Client Alert

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United States Supreme Court Clarifies (Slightly) Limitations on Bankruptcy Court's Jurisdiction

The Supreme Court has issued two opinions on the subject of bankruptcy court authority and jurisdiction in recent years. The first opinion, *Stern v. Marshall*, 564 U.S. ___, 131 S.Ct. 2594 (2011) was a 5-4 split from 2011 that roiled the bankruptcy waters by raising many questions about the constitutionality of the jurisdiction and authority Congress has provided to bankruptcy courts. The more recent opinion—*Executive Benefits Insurance Agency v. Bellingham, Chapter 7 Trustee of Estate of Bellingham Insurance Agency, Inc.*, ___ U.S. ___, No. 12-1200 (June 9, 2014)—was decided unanimously, and is noteworthy because it answered at least one question raised by *Stern v. Marshall*.

A brief bit of background: generally speaking, federal courts are divided between courts created under Article III of the United States Constitution, and everything else. Bankruptcy courts are not Article III courts because bankruptcy judges do not have the life tenure or salary protections required by the Constitution. Since bankruptcy courts are not authorized under Article III of the Constitution, the ability of bankruptcy courts to exercise "judicial powers" is limited since the Constitution reserves such powers for the Article III courts.

When it comes to bankruptcy jurisdiction, Congress divided the types of matters that may be heard in a bankruptcy case as being either "core" or "non-core" proceedings. Core proceedings, as defined by Congress, consist of the quintessential functions of the bankruptcy process—discharging debts, liquidating assets of the debtor, and distributing the proceeds of those assets to creditors. Broadly speaking, everything else is non-core.

To exercise the bankruptcy jurisdiction, Congress provided bankruptcy courts with authority to enter final judgments in core proceedings, but reserved for the Article III district courts the authority to enter final judgments in non-core proceedings. To streamline the process, for non-core proceedings, Congress provided that bankruptcy courts may "hear the proceeding and submit proposed findings of fact and conclusions of law to the district court for *de novo* review and entry of judgment." This means that the Article III district court ultimately exercises the judicial power, as required by the Constitution.

Stern v. Marshall, as summarized in *Bellingham*, "made clear that some claims labeled by Congress as core may not be adjudicated by a bankruptcy court" to the point of a final judgment. In other words, the Court found that Congress had violated the Constitution by providing bankruptcy courts with the power to enter final judgments in certain matters that Congress had labeled as core because this permitted non-Article III judges to exercise the judicial power over matters reserved for the judicial branch established under Article III of the Constitution.

As a result of *Stern v. Marshall,* an issue arose in the context of the universe of core proceedings, because the bankruptcy court does not have authority under the Constitution to issue a final order over certain core proceedings. However, the statutory scheme created by Congress does not expressly provide the bankruptcy court with authority to hear a core proceeding and issue proposed findings of fact and conclusions of law to the district court. Apparently, Congress did not anticipate a constitutional problem with permitting a bankruptcy court to fully adjudicate core proceedings since Congress believed

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that the matters it had designated as core were limited to merely the bankruptcy process and did not entail an exercise of judicial power.

The claims at stake in *Bellingham* were fraudulent conveyance claims against a non-debtor. Congress has labelled such claims as core, yet *Stern* and prior Supreme Court precedents have indicated that adjudicating such claims does in fact involve an exercise of the judicial power and therefore can only be done by Article III judges. Thus, the claims in *Bellingham* fell into this statutory no-man's land because the claims are defined as core under the statute yet the statute does not appear to permit an Article III judge to enter a final judgment in a core proceeding upon recommendation of a bankruptcy court.

To fix this problem, the *Bellingham* court could have either (a) ignored the statutory language limiting the district-court-recommendation procedure to non-core claims, or (b) ignored the statutory language designating the fraudulent conveyance claims at issue as core claims. Option "b" apparently won out, although the opinion does not admit that its statement "the fraudulent conveyance claims in this case are not core" flatly contradicts the plain language of the statute, which states "[c]ore proceedings include, but are not limited to … proceedings to determine, avoid, or recover fraudulent conveyances[.]"

Indeed, the second important aspect of *Bellingham* may be its implication that fraudulent transfer claims, or other avoidance claims, should not be treated as core proceedings despite their designation as such. This may be significant to defendants being sued in bankruptcy court.

One other notable aspect of *Bellingham* is what it does not address—the issue of whether parties may consent to entry of a final judgment in non-core proceedings by a bankruptcy court. Courts of appeals are split on this important issue.[1] While *Bellingham* may be read as implying that consent will suffice, a footnote makes it clear that the question of whether the Constitution "permits a bankruptcy court, with the consent of the parties, to enter final judgment" on a non-core claim is "reserve[d] … for another day."

Stay tuned for further developments.

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[1] The Ninth Circuit Court of Appeals has held that a bankruptcy court can enter a final order in a "non-core" proceeding with the consent of the parties. *In re Bellingham Insurance Agency,* 702 F.3d 553 (9th Cir. 2012). However, the Fifth, Sixth and Seventh Circuit Courts of Appeals have held that the parties cannot consent to the bankruptcy court entering a final order in a "non-core" proceeding. *Frazin v. Haynes & Boone (In re Frazin),* 732 F.3d 313, 320 n.3 (5th 2013), *Wellness Int'l Network v. Sharif,* 727 F.3d 751, 733 (7th Cir. 2013), and *Waldman v. Stone,* 698 F. 3d. 910, 918 (6th Cir. 2012).

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