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Bankruptcy Advisory

Did The Supreme Court Finally Explain *Marathon* And *Stern*?

Executive Benefits' Impact on Bankruptcy Court Jurisdiction

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The Supreme Court has spoken once again on the limited jurisdiction of the bankruptcy courts, adding to the understanding derived from *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), *Granfinanciera v. Nordberg*, 492 U.S. 33 (1989), *Langenkamp v. Culp,* 498 U.S. 42 (1990) and *Stern* v. *Marshall*, 131 S. Ct. 2594 (2011*). Executive Benefits Insurance Agency v. Arkinson*, *Chapter 7 Trustee of the Estate of Bellingham Insurance Agency, Inc.,* 573 U.S. __ (2014) is the Supreme Court's fifth significant case exploring bankruptcy court jurisdiction under the Bankruptcy Code.

A brief and simplified history of bankruptcy jurisdiction may be helpful in understanding where we are today. The Bankruptcy Code (the "Code") became effective in 1978. Before then, bankruptcy was governed by the Bankruptcy Act (the "Act"), which became effective in 1898. Under the Act, bankruptcy judges (called bankruptcy referees until 1974) could hear matters relating to the administration of the estate (such as proof of claim determinations and asset sales) as well as civil proceedings dealing with estate assets in the custody of the estate (called summary jurisdiction). However, bankruptcy judges could not hear civil proceedings between the estate and a third party if the proceeding entailed recovering assets or damages from the third party and the third party had a colorable right or defense (called plenary jurisdiction). So, a state law cause of action against a third party had to be conducted in a federal district court or a state court. The exception to this rule was consent — if the third party consented to the bankruptcy court hearing the litigation, or did not timely object to the bankruptcy court hearing the matter (implied consent), then the bankruptcy court could decide the matter.

In *Katchen v. Landy*, 382 U.S. 3223 (1965), the Supreme Court extended summary jurisdiction by concluding that if a creditor filed a claim, the bankruptcy court could hear fraudulent conveyance actions as part of the claims objection process. This is because section 57(g) of the Act (now section 502(d) of the Code) provided that the filed claim must be disallowed unless all preferences and fraudulent conveyances had been returned (*Katchen* was cited approvingly in *Marathon* and *Stern*, and therefore almost certainly remains good law). Pursuant to *Katchen*, the bankruptcy court would have to determine if there was a fraudulent conveyance as part of its deciding whether the claim was to be allowed or disallowed. Absent this *Katchen* expansion, or the express or implied consent exception discussed above, preference and fraudulent conveyance issues could not be decided by the bankruptcy court.

Congress was concerned that this complicated jurisdictional scheme was delaying the administration of bankruptcy cases and significantly increasing the costs for the estate. Further, the delays caused by the jurisdictional tiffs and the more formal and slower processes of the district or state courts, gave enormous leverage to the third party defendant in settling the matter. As a result, Congress sought to address these issues when drafting the Code, implementing substantial changes. Most significantly, the Code divided cases into three categories: (a) cases "arising in" the bankruptcy case (those proceedings that are not based on any right expressly created by title 11, but that would have no existence outside of the bankruptcy), (b) cases "arising under" the bankruptcy case (those proceedings that involve a cause of action created or determined by a statutory provision of title 11), and (c) cases "related to" the bankruptcy case (those proceedings that are independent from the bankruptcy case but related to the outcome of the bankruptcy case; for example, a suit by

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- Bankruptcy, Restructuring & Commercial Law a trustee to recover damages from a third party). By including the “related to” cases among the cases that a bankruptcy court could decide, the distinction between summary jurisdiction and plenary jurisdiction was seemingly eviscerated by the Code; all three categories could be heard and finally decided by the bankruptcy courts. Yet, case law since the Code’s passage has scaled back this interpretation, replacing it with a variation of the summary and plenary jurisdictional distinctions that existed under the Act.

In 1982, the Supreme Court decided *Marathon*, determining that Congress’ grant of jurisdiction to the bankruptcy court to hear state law actions against a third party to collect assets for the estate was unconstitutional. An Article III court (e.g., federal court) was required to finally decide such matters (a final judgment is a decision on the merits subject only to appeal). Therefore, a case (i) in which the government was not a party, (ii) that was brought by a trustee against a third party, (iii) that was based on a state law cause of action, and (iv) that was brought for the purpose of augmenting the bankruptcy estate, could not be finally determined by a bankruptcy court.

Congress responded to *Marathon* by amending the jurisdictional provisions of the Code in 1984. Through 28 U.S.C § 1334, the district courts were provided jurisdiction over civil proceedings arising in, arising under, and related to a bankruptcy case. Therefore the district court was provided jurisdiction over all civil proceedings that impact the outcome of the bankruptcy case. Further, 28 U.S.C. § 157 allowed the district court to refer all civil actions, whether arising in, arising under, or related thereto, to the bankruptcy court. However, bankruptcy courts were not authorized to issue final judgments with respect to all types of referred cases. Instead, section 157(b)(1) authorized a bankruptcy court to “hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11.” While bankruptcy courts could hear non-core, but related-to, proceedings, in those matters the bankruptcy court could only issue proposed findings of fact and conclusions of law to the district court. The final order is to be entered by the district court after considering the bankruptcy Judge’s finding and conclusions. However, the district court is instructed by section 157(c)(1) to review *de novo* matters to which a party has timely and specifically objected (*de novo* review means a fully independent review with no deference being paid to the lower court decision or recommendation). Note that, similar to the rules under the Act, a consent exception continued to exist under section 157(c)(2). With the consent of all parties, even related to proceedings could be finally determined by bankruptcy courts. In many respects the differences between summary jurisdiction and plenary jurisdiction were resurrected using a different name. In this situation there actually were two different categories created: (1) arising in/arising under versus related to; and (2) core versus non-core. It is not clear why two sets of categories were used and, as will be discussed, that use ultimately led to the result in Stern.

To attempt to illustrate the core/non-core distinction, Congress provided a non-exhaustive list of “core” proceedings in section 157. However, that list included types of core civil proceedings that *Stern* determined could not be constitutionally delegated to the bankruptcy courts for final determination. Notwithstanding the statute’s apparent mischaracterization of certain types of claims, this regime seemed to work reasonably well for the bankruptcy process, and it provided a degree of certainty. On the other hand, having to go to Article III or state courts did lead to some of the increased cost and delay that Congress feared. Nonetheless, the Supreme Court continued to shape Congress’ jurisdictional scheme.

In *Granfinanciera*, the Supreme Court decided in 1989 that a defendant had a right to a jury trial in a fraudulent conveyance case and that the test for Seventh Amendment jury trial purposes was the same as the test for an Article III determination (on whether an issue requires a final determination in the district court). Since *Granfinanciera* was a Seventh Amendment case, it could conceivably be argued that the Article III reference was merely dicta and of no precedential effect. Yet, it was a fairly clear pronouncement on the issue, and a year later the Court reached the same conclusion with respect to the right to jury trials in preference actions in *Langenkamp*. The Court held that once a claim is filed, the bankruptcy court has the authority to determine the preference claim under its equitable power in deciding the allowance or disallowance of the claim. There is no right to a jury trial for such equitable actions. If no claim is filed in the bankruptcy case, preferences and fraudulent conveyances are the type of actions for which there traditionally has been a jury trial right. While *Granfinanciera* and *Langenkamp* were “right to jury trial” cases, the Supreme Court’s statement that the same test should be used to determine whether the bankruptcy court could issue a final order on fraudulent conveyances may have foreshadowed *Stern* and *Executive Benefits*.

Stern pointed out that even if a particular action is treated as "core" by section 157, such matter might still be the type of action that requires final resolution in an Article III court. As the Supreme Court recognized in *Stern*, the counterclaim by the trustee in that case was about a state created right and the counterclaim was designed to augment the bankruptcy estate. Such action was deemed by the Court to be a private action which could not be delegated to a non-Article III court for final determination. Through *Stern*, the Supreme Court recognized that there are some causes of action which are labeled as core in section 157, but that the Constitution still requires to be finally determined by a state court judge or an Article III judge. Not surprisingly, the Supreme Court in *Executive Benefits* reiterated that *Stern* had established that statutory authority granting jurisdiction to the bankruptcy courts can be unconstitutional if the issue is one that must be determined by an Article III judge, like a district court judge. However, *Executive Benefits* dealt with a fraudulent conveyance action rather than a state law based counterclaim.

In *Executive Benefits*, Nicholas Paleveda and his wife owned and ran two companies — Aegis Retirement Income Services, Inc. ("Aris") and Bellingham Insurance Agency, Inc. ("Bellingham"). In January 2006, Bellingham had become insolvent and ceased operations. The Paleveda's used funds of Bellingham to start a new company, Executive Benefits Insurance Company, Inc. ("Executive"). A scheme was devised to transfer assets from Bellingham to Executive.

On June 1, 2006, Bellingham filed a voluntary bankruptcy in the United States Bankruptcy Court for the Western District of Washington. Peter Arkinson was appointed the Chapter 7 trustee. Arkinson filed suit against Executive claiming that the transfer of assets from Bellingham to Executive was a fraudulent conveyance. The bankruptcy court granted summary judgment in favor of Arkinson. Executive appealed the determination to the district court. The district court conducted a *de novo* review and affirmed the bankruptcy court's decision. Executive appealed to the United States Court of Appeals for the Ninth Circuit. It was not until Executive filed its brief in the Ninth Circuit that the Supreme Court issued the decision in *Stern*. Executive then moved to dismiss its appeal for lack of jurisdiction, arguing that Article III did not permit Congress to vest authority in a bankruptcy court to finally decide the trustee's fraudulent conveyance claims. The Ninth Circuit rejected its motion to dismiss and confirmed the district court decision. The Supreme Court upheld the Ninth Circuit and the district court decisions.

Prior to the Supreme Court's ruling in *Executive Benefits,* much had been unclear and unresolved; *Executive Benefits* has provided at least some clarity. While *Stern* had explained the procedural rules for deciding "core proceeding" and "non-core proceedings," there was no statutory direction for the procedure governing actions that the statute designated as "core," but which were not allowed to be treated as "core" because of the constitutional limits of bankruptcy court jurisdiction. These claims have been called "gap" claims or *Stern* claims. The Supreme Court in *Executive Benefits* concluded that gap claims should be treated, procedurally, just like statutory non-core claims. That is, the bankruptcy court may issue proposed findings and conclusions subject to the *de novo* review of the district court and the district court may issue a final order on these claims.

In further analyzing gap claims, the Court in *Executive Benefits* examined whether a fraudulent conveyance claim was a "core" proceeding or a gap claim. The Court did not actually reach a decision, but rather adopted the conclusions of the circuit court that such claims cannot constitutionally be finally decided by the bankruptcy court, which instead may only issue proposed findings and conclusions for the district court to consider *de novo*. Because neither party contested that this was the law, the Supreme Court avoided making such a determination. The Court did seem favorably disposed to the circuit court's ruling that (at least when no proof of claim has been filed by the defendant) fraudulent conveyance claims may not be determined finally by the bankruptcy court. Thus, for purposes of the case, the Court established another type of gap claim (fraudulent conveyance claims) which were to be treated like the state law action in *Stern*. In other words, the Court reaffirmed that the bankruptcy court cannot finally determine all "related to" matters simply because Congress designates such matters as core.

Ultimately, the Court decided to dismiss the appeal because Executive received all of the procedural protection it was entitled to under the Constitution. While not exactly in accordance with the usual procedure, Executive was the beneficiary of a *de novo* determination of the district court on the propriety of the bankruptcy court's summary judgment determination.

The *Executive* decision left two major issues to be decided in a later case. According to footnote 4 in the slip opinion, the Supreme Court decided that under the circumstances, the constitutional concerns had been properly dealt with when the district court reviewed the bankruptcy court *de novo* and entered a final order (no harm, no foul). Therefore there was no need for the Court to decide other critical issues in the case. Accordingly, the Court did not consider whether Executive impliedly consented to bankruptcy court jurisdiction to enter a final order by participating in the case without objection. Further, the Court did not consider whether consent to jurisdiction to enter final orders is even valid under the Constitution. Section 157 specifically provides for the opportunity for all parties to consent and for the matter to be finally decided by the bankruptcy court. That language, of course, does not make such a grant of jurisdiction constitutional.

In conclusion, prior to the passage of the Code, the bankruptcy court jurisdiction over litigation under the Act divided cases between summary and plenary jurisdiction. This distinction is very similar to the concepts used today when distinguishing between "core" and "non-core" proceedings or, alternatively, when distinguishing between matters which "arise under" or "arise in," from those that "relate to" a bankruptcy case. Under the Act, consent was sufficient to allow the bankruptcy court to hear and finally determine plenary actions — this rule has existed for nearly 150 years. If the Court ultimately decides that consent may confer jurisdiction, and that consent may be implied by failure to object timely, then the landscape will look remarkably similar to how it was under the Act. However, the Court may determine that consent cannot overcome jurisdictional deficiencies. Will the Court decide that 150 years of established jurisprudence is unconstitutional? Stay tuned and find out.

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