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The Power Of Bankruptcy Courts To Enter Final Judgments

CIRCUITS WRESTLE WITH BREADTH OF LANDMARK SUPREME COURT RULING

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In 2011, the U.S. Supreme Court sent tremors through the bankruptcy world by holding in *Stern v. Marshall*, 131 S. Ct. 2594 (2011), that bankruptcy courts lacked the constitutional authority to enter final judgment on a debtor's state law counterclaim against a creditor. Although the case's facts were unusual and the Court described its decision as "narrow," the decision's reasoning suggested that bankruptcy courts could not enter final judgments in many disputes that typically occur in bankruptcy cases. Bankruptcy and district courts have since wrestled with the proper breadth of *Stern*. This issue is now making its way up to the Circuit Courts of Appeals and so far, a fairly broad view of *Stern* is prevailing.

The *Stern* decision stems from Article III, Section 1 of the U.S. Constitution, which provides that federal "judicial Power" may only be exercised by judges with lifetime tenure and whose compensation may not be reduced. Only Article III judges may adjudicate parties' private rights; that is, their liability to one another under law. Bankruptcy judges are not Article III judges because they serve for 14-year terms and their salaries are subject to diminution. However, non-Article III judges may adjudicate "public rights." Although the concept is amorphous, "public rights" have been described as those "arising

'between the Government and persons subject to its authority in connection with the performance of the constitutional functions of the executive or legislative departments'" *Stern*, 131 S. Ct. at 2612 (quoting *Crowell v. Benson*, 285 U.S. 22, 50, 51 (1932)). This apparently includes the restructuring of debts central to the Bankruptcy Code. See *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 71 (1982).

Core Vs. Non-Core Proceedings

Stern was not the first time that bankruptcy courts were found to have improperly adjudicated private rights. Shortly after the Bankruptcy Code's enactment in 1978, the Supreme Court held in *Northern Pipeline* that the bankruptcy court could not enter final judgment on a debtor's breach of contract action that solely served to augment the estate's assets.

In response, Congress amended the Bankruptcy Code to create two classes of proceedings: core and non-core. Core proceedings are matters arising under the Bankruptcy Code or in a bankruptcy case, and non-core proceedings are matters that relate to a bankruptcy case. The amendments authorized bankruptcy judges to enter judgments in



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core proceedings, but to only propose findings of fact and conclusions of law to the district court for de novo review in non-core proceedings (unless the parties consent to the bankruptcy court's entry of judgment).

The core and non-core distinction appeared to work until *Stern*. In *Stern*, a creditor, who had filed a proof of claim for injuries arising from the debtor's alleged defamation, objected to the bankruptcy court entering final judgment on the debtor's counterclaim against him for tortious interference with receipt of a gift from her deceased husband. Although the counterclaim was a "core proceeding," the Supreme Court held that it was unconstitutional for a non-Article III court to determine the mat-

ter. The *Stern* court relied on its prior decision in *Granfinanciera S. A. v. Nordberg*, 492 U.S. 33 (1989), holding that a non-creditor defendant has a Seventh Amendment right to a jury trial in a fraudulent transfer action because such claims adjudicate private — not public — rights.

The *Stern* court held that the debtor's counterclaim for tortious interference was similar to the fraudulent transfer claim in *Granfinanciera*: a claim "under state common law between two private parties." *Stern* distinguished prior decisions allowing a bankruptcy court to determine preference claims brought against creditors of the bankruptcy estate. The Court reasoned that the bankruptcy court could enter judgment in those cases because the preference action had to be adjudicated in resolving the creditor's claim since a claim may be disallowed to the extent the creditor received a preferential transfer.

Although *Stern* involved some factual overlap between the debtor's counterclaim and the creditor's claim, the counterclaim would not be resolved through adjudicating the creditor's claim since the counterclaim involved additional elements and facts.

Many bankruptcy and district courts have disagreed on the breadth of *Stern's* holding. Some courts have taken a narrow view of *Stern* and concluded that it did not preclude a bankruptcy judge from finally determining many types of common bankruptcy disputes. Other courts have concluded that *Stern's* reasoning precludes bankruptcy courts from rendering judgment over many state and federal law claims.

Where Do Circuits Stand?

The U.S. Court of Appeals for the Sixth Circuit Court was one of the first Circuit Courts to weigh in on this issue. In *Waldman v. Stone*, 698 F.3d 910 (6th Circuit 2012), the debtor sued a creditor to (1) disallow his claim due to his alleged fraud in the sale of the debtor's business,

and (2) obtain money damages against him based on the same fraudulent conduct. The Sixth Circuit concluded that the bankruptcy court could enter a final judgment disallowing the creditor's claims because the claim disallowance process falls within the public rights exception. However, the Sixth Circuit held that, under *Stern*, the bankruptcy court could not enter judgment on the damages claim because it was a state law claim unrelated to the debtor's restructuring in bankruptcy.

The decision stems from Article III, Section 1 of the U.S. Constitution, which provides that federal 'judicial Power' may only be exercised by judges with lifetime tenure and whose compensation may not be reduced.

While there was factual overlap between the disallowance claim and the damages claim, this was insufficient to allow the bankruptcy court to enter a final judgment. The Sixth Circuit reasoned that the bankruptcy court could only enter a final judgment on the damages claim if there was "reason to believe that the process of adjudicating [the] proof of claim would necessarily resolve the damages claim." Because the damages claim required proof of facts beyond those necessary to disallow the creditor's claim, the Sixth Circuit concluded that adjudicating the disallowance claim would not resolve the damages claim.

The U.S. Court of Appeals for the Ninth Circuit weighed in next in *In re Bellingham Insurance Agency*, 702 F.3d 553 (9th Circuit 2012), which involved a Chapter 7 trustee's fraudulent transfer action under state law and the Bank-

ruptcy Code against a noncreditor. Based on *Stern* and its treatment of the *Granfinanciera* case, the Ninth Circuit concluded that the bankruptcy court could not constitutionally enter a final judgment.

Specifically, the *Ninth Circuit* reasoned that *Stern's* reliance on *Granfinanciera*, even though it involved a noncreditor defendant's right to a jury trial in a fraudulent transfer case, led to the inexorable conclusion that Congress could not assign a non-Article III court to resolve a fraudulent transfer claim. The Ninth Circuit rejected the assertion that the bankruptcy court could enter judgment on the fraudulent transfer claim arising under the Bankruptcy Code. The determinative factor in the Ninth Circuit's analysis was not the source of law, but whether the claim "necessarily had to be resolved in the course of the claims-allowance process . . ." In this case, the trustee's fraudulent transfer claim would not have been resolved in the claim allowance process because the defendant was not a creditor.

While both courts take a broad view of *Stern*, they differ in one material respect. In *Waldman*, the Sixth Circuit held that a violation of Article III cannot be waived because it serves to protect not just the litigant's personal rights, which could be waived, but also the structural checks and balances on the branches of government, which could not be waived. By contrast, the Ninth Circuit held in *Bellingham* that Article III's protections were personal to the litigants and could be waived.

Although *Waldman* and *Bellingham* indicate a growing acceptance of a broad interpretation of *Stern*, we are still left with more questions than answers. For example, can bankruptcy courts enter final judgments in preference cases against non-creditors? What happens if the claim is core but cannot be determined by the bankruptcy court under Article III? Can the bankruptcy court submit proposed findings of fact and conclusions of law to the district court in such cases even though the Bankruptcy Code only authorizes doing so in non-core proceedings? Can a defendant waive violations of Article III?

Unless a legislative change is made or further guidance is provided by the Supreme Court, this uncertainty likely will be with us for the foreseeable future. ■

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