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Practice Update

Supreme Court Clarifies Procedure for Deciding Stern Claims in Bankruptcy Courts, But Leaves Big Questions Unresolved

June 27, 2014

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Bankruptcy courts have jurisdiction over "core" and "non-core" proceedings. *See* 28 U.S.C. § 157. In "core" proceedings, bankruptcy courts can enter final judgments. *See* 28 U.S.C. § 157(b). In "non-core" proceedings, however, bankruptcy courts must make findings of fact and conclusions of law and send their rulings to the district court for *de novo* review. *See* 28 U.S.C. § 157(c).

In certain circumstances, Article III of the U.S. Constitution prohibits a bankruptcy court from entering a final judgment on a claim, even though it is designated as a "core" claim under § 157(b). *See Stern v. Marshall*, 131 S. Ct. 2594, 2608-20 (2011). In the vernacular, these claims are called "*Stern* claims." In the wake of *Stern*, there was no clear procedure for dealing with a *Stern* claim because lower courts assumed they were neither "core" nor "non-core" proceedings. *See In re Bellingham Ins. Agency, Inc.*, 702 F. 3d 553, 565 (9th Cir. 2012).

Holding

In *Executive Benefits Ins. Agency v. Arkison* (*In re Bellingham Ins. Agency, Inc.*), 573 U.S. ____ (June 9,

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2014), the Supreme Court clarified the procedure that bankruptcy courts should follow when they are presented with a *Stern* claim: they should proceed as if the claim were "non-core," sending findings of fact and conclusions of law to the district court for *de novo* review.

Background on Bankruptcy Courts' Jurisdiction

Before 1978, bankruptcy matters within the "summary jurisdiction" of the bankruptcy courts were referred by the federal district courts to specialized bankruptcy referees. *See Bellingham*, 573 U.S. at *4. In 1978, Congress enacted the Bankruptcy Reform Act which eliminated the "summary" distinction and mandated that "bankruptcy judges 'shall exercise' jurisdiction over all civil proceedings arising under title 11 or arising in or related to cases under title 11.'" *See Bellingham*, 573 U.S. at *5.

In 1984, Congress enacted the Bankruptcy Amendments and Federal Judgeship Act, providing that federal district courts have original jurisdiction in bankruptcy cases and that they may refer to bankruptcy judges any "proceedings arising under title 11 or arising in or related to a case under title 11." *See Bellingham*, 573 U.S. at *6. In that act, Congress created "core" and "non-core" designations, which are codified in 28 U.S.C. § 157. *See Bellingham*, 573 U.S. at *6-7. As explained in *Bellingham*, the distinction between "core" and "non-core" is as follows:

If a matter is core, the statute empowers the bankruptcy judge to enter final judgment on the claim, subject to appellate review by the district court. If a matter is non-core, and the parties have not consented to final adjudication by the bankruptcy court, the bankruptcy judge must propose findings of fact and conclusions of law. Then, the district court must review the proceeding *de novo* and enter final judgment.

Bellingham, 573 U.S. at *7. The distinction between

"core" and "non-core" was clear until *Stern*.

Stern and the "_Stern_ Gap"

In *Stern*, the Supreme Court dealt with an apparent conflict between 28 U.S.C. § 157 and Article III of the U.S. Constitution. The Court held that Congress had violated Article III by granting the bankruptcy court the power to enter a final judgment on certain claims (*e.g.*, a counterclaim for tortious interference against a creditor that had filed a proof of claim in the bankruptcy case). *See Bellingham*, 573 U.S. at *8 ("*Stern* made clear that some claims labeled by Congress as 'core' may not be adjudicated by a bankruptcy court in the manner designated by § 157(b)"). But the *Stern* Court did not explain what should be done when a bankruptcy court is presented with such a claim.

Confusion arose when lower courts attempted to apply the *Stern* holding. *See Bellingham*, 573 U.S. at *9. Since *Stern* claims are not "core," § 157(b) does not apply; and since *Stern* claims are not "non-core," § 157(c) does not apply. Lower courts called this the "*Stern* Gap." *See id.* In *Bellingham*, the Court resolved the confusion by holding that "[t]he statute permits *Stern* claims to proceed as non-core within the meaning of § 157(c)." *Id.*

Factual and Procedural Background of the Case

In *Bellingham*, the chapter 7 trustee brought claims for fraudulent conveyance against Executive Benefits Insurance Agency ("EBIA"), and others. *See Bellingham*, 573 U.S. at *2. Under the Bankruptcy Code, an action for fraudulent conveyance is a "core" proceeding. *See* 11 USC 157(b)(2)(H).

The Bankruptcy Court heard the claims and granted summary judgment; EBIA appealed and the district court conducted a *de novo* review, affirming the bankruptcy court; EBIA appealed to the Ninth Circuit Court of Appeals, which affirmed the district court. *See Bellingham*, 573 U.S. at *2-3. While the case was

on appeal, the *Stern* decision was issued. *See id.* at *3. In light of *Stern*, EBIA moved to dismiss for lack of jurisdiction. *See id.* The Ninth Circuit agreed that the fraudulent conveyance claims were *Stern* claims. See id. However, the Ninth Circuit denied the motion to dismiss because: (1) EBIA had impliedly consented to the Bankruptcy Court's jurisdiction; and (2) if the Bankruptcy Court's jurisdiction was limited to proceeding under § 157(c), it could be deemed to have done so since the district court indeed had conducted a *de novo* review. *See id.*

On review, the Supreme Court adopted the Ninth Circuit's holding that fraudulent conveyance claims were *Stern* claims, even though the Ninth Circuit did not make this point clear. *See Bellingham*, 573 U.S. at *11 ("The Court of Appeals held, and we assume without deciding, that the fraudulent conveyance claims in this case are *Stern* claims"). The Court ruled that because the claims were *Stern* claims and because they were handled in the manner set forth under § 157(c), with the district court conducting a *de novo* review (albeit on appeal), final judgment on the claim was proper. *See id.* at *12.

Implications

With *Bellingham* and *Stern*, bankruptcy lawyers have ample tools for arguing that certain claims must be sent to the district court for *de novo* review.

Lingering Issues

While *Bellingham* ends a significant legal uncertainty by confirming that *Stern* claims may be resolved pursuant to the statutory mechanics prescribed for non-core claims and provides assurance that a *de novo* review by the district court can cure any Article III deficiency in earlier proceedings, unresolved questions of consent and waiver remain. Under 28 U.S.C. § 157(c)(2), bankruptcy courts may enter final judgments on non-core and *Stern* claims if the parties consent. *See Bellingham*, 573 U.S. at *12. The Ninth Circuit Court

of Appeals ruled that EBIA had consented to the bankruptcy court's jurisdiction, but the *Bellingham* Court declined to review this decision. *See id.* at 13 ("we need not decide whether EBIA's contentions [regarding waiver and consent] are correct...").

By not addressing whether EBIA consented to the bankruptcy court's jurisdiction – much less whether it *could* consent – the Court left unanswered the question of what constitutes "consent" under 28 U.S.C. § 157. Perhaps more important, however, the Court left unresolved an apparent split between the Circuit Courts of Appeal as to whether a party may consent to the bankruptcy court's jurisdiction over *Stern* claims at all. *See Waldman v. Stone*, 698 F. 3d 910, 918 (6th Cir. 2012) (Article III protections cannot be waived because they implicate "the integrity of judicial decision making" rather than mere personal rights).

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. Litigants should be particularly careful not to "consent" to a bankruptcy court's jurisdiction by failing to timely challenge the court's jurisdiction in accordance with language included in a court's standard pre-trial order. While *Bellingham* did not address the issue, many bankruptcy courts (including the Middle District of Florida, Tampa Division) include an "opt-out" provision in their pre-trial orders, which sets a deadline for a party to file a motion requesting that the court determine whether the proceeding is "core" or otherwise subject to the entry of final orders by the court, otherwise the parties are deemed to have consented to the entry of final orders in the proceeding. Litigants must be careful not to waive their fundamental rights to *de novo* review of their case before a district court judge ...at least until the *Waldman* split is resolved.