

Stern v. Marshall: How Circuit Courts Have Interpreted It

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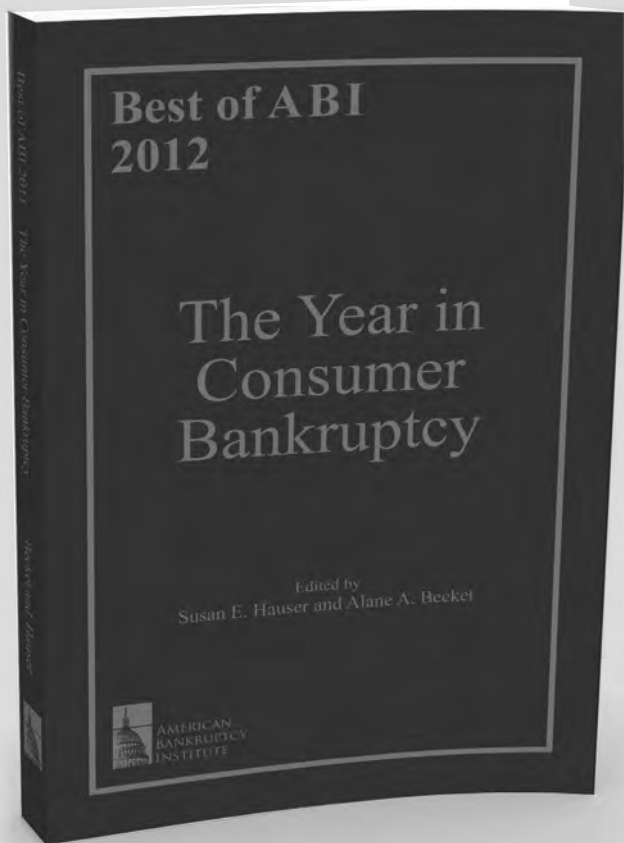
Hon. David S. Kennedy

U.S. Bankruptcy Court (W.D. Tenn.); Memphis



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The Basics of Bankruptcy Jurisdiction

- **Constitutional Framework & *Marathon***
 - United States Constitution -
 - Article I, §8, Clause 4 – (the Bankruptcy Clause)
 - Congress shall enact “uniform laws on the subject of bankruptcy throughout the United States.”
 - Article I power includes the power to create courts to interpret legislation (*i.e.* tax courts, bankruptcy courts)
 - Article III -
 - Vests judicial power in the Supreme Court and in such inferior courts as Congress shall establish.
 - The judicial power shall extend to all cases in law and equity arising under the constitution or laws of the United States.
 - Judges have lifetime tenure and salary protections.

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The Basics of Bankruptcy Jurisdiction

- *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982)
 - 28 U.S.C. § 1471(b), first enacted as part of the Bankruptcy Code (which replaced the Bankruptcy Act), granted the bankruptcy court jurisdiction over “all civil proceedings **arising under** title 11 or **arising in or related to** cases under title 11.”
 - Bankruptcy courts were **adjuncts** of the district court.

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The Basics of Bankruptcy Jurisdiction

Marathon continued -

- The Supreme Court held that the broad grant of jurisdiction to bankruptcy courts violated Article III of the Constitution by vesting non-Article III judges with too much of the “judicial power” of the United States.
 - The unconstitutional portion of the jurisdictional grant could not be severed from the constitutional portion, thus condemning the entire bankruptcy court system, and forcing Congress to reorganize the jurisdictional and court scheme.

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The Basics of Bankruptcy Jurisdiction

Marathon continued -

- The judicial power must be exercised by judges who have the attributes of life tenure and protection against salary diminution specified by Article III.
- This ensures the independence of the Judiciary from the control of the Executive and Legislative Branches.
 - Bankruptcy judges are appointed for 14-year terms, and can be removed for “misconduct, neglect of duty, or physical or mental disability.”
 - Their salaries are not immune from diminution by Congress.

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The Basics of Bankruptcy Jurisdiction

- The Bankruptcy Amendments and Federal Judgeship Act of 1984 (“BAFJA”) was created to enact a new jurisdiction and court scheme.
 - Bankruptcy courts are now **units** of the district court.
 - Bankruptcy courts hear cases and proceedings in bankruptcy only **by reference** from the district courts.
 - BAFJA made a distinction between “**core**” bankruptcy matters, in which the bankruptcy court can enter a final order, and “**non-core**” matters, which must be reviewed *de novo* by the district court.

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Subject Matter Jurisdiction

- Subject matter jurisdiction of the bankruptcy court is now derived from the authority which is granted to the **district court** under 28 U.S.C. §1334.
- Thereafter, a district court “**may** provide that any and all **cases under title 11** and any and all proceedings **arising under** title 11 or **arising in** or **related to** a case under title 11 shall be referred to the bankruptcy judges for the district.” 28 U.S.C. § 157(a).
 - Local district court rules provide a reference of bankruptcy matters to the bankruptcy court in every federal judicial district.

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Subject Matter Jurisdiction

• Core Proceedings

- Matters which come under the phrases “**arising under** title 11” and “**arising in** a case under title 11” are core proceedings within the meaning of 28 U.S.C. §§157(b)(1) and 157(b)(2).
- **28 U.S.C. § 157(b)(2) contains a non-exclusive list of “core” proceedings:**
 - (A) - Matters concerning the administration of the estate;
 - (B) - Allowance or disallowance of claims against the estate or exemptions from property of the estate;
 - (C) - **Counterclaims by the estate against persons filing claims against the estate;**
 - (D) - Orders in respect to obtaining credit;
 - (E) - Orders to turn over property of the estate;
 - (F) - Proceedings to determine, avoid, or recover preferences;
 - (G) - Motions to terminate, annul, or modify the automatic stay;
 - (H) - Proceedings to determine, avoid, or recover fraudulent conveyances;
 - (I) - Determinations as to the dischargeability of particular debts;
 - (K) - Determinations of the validity, extent, or priority of liens;
 - (L) - Confirmations of plans;
 - (M) - Orders approving the use or lease of property, including the use of cash collateral;
 - (N) - Orders approving the sale of property;
 - (O) - Other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor relationship;

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Subject Matter Jurisdiction

- **Core Proceedings**
 - “A core proceeding either evokes a substantive right created by the federal bankruptcy law (arising under) or one which could not exist outside of bankruptcy (arising in).” *In re Lowenbraun*, 453 F.3d 314 (6th Cir. 2006).
 - Under 28 U.S.C. §157(b)(1), a bankruptcy court **may determine all core proceedings and enter final orders.**

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Subject Matter Jurisdiction

- **Non-Core Proceedings**
 - Non-core proceedings consist of those matters “**related to**” the bankruptcy case:
 - Tort, contract, and other claims by and against the debtor that, but for the bankruptcy, would be standalone lawsuits
 - A bankruptcy court may hear matters that are “related to” a bankruptcy case but **may not enter a final order or judgment in such proceedings, unless all parties have consented.** 28 U.S.C. § 157(c)(1) and (2).
 - Absent consent, proposed findings of fact and conclusions of law are prepared and, thereafter, reviewed *de novo* by the district court.

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Stern v. Marshall – Did Everything Just Change?

- As if all that wasn't complicated enough, the Supreme Court significantly muddied the waters in *Stern v. Marshall*, 131 S. Ct. 2594 (2011).
 - Litigation arose in the bankruptcy case of Vickie Lynn Marshall (Anna Nicole Smith).
 - At issue was the bankruptcy court's ability to enter a final judgment on account of a counterclaim by the debtor, which is a **core proceeding** under 28 U.S.C. §157(b)(2)(C).

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Stern v. Marshall – Did Everything Just Change?

- Pierce Marshall, the son of Vickie's late husband, filed a proof of claim against her bankruptcy estate.
 - He claimed that Vickie had defamed him, and requested damages from the bankruptcy estate.
- Vickie responded to the proof of claim filing an unrelated counterclaim against Pierce claiming that he had tortiously interfered with the gift she should have received from her husband's estate when he died.
 - Vickie received a \$450M judgment on her counterclaim against Pierce.
- Pierce appealed the judgment all the way to the Supreme Court, claiming that the bankruptcy court did not have authority to award that judgment.

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Stern v. Marshall – Did Everything Just Change?

- The Supreme Court first determined that **the bankruptcy judge had the statutory jurisdiction** to enter the judgment under § 157(b)(2)(C).
- Nevertheless, noting that their ruling was a “**narrow one,**” the Court held that the judgment was invalid because **the statute violated the Constitution.**
 - “In general, Congress may not ‘withdraw from [Article III] judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty.’ ”

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Stern v. Marshall – Did Everything Just Change?

Rationale:

- Relying on 19th Century decisions, the majority stated that there was no room for any approach that would “chip away” at Article III jurisdiction.
 - Reaffirming *Marathon*, the Court found that separation of powers requires a judiciary that:
 - (i) is independent of the legislative and executive branches, and
 - (ii) has life tenure and salary security, at least with those matters involving state law.
 - The counter-claim arose under **state common law** and Pierce **did not consent** to adjudication by the bankruptcy court.
 - Purely state law matters involve “private” rather than “public rights”
 - Such matters, cannot be finally adjudicated by anyone other than an Article III judge unless they would **necessarily be resolved in conjunction with the allowance or disallowance of the creditor’s claim against the estate.**

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Stern v. Marshall – Did Everything Just Change?

Impact of *Stern v. Marshall*:

- As a result of *Stern v. Marshall*, there is significant uncertainty regarding what matters can be **finally determined before the bankruptcy court**, even with respect to those matters which are deemed to be “core” under the statute.
- Increasingly there is a practice of referring the litigation back to the district court for trial or filing it there in the first place to avoid the *Stern* issue.
 - The alternative is to have the bankruptcy court prepare a **report and recommendation** to be reviewed *de novo* by the district court.

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Statutory Gap Issue

- 28 U.S.C. 157(c)(1) – Provides that the bankruptcy judge is to submit proposed findings of fact and conclusions of law to the district court for a **“proceeding that is not a core proceeding.”**
- Going forward, what about statutorily **core proceedings** where, under *Stern*, the bankruptcy court may not enter a final judgment?
 - By its terms, 157(c)(1) should not apply.
 - There is no other statutory provision that gives the bankruptcy court authority to submit proposed findings of fact and conclusions of law.
 - Arguably, the only thing the bankruptcy court can do is recommend to the district court that it withdraw the reference under 157(d), on the grounds that the bankruptcy court cannot do anything else.
- Most courts have determined that a bankruptcy court can issue proposed findings and conclusions in such proceedings.
 - *Kirschner v. Agoglia*, 2012 WL 1622497 (S.D.N.Y. May 9, 2012).
 - *In re Blixeth*, 2011 WL 3274042 (Bankr. D. Mont. Aug. 1, 2011).
 - *In re Byce*, 2011 WL 6210938 (D. Idaho Dec. 14, 2011).

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Discharge Actions

- Courts seem to agree that the determination of whether a debt is dischargeable under section 523 is within the Court's authority because the right to discharge is **established by the Bankruptcy Code** and is **central to the public bankruptcy scheme**.
 - *In re Muhs*, 2011 WL 3421546 (Bankr. S.D. Tex. 2011).
 - *In re Apostle*, 467 B.R. 433 (Bankr. W.D. Mich. 2012).
 - *In re Boricich*, 464 B.R. 335 (Bankr. N.D. Ill. 2011).
 - *In re Deitz*, 469 B.R. 11 (B.A.P. 9th Cir. 2012).
 - *In re Neves*, 2012 WL 1831717 (S.D. Fla. May, 17, 2012).

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Discharge Actions

- But what about actually determining the **amount of the non-dischargeable claim**, where liability involves state law?
 - A creditor may refuse consent, thinking he has a better shot of getting a big judgment in front of a jury in a state/federal court.
- Absent consent, some courts have expressed doubt about what a bankruptcy court can do:
 - *In re Galindo*, 467 B.R. 201 (Bankr. S.D. Cal. 2012) (noting that there is a question as to whether the bankruptcy court can enter a final money judgment in a discharge action).
 - *In re Ueberroth*, 2011 Bankr. LEXIS 5136 (Bankr. W.D. Mich. Dec. 19, 2011) (holding that it did not have authority to enter a monetary judgment in a non-dischargeability action, and submitting a report and recommendation).
- Ultimately, you are really just determining a creditor's claim. Thus, constitutional authority should exist.

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Fraudulent Transfers/Preferences

- One of the most debated issues in the post-*Stern* world is whether fraudulent transfers and preferences against non-creditors (which are also listed as “core proceedings”) may constitutionally be decided by bankruptcy courts.
- Most courts have concluded that, **in light of *Stern* and prior Supreme Court precedent (*Granfinanciera*), Article III does not permit a bankruptcy court to enter final judgment in such actions absent consent because they involve “private rights.”**
 - *In re Lyondell Chemical Co.*, 467 B.R. 712 (S.D.N.Y. 2012).
 - *In re Se. Materials, Inc.*, 467 B.R. 337 (Bankr. M.D.N.C. 2012).
 - *In re Davis*, 2011 Bankr. LEXIS 3764 (Bankr. W.D. Tenn. Oct. 5, 2011).
 - *In re Teleservices Group, Inc.*, 456 B.R. 318 (Bankr. W.D. Mich. 2011).
 - *In re Heller Ehrman, LLP*, 464 B.R. 348 (N.D. Cal. 2011).

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Fraudulent Transfers/Preferences

- Nevertheless, a number of bankruptcy courts have reached the opposite conclusion, **endorsing a “narrow” reading of *Stern***. These courts have held that *Stern* cannot be read to overrule the judicial power explicitly accorded by Congress to the bankruptcy courts.
 - *In re Refco, Inc.* 461 B.R. 181 (Bankr. S.D.N.Y. 2011).
 - *In re DBSI, Inc.*, 467 B.R. 767 (Bankr. D. Del. 2012).
 - *In re Apex Long Term Acute Care*, 465 B.R. 452 (Bankr. S.D. Tex. 2011).
- Notably, in *In re Global Technovations Inc.*, **694 F.3d 705 (6th Cir. 2012)**, the Sixth Circuit Court of Appeals held that a bankruptcy court has constitutional authority to finally determine fraudulent transfer actions **where the defendant filed a proof of claim**.
 - The court didn’t address the public/private rights distinction.

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In re Bellingham Insurance Agency, Inc.

- In *In re Bellingham Insurance Agency, Inc.*, 702 F.3d 553 (9th Cir. 2012), the Ninth Circuit did address the issue.
 - Prior to its filing, Bellingham sold insurance and annuity products.
 - On the eve of its filing, the debtor assigned insurance commissions to an insider who used such funds to start a new company.
 - The chapter 7 trustee sought to avoid and recover such funds as fraudulent transfers and the bankruptcy court granted summary judgment in its favor.
 - The district court affirmed and the defendant appealed.
 - Before the 9th Circuit, the defendant argued **for the first time** that *Stern* precluded the bankruptcy court from determining the fraudulent transfer claim in the absence of a filed proof of claim.

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In re Bellingham Insurance Agency, Inc.

- The Ninth Circuit held that, under *Stern*, the bankruptcy court **lacked authority to enter final judgment in the fraudulent transfer action.**
 - The court held that *Stern* “point[s] ineluctably to the conclusion that fraudulent conveyance claims, because they do not fall within the public rights exception [despite their statutorily core status], cannot be adjudicated by non-Article II judges.”
 - The court distinguished the Sixth Circuit’s *In re Global Technovations* opinion by noting that, in that case, the defendant had filed a proof of claim, thereby implicating section 502(d).
- Regarding the **statutory gap** issue, the court held that, despite the language of 28 U.S.C. 157(c), bankruptcy courts retain the “more modest power” to submit proposed findings to the district courts.
- Finally, the court held that the **Article III right was impliedly waived.**
 - An independent judiciary serves primarily to protect personal, not structural rights and, as a personal right, the constitutional “guarantee of an impartial and independent federal adjudication is subject to waiver.”

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Waldman v. Stone

- In *Waldman v. Stone*, 698 F.3d 910 (6th Cir. 2012), the Sixth Circuit Court of Appeals held that **a litigant could not waive its *Stern* rights.**
 - The debtor was defrauded by an investor in his company who convinced him to sell the company's assets to him for substantial consideration.
 - Unbeknownst to the debtor, the purchase documents that were signed did not reflect much of the promised consideration.
 - Moreover, the investor secretly made a side-deal with the debtor's bank to purchase the company's loan, thereby acquiring both the company's assets and its debt.
 - Upon discovering the fraud, the debtor filed a chapter 11 and: (i) sought to disallow the fraudster's claims, and (ii) brought a variety of state law fraud-related claims against him.
 - After trial, the bankruptcy court entered judgment in favor of the debtor on both the disallowance and fraud claims and awarded over \$3.9 million in compensatory and punitive damages.

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Waldman v. Stone

- On appeal to the Sixth Circuit, the investor argued for the first time that the bankruptcy court lacked authority under *Stern*.
- The Sixth Circuit agreed, **holding that the defendant could not waive his right to an Article III adjudication on the fraud claims.**
- The court reasoned that "Article III has a dual character: one part personal right of the litigant, **one part structural principal.**"
 - The issue is one of separation of powers:
 - "The issue is not so much the aggrandizement of the Legislative or Executive Branches, as it is the diminution of the Judicial one.... To the extent Congress can shift the judicial power to judges without these protections, the Judicial Branch is weaker and less independent than it is supposed to be."
 - Because the right to an Article III adjudication is inherently structural, **"it is not Waldman's to waive."**
 - Accordingly, the matter was sent back to the bankruptcy court for proposed findings of fact and conclusions of law.

(24)

Can you Waive or Consent?

- There is now a circuit split on the issue of whether a litigant can consent or waive its right to an Article III adjudication.
 - The Ninth Circuit says you can in *Bellingham*.
 - The Sixth Circuit says you cannot in *Waldman*.
- Does this make sense?
 - You can waive a jury trial right, which is generally viewed as a personal right.
 - Likewise, you can agree to permit a magistrate judge or arbitrator to resolve disputes.
- If you can consent/waive, how?
 - Can it be implied or must it be express?
 - Filing a proof of claim is not sufficient under *Stern* unless that claim and the cause of action must necessarily be resolved together.

[25]

Where Do We Go From Here?

- In August of 2012, the Judicial Conference of the U.S. Advisory Committee submitted **proposed rules in response to *Stern*** for public comment.
 - The proposed amendments remove the terms “core” and “non-core” from the Bankruptcy Rules and modify Rule 7016 (pretrial proceedings) to direct bankruptcy courts to decide authority/jurisdictional issues at the outset after inquiring about consent from the parties.
 - This is consistent with a S.D.N.Y. Local Rule (since adopted in several jurisdictions) which **requires a statement whether the proceeding is core or non-core and whether the parties consent to bankruptcy adjudication at the outset of litigation.**
- In light of *Waldman v. Stone*, however, these rules may not work, at least in the Sixth Circuit.

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Where Do We Go From Here?

- There will likely be increased motion practice early in the case to address *Stern* issues, resulting in additional costs and delays, at least until Congress or the Supreme Court acts.
- This may happen sooner rather than later though.
 - The defendant in *Bellingham* submitted a certiorari petition to the United States Supreme Court on April 3rd regarding the Ninth Circuit's determination on: (i) the statutory gap issue, and (ii) the consent/waiver issue.
 - It remains to be seen whether they will hear the matter.

[27]

Questions?

[28]