

Supreme Court Ruling in *Bellingham* Offers Comfort but Little Clarity

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A unanimous Supreme Court, in Executive Benefits Ins. Agency, Inc. v. Arkinson (In re Bellingham Ins. Agency, Inc.), 573 U.S. ____ (2014), confirmed a bankruptcy court's power to submit proposed findings of fact and conclusions of law for the district court's de novo review, even though such court is constitutionally barred from entering a final judgment on a bankruptcy-related claim under Stern v. Marshall. While the Bellingham decision mitigates the jurisdictional uncertainty left in Stern's wake, the Supreme Court's decision leaves several significant questions unanswered. While Bellingham leaves the terrain of bankruptcy court jurisdiction somewhat clearer, the bankruptcy jurisdictional statute still contains provisions that the Court has found are unconstitutional.

The Landscape of Bankruptcy Courts' Jurisdiction

Enacted in 1978, the Bankruptcy Code established a system of non-Article III¹ bankruptcy courts vested with broad jurisdiction to hear and determine all civil proceedings arising under or related to the Bankruptcy Code. Four years later, however, the Supreme Court in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, invalidated this grant of jurisdiction, holding that Congress could not grant non-Article III courts jurisdiction to finally decide state law claims that were merely "related to" a bankruptcy case because doing so removed "the essential attributes of judicial power from the Art. III district court." 458 U.S. 50, 87 (1982) (internal quotations omitted). Congress responded by enacting 28 U.S.C. § 157, which classified bankruptcy judges as non-Article III "units" of district courts and limited their authority to finally adjudicate matters to those arising under or arising in a case under the Bankruptcy Code. For cases merely "related to" a case under the Bankruptcy Code, bankruptcy court authority was limited to submitting proposed findings of fact and conclusions of law to the district court, which could then enter a final judgment.



¹ Article III, Section 1 of the U.S. Constitution mandates that the "judicial Power of the United States, shall be vested in one supreme Court, and in such other inferior Courts as the Congress may from time to time establish."

Section 157(b)	A bankruptcy judge may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11. Among proceedings expressly defined as “core” are “counterclaims by the estate against persons filing claims against the estate[.]”
Section 157(c)	A bankruptcy judge may hear a proceeding that is not a core proceeding but that is otherwise related to a case under title 11, and then submit the proposed findings of fact and conclusions of law to the district court, who may enter a final order or judgment after a <i>de novo</i> review.

Muddled Waters after *Stern v. Marshall*

In 2011, the Supreme Court threw the jurisdictional provisions of section 157 into disarray by holding, in *Stern v. Marshall*, 564 U.S. ___, 131 S. Ct. 2594 (2011), that Article III of the Constitution prohibits Congress from vesting a bankruptcy court with the authority to finally adjudicate certain claims even if those claims are listed as “core” claims under section 157(b) of the Judicial Code.

In *Stern*, the now-famous dispute over the estate of former Playboy model Anna Nicole Smith, the Supreme Court considered whether a debtor’s counterclaim against a creditor, an action specifically identified as a “core” proceeding in section 157(b), could be constitutionally adjudicated by a bankruptcy judge. In determining that it could not, the Court held that only an Article III judge has the constitutional authority to resolve such a dispute. The decision, crafted by Chief Justice Roberts, refused to allow Congressional enlargement of bankruptcy judges’ authority to resolve disputes between the debtor and a third party beyond the Court’s view of the proper Article I jurisdiction of legislatively created courts.

The *Stern* decision thus created a hole in the statutory scheme of jurisdiction for bankruptcy disputes set up in the Judicial Code. A claim designated for final adjudication in the bankruptcy court as a statutory matter, but prohibited from proceeding in that way as a constitutional matter was aptly named a “*Stern* Claim” by Justice Thomas. Because *Stern* failed to provide a substitute mechanism for how such claims *should* be addressed, the result was a “statutory gap” as wide as the unconstitutional provision itself: a *Stern* Claim is expressly defined as a “core” claim under section 157(b), but cannot be finally adjudicated by a bankruptcy court under section 157(b). However, the alternative statutory mechanism prescribed by section 157(c)—whereby the bankruptcy court submits proposed findings of fact and conclusions of law to the district court—by its terms applies only to non-core claims. Arguably, *Stern* drained bankruptcy courts of authority to act on *Stern* Claims, requiring all such claims to be heard by district courts in the first instance, although in practice, bankruptcy courts in most circuits labeled their *Stern* Claims rulings as proposed findings of fact and conclusions of law which then could be reviewed *de novo* by the district court. However, whether this practice comported with constitutional muster remained in jurisdictional limbo for three years until it was finally resolved by *Bellingham*.

Bellingham in the Lower Courts

In *Bellingham*, the Chapter 7 bankruptcy trustee sought to recover allegedly fraudulent transfers made by the debtor, Bellingham Insurance Agency, Inc. (“BIA”) to Executive Benefits Insurance Agency, Inc. (“EBIA”)—not itself a creditor—prior to filing for bankruptcy. The bankruptcy court granted summary judgment to the trustee, and the ruling was affirmed by the District Court after a *de novo* review.

EBIA appealed to the Ninth Circuit Court of Appeals, which likewise affirmed the ruling despite noting that *Stern*’s interpretation of Article III prohibited a bankruptcy court from entering final judgment on a fraudulent conveyance claim against a noncreditor absent the parties’ consent. *In re Bellingham Ins. Agency, Inc.*, 702 F.3d 553, 557 (9th Cir. 2012). The Ninth Circuit cited two alternative grounds for its decision: (i) EBIA had impliedly consented to the bankruptcy court’s jurisdiction to adjudicate the fraudulent

conveyance claim; and (ii) the bankruptcy court's judgment could be treated as a recommendation to the district court, whose affirmance upon a *de novo* review was sufficient as a final judgment for Article III purposes.

Circuit Split Concerning the Effect of Consent

The Ninth Circuit's decision in *Bellingham* formed the basis of a circuit split: the Sixth Circuit Court of Appeals' opinion in *Waldman v. Stone*, 698 F.3d 910 (6th Cir. 2012), issued several months earlier, completely rejected bankruptcy courts' constitutional authority to finally decide *Stern* Claims notwithstanding the parties' consent to a final adjudication by the bankruptcy court.

In *Waldman*, the debtor obtained a \$3 million bankruptcy court judgment based on a state law fraud claim against his creditor. Applying *Stern*, the Sixth Circuit decided that the bankruptcy court's judgment was unconstitutional because "the structural principle advanced by Article III" was not a personal right that could be waived. The case was remanded back to the bankruptcy court with instructions to recharacterize the judgment as a proposed ruling for district court review. As many courts allow litigants to expressly or impliedly waive their Article III right to have their *Stern* Claims adjudicated by Article III district courts, *Waldman* was the first Circuit-level decision to reject consent-based jurisdiction for *Stern* Claims.

The Supreme Court Ruling

Faced with a circuit split on the consent question, the Supreme Court accepted EBIA's petition for certiorari on June 24, 2013 and was thereby charged with determining whether the practice of submitting proposed findings and conclusions to the district court for review and approval is a constitutionally acceptable method for handling *Stern* Claims. The *Stern* ruling's effects had the potential to extend beyond the bankruptcy context: implicit in the issue before the Court was whether the practice of holding consent trials before U.S. Magistrates throughout the federal court system would likewise become unworkable.

In a unanimous opinion authored by Justice Thomas, the Supreme Court confirmed the power of a bankruptcy court to rule on *Stern* Claims subject to a federal district court's *de novo* review, thereby closing the gap created by *Stern*. Consequently, the Supreme Court held that the *Bellingham* bankruptcy court did not exceed the scope of its authority when it considered the fraudulent conveyance counterclaim against EBIA.

The Court flatly rejected the notion that *Stern*'s treatment of certain statutory "core" proceedings left bankruptcy courts powerless to adjudicate them under an alternative process (*i.e.*, as non-core claims under section 157(b)). Applying the well-known canon of statutory construction that favors "giv[ing] effect to the valid portion of a statute so long as it remains fully operative as a law," the Court concluded that bankruptcy courts can simply treat *Stern* Claims as non-core claims and adjudicate them accordingly. Assuming that the fraudulent conveyance claims were indeed *Stern* Claims, the Supreme Court found that the claims were clearly "related to" the bankruptcy case and fit within the scope of section 157(c). Further, while the bankruptcy court in *Bellingham* (in a ruling that predated *Stern*) had adjudicated the issue as a core proceeding and purported to enter a final judgment, the Supreme Court found the district court's *de novo* review was sufficient to retroactively "cure any potential error" in the pre-*Stern* lower court proceedings.

Unresolved Issues

While *Bellingham* ends a significant legal uncertainty by confirming that *Stern* Claims may be resolved via the procedural mechanics prescribed for non-core claims and provides assurance that a *de novo* review by

the district court cures any Article III deficiency in earlier proceedings (thereby eliminating *post hoc* challenges to jurisdiction like that in *Bellingham*), unresolved questions of consent and waiver remain.

Puzzlingly, the Supreme Court failed to address the issue at the heart of the circuit split: whether Article III permits a bankruptcy court to enter a *final* judgment on a *Stern* claim *with the consent of the parties*. Compare *Waldman*, 698 F.3d at 918 (“Waldman’s objection thus implicates not only his personal rights, but also the structural principle advanced by Article III. And that principle is not Waldman’s to waive.”), *with In re Bellingham Ins. Agency*, 702 F.3d at 566. (“The waivable nature of the allocation of adjudicative authority between bankruptcy courts and Article III courts is well established.”)

Perhaps more troubling still is that, because the authority for federal magistrate judges to issue final judgments under the Federal Magistrates Act is very similar to the current statutory authority upon which bankruptcy judges have statutory authority to issue final judgments with the consent of litigants, the effects of *Waldman*, which holding remains largely intact even after *Bellingham*, may reach far beyond the bankruptcy context. In light of the continued uncertainty regarding bankruptcy courts’ Constitutional powers, the risk of waiver should remain a significant factor in considering an early objection to a bankruptcy court’s purported jurisdiction.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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