U.S. Supreme Court to Reexamine Bankruptcy Jurisdiction.... ...*Again!*

By Jeffrey A. Wurst, Esq. and Jon H. Ruiss, Jr., Esq.

Stern v Marshall was not the first time the Supreme Court addressed Bankruptcy Court jurisdiction. The 1982 Northern Pipeline and 1989 *Granfinanciera* cases redefined Bankruptcy Court jurisdiction. Last year, the Court again curtailed the powers of the Bankruptcy Courts in *Executive Benefits*. Just when you thought it was safe to go back in the water……. the Supreme Court will hear *Wellness International Network, Ltd., v. Sharif*, where it will address additional jurisdictional issues. In this must read article, Jeff Wurst discusses this evolving jurisprudence and its effects on lenders.

Members of the US Supreme Court pose for a group photograph at the Supreme Court building on September 29, 2009 in Washington, DC. Front row (L-R): Associate Justice Anthony M. Kennedy, Associate Justice John Paul Stevens, Chief Justice John G. Roberts, Associate Justice Antonin Scalia, and Associate Justice Clarence Thomas. Back Row (L-R), Associate Justice Samuel Alito Jr., Associate Justice Ruth Bader Ginsburg, Associate Justice Stephen Breyer, and Associate Justice Sonia Sotomayor. (Photo by Mark Wilson)

The United States Supreme Court, as well as its *federal courts*, have been preoccupied with bankruptcy jurisdiction. Only months after its decision in *Executive Benefits Insurance Agency v. Arkison*, the Supreme Court has agreed to address similar issues presented in *Wellness* International Network, Ltd. v. Sharif. *Wellness* is the third case in four years where the Supreme Court will address the often-befuddled issue of bankruptcy court jurisdiction.

The first of these three cases was *Stern v. Marshall*, which was decided in 2011. That case focused on the late Anna Nicole Smith and her bankruptcy trustee's efforts to recover her inheritance from the estate of her late husband, J. Howard Marshall. Salient to the case was the Court's removal of certain powers traditionally thought to have been vested in the bankruptcy court. In effect, the case set forth a momentous change in practice in the bankruptcy court. The Supreme Court's holding in *Stern* stated that bankruptcy courts lacked the constitutional authority to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim.

The second installment in this series of cases was *Executive Benefits Insurance Agency v. Arkison,* decided in June of 2014. *Executive Benefits* raised a series of follow-up questions resulting from the confusion that stemmed from the Court's decision in *Stern*. Many practitioners anticipated that the Supreme Court would use *Executive Benefits* to provide a more explanative ruling. Although the Supreme Court did, in fact, shed some light on the questions and issues raised by *Stern*, it did not fully address the follow-up issues raised by *Stern*. The Supreme Court essentially held that, when a bankruptcy court is presented with a "*Stern* claim", it may only issue proposed findings of fact and conclusions of law instead of a final judgment. The Supreme Court did not address the lingering issue of litigant consent, which is the subject of *Wellness*.

Wellness presents three distinct

questions for the court to consider: (i) whether the powers of Article III, life-tenured judges, can be exercised by a bankruptcy judge by consent of the parties; (ii) whether that consent can be implied; and (iii) if a case involves a subsidiary issue of state property law, whether the bankruptcy court may issue a final decision on that issue.

In order to understand the potential impact of the *Wellness* case and its predecessors, it is necessary to examine the historical context surrounding this area as well as the evolution of bankruptcy court jurisdiction. The core issues in *Wellness* arise with the method by which United States Constitution divides powers amongst the different branches of the federal government and, specifically, the judicial branch. Article III of the Constitution requires that federal district court judges be appointed by the President with the advice and consent of the Senate. Article III judges, as they are commonly referred to, are tenured for life and are not subject to any salary decrease. These judges hold office for "good behavior," which means that they can only be removed by impeachment. These benefits were put in place to promote an unbiased and independent judiciary.

Bankruptcy judges, on the other hand, are appointed by federal circuit courts of appeals for 14-year terms. Additionally, bankruptcy judges' salaries are subject to Congressional action. The powers of the bankruptcy judges are created solely by statute and are limited to the adjudication of bankruptcy matters. Bankruptcy judges may possess special knowledge and training, but they lack the Constitutional authority possessed by Article III judges.

Another key difference between Article III judges and bankruptcy judges is that Article III judges may enter "final" decisions on matters pending before them. A final decision is one that can be appealed to a higher court and ends the current litigation. The Bankruptcy Code authorizes bankruptcy judges only to make final decisions on proceedings categorized by Congress as "core" proceedings. For instance, bankruptcy judges had typically been authorized by statute to enter final decisions on fraudulent transfer claims, but that power recently came into question under *Stern*. The Court's decision in *Stern* muddied these waters. Under *Stern*, litigants that were defending fraudulent transfer claims and had not filed proofs of claim or otherwise submitted to the jurisdiction of the bankruptcy court were free to have their cases tried before an Article III judge rather than a bankruptcy judge. Consequently, what had been a routine power of bankruptcy judges disappeared, which materially shifted the power dynamics within the federal court system by moving the power of the bankruptcy court to hear and enter final decisions to the district courts.

The issues presented by *Wellness* and its predecessors began to take shape as far back as 1978. In 1978, Congress enacted the Bankruptcy Code which replaced the prior outdated Bankruptcy Act. The Bankruptcy Code, originally bestowed upon bankruptcy courts powers that were otherwise reserved for Article III judges sitting in federal district courts.

The Supreme Court's 1982 decision in *Northern Pipeline* Construction v. Marathon Pipe Line, voided Congress' grant of statutory power to the bankruptcy court on the grounds that it violated the Constitution's separation of powers by allowing Congress to hire and fire bankruptcy judges. This decision threatened to collapse the framework of the new bankruptcy system created by Congress. Congress hastily took action to remedy the issue by amending the Bankruptcy Code to allow bankruptcy judges to issue final decisions only on "core" matters.

The Court in *Northern Pipeline* also addressed another important aspect of federal court jurisdiction – the "public rights" exception. Under the public rights exception, a non-Article III judge, or a judge serving in a legislatively created tribunal, may enter a final decision on certain types of matters that are considered public rather than private. These public matters include certain claims created by Congress that flow from a federal statutory scheme. Since bankruptcy courts are an example of a legislatively created tribunal, the Supreme Court in *Northern Pipeline* recognized the public rights exception as a way for bankruptcy judges to enter final decisions on certain matters.

All remained quiet until 1989 when the Court decided the next significant case addressing bankruptcy court jurisdiction, *Granfinanciera,* S.A. v. Nordberg. The public rights concept was again addressed in *Granfinanciera*. In *Granfinanciera,* the Court held that, in a fraudulent transfer action, a defendant who did not file a proof of claim–subjecting it to the bankruptcy court's jurisdiction–was entitled to a jury trial before the district court. The Supreme Court made clear that Congress could not deprive a defendant on a fraudulent transfer claim the right to a jury trial because a fraudulent transfer action was not recognized as a public right subject to the exception. The Court deemed the right to a jury trial in that situation as a private right, however, the Court expressly declined to address whether the bankruptcy court could conduct a jury trial, leaving further questions unanswered. In 1994, Congress reacted to the *Granfinanciera* decision by amending the statute to allow bankruptcy courts to conduct jury trials with the consent of the parties, a key aspect in the issues facing the Court in *Wellness*.

Since these cases, the district courts have retained jurisdiction over bankruptcy cases, and each district court has issued a "standing order of reference", whereby bankruptcy matters are automatically referred to the bankruptcy courts. The reference system encourages district courts to delegate power to bankruptcy judges in order to create judicial economy, just as the district courts delegate authority to their magistrate judges, also Article I judges. As it stands, the Bankruptcy Code authorizes bankruptcy courts to hear and determine "core" proceedings and to make recommendations to the district courts of findings of fact and conclusions of law with respect to "noncore" proceedings.

The reference system remained in place until *Stern v. Marshall*. In fact, practitioners had thought that the Supreme Court laid to rest jurisdictional questions regarding the bankruptcy court by *Northern Pipeline* and *Granfinanciera*. The Supreme Court's decision in *Stern* further curtailed the powers of the bankruptcy judges. The Supreme Court noted that even though the bankruptcy court had the authority to render a final decision by statute, the statute itself was unconstitutional. Essentially, the Supreme Court held that bankruptcy judges could only issue final decisions on certain types of proceedings. Conversely, the bankruptcy court could only issue findings of fact and conclusions of law on all other proceedings. These proceedings have become *Stern* claims.

Stern also discussed the public rights exception. In *Stern*, the high court also held that bankruptcy courts cannot enter a final decision on a state law claim that does not fall within the public rights exception. A final decision in this situation must be reserved for the district courts. *Wellness* will revisit this issue as the Court has certified the question of whether a subsidiary state property law issue against a bankruptcy estate may be adjudicated by the bankruptcy court. Essentially, *Wellness* presents the Supreme Court with the opportunity to determine whether bankruptcy courts may enter final judgments on *Stern* claims if the parties consent; and, if so, whether a party may impliedly consent to jurisdiction through its conduct.

Although the Supreme Court intended that its decision in *Stern* be interpreted narrowly, the case's progeny demonstrates that there are many unanswered questions and a multitude of issues regarding the bankruptcy court's powers over certain proceedings, especially *Stern* claims. In the litany of cases decided post-*Stern* many federal courts have come to inconsistent conclusions on how to apply the law. The uncertainty created by *Stern* centered mostly on how courts should apply to the case law already in place the jurisdictional statute as amended by Congress.

The confusing questions and inconsistent case law that developed as a result of *Stern* prompted many practitioners to eagerly await a decision in the next big case, *Executive Benefits* v. Arkison. In fact, *Executive Benefits* put to bed many of the concerns raised by *Stern*. In *Executive Benefits*, the court held that the relevant statute governing bankruptcy jurisdiction allows the bankruptcy court to issue findings of fact and conclusions of law, which may be reviewed anew by the district court on claims such as the ones addressed in *Stern*. However, questions still remained unanswered. The Supreme Court punted on the issue of whether a bankruptcy judge may enter a final judgment on a *Stern* claim where the parties consented to the bankruptcy court's jurisdiction.

In *Wellness*, the Supreme Court has agreed to address whether parties may consent to the final adjudication of *Stern* claims on consent. It will be interesting to see what the Supreme Court will have to say regarding its decision in *Stern* and *Executive Benefits*. The Supreme Court in its *Stern* decision noted that it did not intend to create an imbalance in the division of labor between the bankruptcy court and the district court. However, some bankruptcy practitioners are of the mindset that the Supreme Court's recent decisions have added unnecessary time and expense to the bankruptcy litigation process, essentially requiring a "trial run" at the bankruptcy court and then "the real thing" at the district court.

Additionally, if the power is shifted to the district courts, some practitioners believe that the results of litigation will be less predictable and the process unreliable because bankruptcy judges have special knowledge and experience that district court judges do not possess. Since bankruptcy litigation is complex and fast-moving, these practitioners feel that the district court may be burdened with issues that a bankruptcy court would otherwise have the expertise to deal with quickly and efficiently. Others believe that by defending themselves in the district court, they will deprive debtors and trustees of the "home field advantage." These practitioners, however, would welcome the shift, as it promotes practice before the district courts where they feel their client would be better treated. The potential for overworked and over-burdened district courts has already been noted by the Supreme Court.

The issue of consenting to a bankruptcy court's jurisdiction is an interesting one–especially to lenders. Should the Court decide that parties may not consent (including implied consent by the filing of a proof of claim or being a party to a cash collateral order, etc.), it may give more leverage to lenders wishing to litigate in district court. It will also create a powerful litigation tactic for practitioners who routinely represent lenders. However, if the Court decides that parties may consent, even impliedly, lenders may be forced to defend themselves in bankruptcy court. Stay tuned. **TSL**

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