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CLIENT MEMORANDUM

# Supreme Court Provides Guidance to Bankruptcy Courts in Addressing "Stern Claims" and Holds That "Stern Claims" May Proceed as Non-Core Claims

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In a recent decision[1] (the "Decision") the U.S. Supreme Court (the "Court") held that bankruptcy courts are authorized to hear and issue proposed findings of facts and law on so-called "Stern claims," rejecting the argument that bankruptcy courts lack such authority because Stern claims fall into a "statutory gap."

The Bankruptcy Amendments and Federal Judgeship Act of 1984 (the "Bankruptcy Statute" or the "Statute") bifurcates bankruptcy courts' authority to address certain matters.[2] While empowering bankruptcy courts to independently resolve certain enumerated "core" claims,[3] the Bankruptcy Statute limits bankruptcy courts to issuing non-binding proposed findings regarding other claims "related to" bankruptcy cases, thereby requiring a federal district court to consider and resolve all such "non-core" claims *de novo*.[4]

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1 Exec. Benefits Ins. Agency v. Arkinson, Case No. 12-1200 (U.S. June 9, 2014).

2 See 28 U.S.C. §151 *et seq*.

3 28 U.S.C. §157(b)(1).

4 28 U.S.C. §157(c)(1). *De novo* review of a claim means that the district court will review the law and facts involved in the claim, and will freely substitute its judgment on the proper resolution of the claim for that of the bankruptcy court's.

Three years ago, Stern v. Marshall held that the United States Constitution prevents bankruptcy courts from resolving claims based on rights assured by state law, even when those same claims are among the core claims that the Bankruptcy Statute authorizes bankruptcy courts to resolve.[5] "Stern claims" are those claims designated core claims by the Bankruptcy Statute, but prohibited from final resolution by bankruptcy courts as a constitutional matter by Stern. Courts are divided on which claims are, in fact, Stern claims.[6]

The Decision resolves a lower-court split regarding how bankruptcy courts should treat a Stern claim. Viewing Stern claims as neither valid core claims under the Constitution, nor as non-core claims under the Bankruptcy Statute, some post-Stern decisions had suggested that bankruptcy courts cannot even hear and issue proposed findings on Stern claims.[7] The Decision removes any doubt that debtors in all jurisdictions may present their Stern claims to a bankruptcy judge who is familiar with the details of the debtor's case, and obtain proposed findings from such judge that are likely to have weight with the district court.

Background

Bellingham Insurance Agency, Inc. ("BIA"), a corporation wholly owned by Nicolas Paleveda and his wife ("Paleveda"), filed for chapter 7 bankruptcy in the United States Bankruptcy Court for the Western District of Washington (the "Bankruptcy Court"). A bankruptcy trustee (the "Trustee") was appointed to gather and oversee the sale of BIA's assets. The Trustee alleged that before filing for bankruptcy protection, BIA had transferred (the "Transfers") its valuable assets to Executive Benefits Insurance Agency, Inc. (the "Defendant" or "EBIA"), another corporation wholly owned by Paleveda. To recover these transferred assets, the Trustee brought fraudulent conveyance claims against EBIA in the Bankruptcy Court.

The Bankruptcy Court found that the Transfers constituted fraudulent conveyances. The Defendant appealed the Bankruptcy Court's decision to the United States District Court for the Western District of Washington (the "District Court"), arguing that the Bankruptcy Court had misunderstood or misapplied the law of fraudulent conveyance to the agreed upon facts. Reviewing the claims *de novo*, the District Court also decided that the Transfers constituted fraudulent conveyances.

While appeal from the Bankruptcy and District Courts was pending before the Ninth Circuit, the Supreme Court decided Stern. Recognizing the possibility that Stern made it unconstitutional for a bankruptcy court to resolve fraudulent conveyance claims against non-creditors (that is, the possibility that fraudulent conveyance claims are Stern claims), the

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5 131 S. Ct. 2594 (2011).

6 See e.g., In re Agriprocessors, Inc., 479 B.R. 835, 841-46 (Bankr. N.D. Iowa 2012) (discussing disagreement among courts regarding whether fraudulent conveyance and preference claims against non-creditors are Stern claims).

7 See e.g., Waldman v. Stone, 598 F.3d 910, 921 (6th Cir. 2012) (holding in *dicta* that bankruptcy courts may not issue proposed finding in proceedings listed as "core" in the Bankruptcy Statute); Ortiz v. Aurora Health Care, Inc., 665 F.3d 906, 915 (7th Cir. 2011) (same).

Defendant argued that the underlying judgment was void because the Bankruptcy Court never had the constitutional authority to resolve the fraudulent conveyance claims against EBIA, a non-creditor. The Defendant essentially urged the Ninth Circuit to treat the Bankruptcy Court's resolution of the fraudulent conveyance claims as though it never happened.

The Ninth Circuit held that fraudulent conveyance claims against non-creditors are Stern claims, but nevertheless also held that the judgment against the Defendant was valid based on two legal theories. First, the Ninth Circuit held that the Defendant had "impliedly consented" to the Bankruptcy Court's resolution of the claims, and that the Bankruptcy Court's resolution of the claims was therefore valid.[8] Second, the Ninth Circuit held that because the District Court had reviewed the matter *de novo* on appeal, the Bankruptcy Court's judgment could be treated as proposed findings that were later adopted by the District Court, thus circumventing any constitutional issues.[9] In other words, the Ninth Circuit did not adopt the Defendant's theory that a statutory gap prevented bankruptcy courts from hearing and issuing proposed findings with respect to a Stern claim.

The Supreme Court's Decision

Authority is deeply divided on whether fraudulent conveyance claims brought against non-creditors are Stern claims.[10] Those hoping to have this question resolved were presumably disappointed by the Supreme Court's decision. Rather than provide clarity on this, the Court assumed without deciding that fraudulent conveyance claims are Stern claims, and thus that the statutory provision categorizing them as core claims is invalid.[11]

Moving from the preliminary assumptions, the Court's analysis began with the severability provision contained in the Bankruptcy Statute, which states that if any provision of the Statute is found invalid, the remainder of the Statute will remain valid and unaffected.[12] Applying the severability provision and its own precedent, the Court held that the portion of the Bankruptcy Statute that categorizes fraudulent conveyances as core claims is ineffective to the extent that the Bankruptcy Court lacks constitutional authority to resolve the claim.[13]

The Court then analyzed the scope of the Bankruptcy Court's authority with respect to fraudulent conveyance claims as though such claims were never included in the Statute's enumeration of core claims. The Bankruptcy Statute defines non-core claims as any claims "related to" a bankruptcy case.[14] The Court held that because fraudulent conveyance claims

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8 In re Bellingham Ins. Agency, Inc., 702 F.3d 553, 568 (2012).

9 Id., at 565-66.

10 See Observations Infra p. 4.

11 Id. at 11.

12 Decision. at 9 (citing 98 Stat. 344, note following 28 U.S.C. §151).

13 Id.

14 Id. at 11.

"assert[] that property that should have been part of the bankruptcy estate and therefore available for distribution . . . was improperly removed," the claims qualify as non-core claims within the meaning of the Bankruptcy Statute.[15] Because Stern claims will now be considered non-core claims under the Statute, the Court's decision fills the "statutory gap" posited by some lower courts post-Stern.

As discussed above, while bankruptcy courts are not permitted to independently resolve non-core claims, they can issue proposed findings to a district court, which must then review the claims *de novo* and enter final judgment upon them. Thus, the Court agreed that the Defendant was constitutionally entitled to have its fraudulent conveyance claims decided *de novo* by a district court.

Inasmuch as the District Court reviewed the Bankruptcy Court's decision *de novo*, the Court held that the constitutional requirement had, "in effect," been satisfied.[16] Thus even if the fraudulent conveyance claims are Stern claims (meaning that the Bankruptcy Court lacked the authority to independently resolve them), the *de novo* review of the claims by the District Court cured the Bankruptcy Court's potential error.

Having decided the case by holding that Stern claims should be treated as non-core claims, the Court then explicitly declined to address whether the Defendant could have impliedly consented to the Bankruptcy Court's resolution of the fraudulent conveyance claims, as the Ninth Circuit found.[17]

Observations

As important as what the Decision resolves, is what it leaves unresolved. The Decision is a narrow one, essentially holding only that bankruptcy courts should approach Stern claims as non-core bankruptcy claims. The Decision thus resolves one lingering issue surrounding Stern claims, while explicitly abstaining from resolving two others.

First, the Court did not decide whether fraudulent conveyance claims are Stern claims or whether bankruptcy courts may issue final judgments in those actions. Lower courts are split on this issue. For instance, in its opinion below, the Ninth Circuit held that fraudulent conveyance claims brought against non-creditors are Stern claims.[18] Yet many bankruptcy courts have held that fraudulent conveyance claims are not Stern claims.[19] Given the Court's silence on the matter,

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15 Id.

16 Id. at 13.

17 Id.

18 In re Bellinghm, 702 F.3d at 561.

19 See e.g., Mason v. RJK Investors (In re Klarchek), 2014 Bankr. LEXIS 1407, at *4 (Bankr. N.D. Ill. Apr. 3, 2014); Strauss v. Cole (In re Mamtek US, Inc.), 2013 Bankr. LEXIS 3592, at *2 (Bankr. W.D. Mo. Aug. 29, 2013); Tyler v. Banks (In re Tyler), 493 B.R. 905, 918 (Bankr. N.D. Ga. 2013); KHI Liquidation Trust v. Wisenbaker Bldr. Servs. (In re Kimball Hill, Inc.), 480 BR 894, 901 (Bankr. N.D. Ill. 2012) (holding that bankruptcy courts are empowered to resolve fraudulent conveyance claims against non-creditors and listing dozens of bankruptcy courts in agreement).

bankruptcy courts may continue to assert that they have the authority to resolve fraudulent conveyance claims against non-creditors.

Second, the Court did not decide whether a party can consent to having a Stern claim resolved by a bankruptcy court and, if so, whether such consent can be "implied" from parties' conduct or otherwise. The Ninth Circuit opinion below held that implied consent was sufficient to waive the Defendant's right to object to having its Stern claim resolved by a bankruptcy court.[20] In direct disagreement, the Sixth and Seventh circuits have held that a party cannot waive its right to have a district court resolve its Stern claim even by giving direct consent.[21]

Based on the Decision, if a bankruptcy court indentifies a claim as a Stern claim, the bankruptcy court will be forced to limit its jurisdiction to issuing proposed findings. The issue will become murkier if a bankruptcy court declines to characterize a claim as a Stern claim, even though the litigant believes such a claim may constitute a Stern claim. Divided authority on the issue of implied consent means that litigants who do not object to a bankruptcy court's characterization of their claims as non-Stern claims risk forfeiting the right to challenge the characterization on appeal.[22] Thus, if the characterization of a claim is debatable, an objection should be made early on in the bankruptcy proceeding in order preserve the objection for appeal.

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If you have any questions regarding this memorandum, please contact Shaunna D. Jones (212 728-8521, sjones@willkie.com), Paul V. Shalhoub (212 728-8764, pshalhoub@willkie.com) or the Willkie attorney with whom you regularly work.[23]

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[20] In re Bellingham, 702 F.3d at 568.

[21] Wellness Int'l Network, Ltd. v. Sharif, 727 F.3d 751, 773 (7th Cir. 2013); Waldman, 598 F.3d at 918.

[22] See e.g., In re Rose, 483 B.R. 540 (B.A.P. 8th Cir. 2012), reh'g denied (Jan. 9, 2013); In re Sunra Coffee LLC, No. 09-01909, 2011 WL 4963155 (Bankr. D. Haw. Oct. 18, 2011) aff'd sub nom. In re Sunra Coffee, LLC, BAP HI-11-1635-PAJUH, 2012 WL 3590754 (B.A.P. 9th Cir. Aug. 21, 2012); see also In re Oldco M Corp., 484 B.R. 598, 600 (Bankr. S.D.N.Y. 2012) (holding that failure to respond to complaint constituted implied consent to bankruptcy adjudication of Stern claim).

[23] The authors wish to thank summer law clerk Aaron T. Savella for his contributions in the preparation of this memorandum.