consent, a bankruptcy judge may only make proposed findings of fact and conclusions of law for *de novo* consideration by a federal district court.[29]

However, some courts have ruled that *Stern* deprives bankruptcy courts of subject matter jurisdiction over fraudulent conveyance actions.[30] For example, in *In re Blixseth*, the court ruled that it had no power to act at all in such matters, meaning that parties could not consent to the court hearing the matter, and that the court could not even enter mere proposed factual findings and legal conclusions for consideration by a district court. The court, therefore, directed the parties to move to withdraw the reference of the fraudulent transfer litigation to the district court or else it would dismiss the action for lack of subject matter jurisdiction.[31]

The Supreme Court's opinion in *Stern* is complicated and arguably is internally inconsistent on the subject matter jurisdiction point.[32] As such, although a majority of bankruptcy judges appear to hold the view that the decision was not about subject matter jurisdiction, those holding otherwise are not entirely without textual support, thus leading to the current state of confusion as to *Stern*'s impact on bankruptcy judges' subject matter jurisdiction. Litigants therefore must seriously consider how best to proceed in fraudulent conveyance and similar litigation, including breach of fiduciary duty litigation.

In particular, as pointed out above, a court's lack of subject matter jurisdiction can be raised at any time, even after the court has ruled. A litigant therefore could litigate a matter and, if it is unhappy with the result, it could later attempt to void the result on appeal by asserting that the court had no subject matter jurisdiction to begin with. Accordingly, each party is at risk of incurring litigation expense, only to find out later that such expenditures were in vain. Until higher courts — federal district courts or federal courts of appeals — definitively speak to this issue, doubt over subject matter jurisdiction will linger.[33]

b. What constitutes binding consent to entry of final bankruptcy court orders?

One of the other controversies surrounding *Stern* is the type of consent necessary to evidence a party's agreement to entry of final orders by a bankruptcy judge. The creditor in *Stern* chose to participate in the debtor's bankruptcy case in four significant ways: (i) he filed a proof of claim against the debtor related to his defamation claim; (ii) he also filed suit against the debtor in the bankruptcy

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28 *See, e.g., In re Teleservices Group, Inc.,* 2011 WL 3610050 (Bankr. W.D. Mich. Aug. 17, 2011).

29 *In re Innovative Commc'n Corp.*, 2011 Bankr. LEXIS 3040 (Bankr. D. Virg. Isl. Aug. 5, 2011).

30 *In re Blixseth*, 2011 WL 3274042 (Bankr. D. Mont. Aug. 1, 2011); *Sitka Enterprises, Inc. v. Wilfredo Segarra-Miranda*, 2011 U.S. Dist. LEXIS 90243 (D.C.P.R. Aug. 12, 2011); *see also In re Palazzola*, 2011 WL 3667624 (Bankr. N.D. Ohio Aug. 22, 2011) (debtor brought suit against lender for alleged violation of discharge injunction; assuming such an action was a core proceeding, proceeding nonetheless should be dismissed for lack of subject matter jurisdiction).

31 Other bankruptcy courts have strongly disagreed with this approach. *See, e.g.*, *Lehman Brothers Holdings, Inc. v. JPMorgan Chase Bank, N.A.* (In re Lehman Brothers Holdings, Inc.), Adv. No. 10-03266, Docket No. 93, (Bankr. S.D.N.Y. Aug. 15, 2011) (it "makes no sense and is not a fair reading" of *Stern* to suggest that a bankruptcy court cannot do anything at all in a core matter that is not linked to the process of allowing a claim); *In re Olde Prairie Block Owner, LLC*, 2011 Bankr. LEXIS 3170 (Bankr. N.D. Ill. Aug. 25, 2011); *In re Emerald Casion, Inc.*, 2011 WL 3799643 (Bankr. N.D. Ill. Aug. 26, 2011); *In re Heller Ehrman LLP*, 2011 WL 4542512 (Bankr. N.D. Cal. Sept. 28, 2011); *see also Hagan v. Freedom Fidelity Management, Inc.*, 2011 U.S. Dist. LEXIS 106446 (W.D. Mich. Sept. 20, 2011) (noting that courts have approved use of reports and recommendations in core proceedings).

32 The Supreme Court in *Stern* said that its decision "does not implicate questions of subject matter jurisdiction." 131 S. Ct. at 2607. However, it also made statements implying that bankruptcy courts could not treat core matters as if they were non-core matters. *Id*. at 2605. If a bankruptcy court cannot constitutionally enter a final order in a core matter, then the court arguably cannot fulfill its central judicial function of deciding such cases. And if a court cannot decide such cases, one could argue that this is simply another way of saying that the court has no subject matter jurisdiction.

33 A petition recently was filed with the Supreme Court raising the question whether, based on *Stern*, a bankruptcy court has subject matter jurisdiction to determine the state law rights of two nondebtors who are not creditors in the bankruptcy case. *Rienour v. Osborne*, 2011 WL 4543947 (U.S.S.C. Sept. 27, 2011).

court asserting his defamation claim, advising the bankruptcy court that he was "happy" to litigate the matter there; (iii) he filed a suit requesting a declaration that his defamation claim would not be discharged in the debtor's bankruptcy; and (iv) he litigated the debtor's tort counterclaim to judgment.

Notwithstanding all of that, the Supreme Court ruled that the creditor had not effectively consented to adjudication of the debtor's counterclaim, emphasizing that the filing of a proof of claim is not "true" consent because the creditor had no choice but to do so in order to preserve his right to a distribution from the estate.[34] However, the Court's ruling raises an obvious question: If none of the foregoing suffices for consent, then what sort of consent should bankruptcy judges and litigants insist upon in order to foreclose later assertions by a party that its consent was not effective or was given under some type of duress? Judge Gerber in New York probably best captured the exasperation over *Stern's* lack of clarity on this point:

> [I]t's fair to assume that it will now be argued, that consent, no matter how uncoerced and unequivocal, will never again be sufficient for bankruptcy judges to issue final judgments on non-core matters. That huge uncertainty presages litigation over that issue with the potential to tie up this case, and countless others, in knots. It also would at least seemingly invite litigants to consent, see how they like the outcome, and then, if they lose, say their consents were invalid.[35]

In an effort to bring some clarity to the issue of consent, Judge Peck in New York entered an order in one of the *Lehman* adversary proceedings requiring either that parties explicitly state whether or not they consent to each and every claim asserted in the complaint, or that they seek withdrawal of such claims to the district court.[36] While this may resolve the question of whether or not the parties' consent was truly free and uncoerced, it does not resolve the more fundamental issue of a bankruptcy court's subject matter jurisdiction because, as noted above, parties cannot by their consent confer subject matter jurisdiction upon a court that does not otherwise have such jurisdiction.

c. Should a potential defendant file a proof of claim?

(i) *Fraudulent and preferential transfer litigation*

While one possible implication of *Stern* is that bankruptcy judges no longer can enter final orders in fraudulent transfer and preferential transfer litigation, at least absent the parties' consent, it is clear that if a defendant has filed a proof of claim in the related bankruptcy proceedings, then a bankruptcy court constitutionally may adjudicate a fraudulent or preferential transfer action against the defendant to final judgment.[37] This conclusion stems from the fact that section 502(d) of the Bankruptcy Code mandates that any such action be resolved as a condition to allowance of the defendant's proof of claim.

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34 *Stern*, 131 S. Ct. at 2615, n.8.

35 *In re Bearingpoint, Inc.*, 2011 WL 2709295 at *8, n. 37 (Bankr. S.D.N.Y. July 11, 2011).

36 *Lehman Brothers Holdings, Inc. v. JPMorgan Chase Bank, N.A.* (*In re Lehman Brothers Holdings, Inc.*), Adv. No. 10-03266, Docket No. 93 (Bankr. S.D.N.Y. Aug. 15, 2011); *see also In re Coudert Brothers LLP*, 2011 U.S. Dist. LEXIS 110425, at *33 (S.D.N.Y. Sept. 23, 2011) ("Following *Stern*, it is doubtful whether mere participation in litigation is enough to imply consent.").

37 *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989); *Langenkamp v. Culp*, 498 U.S. 42 (1990); *In re Polaroid Corp.*, 2011 WL 2694316 (Bankr. D. Minn. July 7, 2011) (bankruptcy court could enter final judgment on trustee's preference claim where defendant had filed proof of claim).

This begs the question whether a creditor should consider not filing a proof of claim if it believes it may later be sued for a fraudulent or preferential transfer. When a creditor receives notice of a bar date for filing a proof of claim, the immediate reaction is to get a claim on file. The Supreme Court's ruling, however, likely will make some creditors pause before doing so. In particular, some creditors may choose to forego filing a claim and participating in any distribution from the estate if they think that they may be sued for a fraudulent or preferential transfer and they wish to preserve their options to attempt to have the litigation heard in a forum other than the bankruptcy court.

For example, an out-of-the-money equity sponsor of a debtor who received large dividends prefiling and, hence, may be sued by the debtor's estate seeking recovery of the dividends as fraudulent transfers, may choose not to submit itself to bankruptcy court jurisdiction by filing a claim. If a fraudulent conveyance suit is brought later in the bankruptcy court, the defendant could attempt (i) to have the matter heard before the bankruptcy court, but only to make proposed factual findings and legal conclusions for later *de novo* review by the district court; (ii) to withdraw the reference of the matter to the district court for it to consider the matter in the first instance;[38] (iii) to transfer venue of the case to another federal district court;[39] or (iv) to request the bankruptcy court to abstain from hearing the matter so that it can be adjudicated in state court.[40] None of these potential options is available to a defendant who has filed a proof of claim.

(ii) *Fiduciary duty litigation*

Similar considerations could apply in fiduciary duty litigation brought against former officers and directors of corporate entities. A possible implication of *Stern* and earlier Supreme Court rulings is that bankruptcy courts cannot enter final judgments in such matters. Indeed, post-*Stern*, Judge Gerber granted a request by a litigation trustee to modify a provision of a confirmed plan that vested the bankruptcy court with exclusive jurisdiction over a fiduciary duty suit so that the parties could pursue the matter in another court.[41]

This conclusion arguably presumes, however, that the directors and officers have not filed proofs of claim. The charters of corporate debtors invariably provide for the indemnification of directors on account of alleged breaches of the duty of care. Directors frequently file proofs of claim against reorganizing corporate enterprises to preserve their rights to recover on account of such rights if they have been sued and/or to preserve their right to do so if they are later sued.

If a director in this scenario has filed a proof of claim for indemnification, he or she may have forfeited the right to attempt to litigate fiduciary duty claims in another court. The matter is not entirely clear, however, because *Stern* held that bankruptcy courts may enter final rulings on estate claims in this context only if resolution of that claim will "necessarily" resolve the director's proof of claim. It is at least conceivable that resolution of a fiduciary duty suit "necessarily" will determine a director's proof of

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38 28 U.S.C. § 157(d); Fed. R. Bankr. P. 5011.

39 28 U.S.C. § 1412; Fed. R. Bankr. P. 1014.

40 28 U.S.C. §§ 1334(c), 1452; Fed. R. Bankr. P. 9027; *see also In re Schmidt*, 2011 WL 3300693 (8th Cir. BAP Aug. 3, 2011) (remanding plaintiff's state court replevin action against debtors to state court after debtors had removed same to bankruptcy court); *In re Southwest Sports Center, Inc.*, 2011 WL 4002559 (Bankr. N.D. Ohio Sept. 6, 2011) (abstaining from hearing debtor's adversary proceeding raising state law claims against creditor).

41 *In re Bearingpoint, Inc.*, 2011 WL 2709295 (Bankr. S.D.N.Y. July 11, 2011). By contrast, Judge Walrath retained jurisdiction to hear breach of fiduciary duty and related claims in *In re Am. Bus. Fin. Servs., Inc.* because the claims arose *post*-bankruptcy and hence, were entangled with administration of the estate. 2011 WL 3240596 (Bankr. D. Del. July 28, 2011). And in *In re Ambac Fin. Group, Inc.*, Judge Chapman ruled that she could enter a final order approving a settlement among a debtor, its directors and officers, and its directors' and officers' liability insurance carrier that included a release of potential estate claims against the directors and officers. 2011 WL 4436126 (Bankr. S.D.N.Y. Sept. 23, 2011). However, in *In re DBSI, Inc.*, Judge Walsh declined to enter a final order, pending further briefing on the effects of *Stern*, in an action involving a dispute among an insurance carrier, creditors and directors and officers over who had superior claims over the proceeds of a directors' and officers' liability insurance policy. 2011 WL 3022177 (Bankr. D. Del. July 22, 2011).

claim, but that may depend on the facts. Accordingly, a director wishing to retain the option to litigate in another court may need to forego filing a proof of claim altogether.[42]

d. Can bankruptcy judges still enter final financing and cash collateral orders?

The Bankruptcy Code specifies that proceedings relating to debtor-in-possession financing and cash collateral are core proceedings as to which bankruptcy judges may enter final orders.[43] There is nothing in *Stern* that suggests a different result. Indeed, *Stern* and the other Supreme Court decisions discussed above focus more on state law claims by a debtor against nondebtors.[44] Debtor-in-possession financing and cash collateral proceedings are qualitatively different from state law claims by a debtor. Rather, they are solely creations of the Bankruptcy Code — they do not exist outside bankruptcy — and they are not at all akin to a lawsuit by one party against another.

However, it is customary for financing and cash collateral orders to contain provisions affording a creditors' committee a limited period in which to investigate a lender's claims and liens and, if necessary, challenge those claims and liens. Does *Stern* implicate such matters? To the extent a committee may identify fraudulent or preferential transfer claims against a lender, the answer may be "yes" for the reasons outlined above. But what if a committee identifies a lender liability claim against a lender? What if the committee determines that the estate has valid grounds to attempt to equitably subordinate the lender's claim? What if the committee believes that the lender is not entitled to a prepayment premium under the loan documents? What if the committee determines that the lender's lien is invalid?

The Bankruptcy Code specifies that proceedings to determine the validity, extent and priority of a lien are core proceedings.[45] Whether a lender has perfected a lien is a question of state law. Accordingly, under *Stern*, there is a question as to whether a bankruptcy court can enter a final order in such a proceeding. Some bankruptcy judges have concluded post-*Stern* that actions to determine the validity, extent or priority of a lien is a core proceeding as to which a bankruptcy judge may enter a final order,[46] whereas others have suggested that they must treat such actions as if they are non-core matters as to which they may only submit proposed recommended findings and conclusions to the district court.[47]

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42 One of the dilemmas facing a director or officer who may be sued in fiduciary duty litigation is that he or she likely will need to make the proof of claim decision long before he or she knows whether there will be funds for distribution to creditors, as proof of claim bar dates often are set well before estimated distributions are available, and long before the statutes of limitations for filing many types of litigation. 11 U.S.C. § 546(a) (debtor may bring avoidance actions up to two years after the petition date).

43 28 U.S.C. §§ 157(b)(2)(D) and (M).

44 *Compare Turner v. First Community Credit Union*, 2011 WL 2708907 (Bankr. S.D. Tex. July 11, 2011) (bankruptcy court could enter final order in debtor's lawsuit against creditor for alleged violations of the automatic stay, because the automatic stay is a creation of the Bankruptcy Code and, hence, is core to the administration of the bankruptcy estate).

45 28 U.S.C. § 157(b)(2)(K).

46 *In re Szerwinski*, 2011 WL 2552012 (Bankr. N.D. Ohio June 27, 2011) (concluding, without analysis, that action by trustee to avoid a lien pursuant to 11 U.S.C. § 544 is within the court's constitutional authority); *In re Hudson*, 2011 WL 3583278 (Bankr. W.D. Mich. Aug. 16, 2011) (acknowledging that lien avoidance action under 11 U.S.C. § 544 involved issues of state law, court nonetheless said that it "cannot envision a core proceeding that is more 'core' than lien avoidance"); *In re Salander O'Reilly Galleries*, 2011 WL 2837494 (Bankr. S.D.N.Y. July 18, 2011) (bankruptcy court could enter final order on trustee's suit to determine consignor's rights in consigned goods under 11 U.S.C. § 544); *In re Bigler LP*, 2011 WL 3665007 (Bankr. S.D. Tex. Aug. 19, 2011) (while lien priority dispute implicated issues of state law, bankruptcy court could enter final ruling in same without need to obtain parties' consent).

47 *In re South Louisiana Ethanol, LLC*, 2011 WL 3047805 (Bankr. E.D. La. July 25, 2011) (noting that "[t]o the extent this Court does not have *subject matter jurisdiction* over this [action by a debtor to determine the validity of a lien pursuant to [*Stern*]], this Opinion will be considered a Report and Recommendation . . . . ") (emphasis added); *see also In re Rivera,* 2011 WL 4382001 (Bankr. D. Colo. Sept. 20, 2011) (in trustee's action to void lender's lien pursuant to 11 U.S.C. § 544, court stated that is was "prudent, if not necessary," in light of *Stern* to certify to Colorado Supreme Court question whether failure to provide legal description of property in deed of trust was fatal to lender's lien).

However, there should be no question under *Stern* that a bankruptcy court can enter a final order adjudicating the committee's objection to the lender's claim for a prepayment premium. The Bankruptcy Code specifically states that matters related to the allowance or disallowance of claims are core proceedings,[48] and the Supreme Court and several courts post-*Stern* have confirmed that the adjustment of creditor claims are central to the bankruptcy process, even though claim disputes may turn on questions of state law.[49]

The Bankruptcy Code says nothing specific about entry of final orders on equitable subordination claims. However, equitable subordination litigation arguably is nothing more than a type of claim determination. Accordingly, an estate's attempt to equitably subordinate a lender's lien should be considered a core matter as to which a final bankruptcy court order may be entered.[50] On the other hand, a lender liability claim for money damages is a creature of state law that a bankruptcy court likely could not adjudicate on a final basis, at least not without the parties' consent. The court may be able to do so without parties' consent, however, in the likely event that the lender has filed a proof of claim, but only if adjudication of the lender liability suit "necessarily" will resolve the lender's proof of claim as mandated by *Stern*.

e. What if a debtor's plan contains settlements and/or nonconsensual releases?

As noted above, the Bankruptcy Code specifies that plan confirmation proceedings are core matters as to which bankruptcy judges may enter final confirmation orders. Pre-*Stern*, no one would seriously have questioned this. Post-*Stern*, however, nothing can be taken for granted. As Judge Chapman recently said, *Stern* "has become the mantra of every litigant who, for strategic or tactical reasons, would rather litigate somewhere other than the bankruptcy court."[51] Indeed, the propriety of bankruptcy court jurisdiction over plan confirmation proceedings has been litigated in at least two cases since *Stern* was decided.

One of these cases is *In re Washington Mutual, Inc.*[52] In that case, Judge Walrath considered confirmation of a Chapter 11 plan of a bank holding company that included, as a central aspect of the plan, a settlement of claims of the debtor, its creditors, and the Federal Deposit Insurance Corporation. Certain stakeholders asserted that Judge Walrath had no jurisdiction to consider the plan, pointing to the fact that the settlement resolved state law claims over, among other things, bank deposits and related matters. The stakeholders argued that a plan that purports to resolve such matters is beyond a bankruptcy court's jurisdiction.

Judge Walrath disagreed. She pointed out that bankruptcy courts have a long history of approving settlements; that settlements are especially favored in bankruptcy; and that the Bankruptcy Code specifically provides that a Chapter 11 plan of reorganization may provide for "the settlement or adjustment of any claim or interest belonging to the debtor or to the estate."[53]

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48 28 U.S.C. § 157(b)(2)(B).

49 *See, e.g.*, *In re Salander O'Reilly Galleries*, 2011 WL 2387494 (Bankr. S.D. N.Y. July 18, 2011); *In re Jordan River Resources, Inc.*, 2011 WL 3625096 (Bankr. W.D. Mich. Aug. 16, 2011); *In re Teleservices Group, Inc.,* 2011 WL 3610050 (Bankr. W.D. Mich. Aug. 17, 2011); *Kurz v. Worldwide, Inc.*, 2011 WL 4048966 (D. Del. Sept. 9, 2011).

50 *In re Blixseth*, 2011 WL 3274042 (Bankr. D. Mont. Aug. 1, 2011).

51 *In re Ambac Fin. Group, Inc.,* 2011 WL 4436126, at *8 (Bankr. S.D.N.Y. Sept. 23, 2011).

52 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011).

53 *Id.* at *4 (quoting 11 U.S.C. § 1123(b)(3)). Judge Walrath also pointed to Supreme Court and other authorities holding that courts can approve settlements of matters — even if they do not otherwise have jurisdiction over the claims that are being settled. *See Matsushita Elec. Indus. Co., Ltd. v. Epstein*, 516 U.S. 367 (1996); *Grimes v. Vitalink Commc'ns Corp.*, 17 F.2d 1553 (3d Cir. 1994). Judge Chapman relied on the same theory in approving a settlement that included releases of potential estate claims against officers and directors. *In re Ambac Fin. Group, Inc.*, 2011 WL 4436126 (Bankr. S.D.N.Y. Sept. 23, 2011).

The litigation in *Washington Mutual* concerned the propriety of a settlement that contained so-called debtor releases: releases by a debtor of estate claims against nondebtor third parties. However, many plans also contain so-called "nondebtor" or "third-party" releases: releases by one set of nondebtors of claims against other nondebtors. In fact, some plans contain nonconsensual releases, *e.g.*, public holders of bond debt compromised under a plan are deemed to release certain nondebtor third parties of whatever claims those public holders may have, regardless of whether they have voted in favor of the plan. Standard plan provisions that exculpate key stakeholders and their professionals in connection with their efforts to effectuate a debtor's reorganization similarly afford non-consensual limitations of liability to their beneficiaries.

Reorganizing debtors should expect *Stern*-type challenges to a bankruptcy court's ability to approve reorganization plans that contain third-party releases and standard exculpation provisions.[54] Objectors will argue that state law claims which one nondebtor has against another nondebtor are beyond the court's subject matter jurisdiction; beyond its constitutional authority to approve on a final basis; and/or are at best, non-core, "related to" matters as to which only proposed factual findings and legal conclusions can be made. Indeed, these arguments were made — albeit unsuccessfully — in the only other case post-*Stern* that challenged a bankruptcy court's authority to preside over a Chapter 11 confirmation hearing.[55]

While these and other arguments undoubtedly will be made in other cases, arguably the better view is that they simply do not implicate *Stern*. Settlements and releases that implicate third parties' rights are integral and inseparable components of the process by which many debtors reorganize their affairs and adjust creditor claims.[56] They cannot be peeled away and dealt with separately by federal district judges without disrupting the entire process. Nor is the proper course to remove to federal district courts all proceedings concerning reorganization plans that contain such provisions.

* * *

It is clear that the dust has not yet settled on any of these or myriad other issues raised by *Stern v. Marshall*. Reorganizing debtors, their stakeholders, and bankruptcy and other judges will be unwinding these issues for many years to come. Arguably the easiest fix is for Congress to designate bankruptcy judges as so-called "Article III judges" with the same breadth of power as federal district judges. However, that is not likely to occur any time soon, if at all. Accordingly, bankruptcy litigants will be required to make careful assessments of their litigation strategies, as even seemingly innocuous decisions like whether to file a proof of claim could have significant potential consequences.

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54 *Compare In re Safety Harbor Resort and Spa*, 2011 WL 3849639 (Bankr. M.D. Fla. Aug. 30, 2011) (*Stern* did not preclude bankruptcy court from entering confirmation order approving plan under which principals of nondebtor guarantor of lender's debt contributed substantial assets to reorganization in consideration for temporary stay of lender's efforts to collect deficiency claim from guarantors).

55 *In re Yellowstone Club, Inc.*, No. 08-61570-11 (Bankr. D. Mont. Sept. 30, 2011) (disagreeing with fraudulent conveyance target's argument that court could not confirm a plan that established a litigation trust to pursue fraudulent conveyance claims and that contained exculpation clauses that, in target's view, would have foreclosed its ability to seek contribution from exculpated parties).

56 *In re Washington Mutual, Inc.*, 2011 WL 4090757, at *4; *see also In re Okwonna-Felix*, 2011 WL 3421561 (Bankr. S.D. Tex. Aug. 3, 2011) (debtor's motion to approve settlement regarding estate's entitlement to settlement proceeds from an insurance action was a core proceeding as to which a bankruptcy court could enter a final order); *In re Teleservices Group, Inc.*, 2011 WL 3610050, at *12, n. 52 (Bankr. W.D. Mich. Aug. 17, 2011) (final order may be entered by bankruptcy courts approving settlements under Rule 9019). At least one court post-*Stern* has also held that bankruptcy judges may enter final orders substantively consolidating multiple bankruptcy estates. Substantive consolidation also is a common feature of reorganization plans. *In re LLS America, LLC*, 2011 Bankr. LEXIS 3429 (Bankr. E.D. Wash. Sept. 8, 2011).