# U.S. Supreme Court:
## Stage Set for Potential Shift in Bankruptcy Court Jurisdiction

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**Earlier this year, the Supreme Court heard arguments** in *Executive Benefits Insurance Agency v. Arkison*, a case that may very well change the powers of bankruptcy court judges and settle important questions regarding bankruptcy litigation. Attorney Jeff Wurst walks us through the history and provides insights on the issues, knowing a decision can come down any day.

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Less than three years since its landmark decision in *Stern v. Marshall*, which rocked the world of bankruptcy practitioners and set the stage for a potential shift in the federal court system, the United States Supreme Court is considering a significant pullback of the jurisdiction of bankruptcy courts. *Stern v. Marshall* presented a juicy fact pattern. The case centered on the late Anna Nicole Smith and her bankruptcy trustee's battle to recover her inheritance from the estate of her late husband, J. Howard Marshall. It also presented a significant change from the way lawyers and judges viewed practice in bankruptcy court by usurping from the bankruptcy courts certain powers that many practitioners had taken for granted. Since *Stern*, many courts have considered the effect of its holding and have come down with conflicting rulings.

**The Fifth, Sixth and Seventh Circuits have all ruled that parties may object to the bankruptcy court's jurisdiction and that the right to proceed before an Article III court is not waivable. In fact, the Fifth Circuit has already ruled twice on this particular matter. However, these cases will become historical fodder once the Supreme Court issues its decision in *Executive Benefits*.**

On January 14, 2014, the Supreme Court heard arguments in *Executive Benefits Insurance Agency v. Arkison*, a case that may very well change the powers of bankruptcy judges and settle important questions regarding bankruptcy litigation. A decision can come down any day.

### Watershed Case

The issues at hand in *Executive Benefits* lie with the way the United States Constitution delegates powers to federal judges. Article III of the Constitution provides that federal district court judges will be appointed by the President with the advice and consent of the Senate. Article III judges enjoy life tenure with no risk of a salary decrease and hold office for "good behavior." The only way these judges can be removed is through impeachment. The theory behind these benefits is to promote an unbiased and independent judiciary. Bankruptcy judges, on the other hand, are appointed by federal appeals courts for 14-year terms, and their salaries are subject to Congressional action. The powers of the bankruptcy judges are created by statute and are limited to matters relating to bankruptcy proceedings. Bankruptcy judges may possess special knowledge and training, but they lack the Constitutional authority that Article III judges possess.



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Another difference between federal district court judges and bankruptcy judges is that federal district court judges may enter "final" decisions on matters before them. A final decision is one that can be appealed to a higher court and ends the litigation on a particular issue unless it is appealed. In essence, a final decision disposes of the case that is before the court. As it relates to bankruptcy, the Bankruptcy Code authorizes bankruptcy judges to make final decisions on "core" matters, but not all matters. For example, bankruptcy judges have been authorized by statute to enter final decisions on fraudulent transfer claims, a power that has seemingly been in place for years. As a result of *Stern*, however, litigants defending fraudulent transfer claims, which had not filed proofs of claim or otherwise submitted to the jurisdiction of the bankruptcy court, became free to have their cases tried before an Article III judge instead of before the bankruptcy judge. This decision created a power shift in the court system that may turn the bankruptcy process on its head. *Executive Benefits* will consider, amongst other issues, whether the bankruptcy court has jurisdiction to consider "non-core" matters — even when litigants have consented to its jurisdiction.

### Historical Background

The issues presented in *Executive Benefits* started to percolate as far back as 1982 when the Supreme Court issued its landmark ruling in *Northern Pipeline Construction v. Marathon Pipe Line*. Congress, through the enactment of the 1978 Bankruptcy Code, had delegated to bankruptcy courts certain powers reserved for federal district court. The Supreme Court voided this grant of statutory power because it violated the separation of powers doctrine in that it allowed Congress, for the most part, to hire and fire bankruptcy judges. This case threatened to collapse the framework of the system created by Congress under the Bankruptcy Code. Congress took quick action to fix the problem by amending the Bankruptcy Code to allow bankruptcy judges to issue final decisions on "core" matters.

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

The public rights concept was again addressed in another landmark Supreme Court case, *Granfinanciera, S.A v. Nordberg*. In *Granfinanciera*, the Court ruled that a defendant in a fraudulent transfer proceeding that had not filed a proof of claim in a bankruptcy case was entitled to a jury trial before the district court. The Supreme Court stated that Congress could not deprive the defendant of a fraudulent transfer claim the right to a jury trial inasmuch as a fraudulent transfer action was not recognized within the public rights exception.

### District Court Jurisdiction

Since *Northern Pipeline* and *Granfinanciera*, the district courts have retained jurisdiction over bankruptcy matters; however, each district court has issued its "standing order of reference" where it has referred bankruptcy matters to the bankruptcy courts. In fact, the reference system encourages district courts to delegate power to bankruptcy judges. The Bankruptcy Code authorizes bankruptcy courts to hear and determine "core" matters and to make recommendations of findings of fact and conclusions of law to the district courts with respect to "non-core" matters.

This scheme remained in place until the Supreme Court decided *Stern*. In fact, practitioners thought that many of the questions raised in *Northern Pipeline* and *Granfinanciera* had been put to rest years ago. The Supreme Court's decision in *Stern* curtailed the powers of the bankruptcy judges even further than in *Northern Pipeline*



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and narrowed the application of the public rights exception. 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.

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The Bankruptcy Code does not empower the bankruptcy courts to make recommendations to the district courts on "core" matters; prior to *Stern*, the bankruptcy courts issued final judgments in such cases. As a result, the Supreme Court in *Executive Benefits* will also likely consider whether a bankruptcy court may make recommendations in *core proceedings* where the defendants are subject to its jurisdiction.

Although the Supreme Court in *Stern* stated that its decision was to be interpreted narrowly, the case law decided since demonstrates that there are many unanswered questions regarding the bankruptcy court's powers over certain proceedings, especially fraudulent transfer actions. The uncertainty created by *Stern* centered on how courts should apply the statute as amended by Congress to the case law already in place. This uncertainty is conveniently referred to as the "statutory gap." Hopefully, the statutory gap will be closed by the Supreme Court's pending decision in *Executive Benefits*.

### Executive Benefits Arguments

The facts of *Executive Benefits* are not as interesting as those of *Stern*. The case involves a garden variety fraudulent transfer claim brought by the Chapter 11 trustee. The debtor made a payment to a related entity, and the trustee sued to clawback the payment under a theory of fraudulent conveyance. The bankruptcy court granted judgment in favor of the trustee. After several appeals, the defendant invoked the doctrine of *Stern v. Marshall*, arguing that the bankruptcy court did not have the power to adjudicate the fraudulent transfer claim. Their argument is that the trustee is constitutionally precluded from obtaining a final decision from the bankruptcy court because final decisions may only be rendered by Article III judges. The district court and the Court of Appeals for the Ninth Circuit affirmed the bankruptcy court's ruling and the defendant appealed to the Supreme Court.

An interesting twist in this case is that the Ninth Circuit ruled that *Executive Benefits* actually consented to the bankruptcy court issuing a final decision on the fraudulent transfer claim because it did not raise the *Stern* argument early enough in the case. Ultimately, the Ninth Circuit said that *Executive Benefits' Stern* argument was too late to the game, and because of this, *Executive Benefits* had waived its right to have a district court judge determine the outcome of the case. Thus, the other issue in this case becomes whether a party is able to give express or even implied consent to a bankruptcy court's final adjudication of a matter. This argument challenges the bankruptcy court's jurisdiction over the subject matter of the dispute.

Jurisdiction is an interesting concept that lawyers master early in law school. Law schools teach us that personal jurisdiction may be waived. For example, a party can waive service of process and submit to the jurisdiction of the court. Subject matter jurisdiction, however, cannot be waived. We learn about courts of general jurisdiction and courts of limited jurisdiction. Thus, a court of limited jurisdiction may only hear types of matters that are specific to its limited jurisdiction. Bankruptcy courts, as you would expect, are courts of limited jurisdiction. The issues being considered in *Executive Benefits* include addressing the subject matter limits of the jurisdiction of the bankruptcy courts.

### Ruling Ramifications

The Ninth Circuit's decision also created a split among its sister circuits. Usually, when there is a split among the Circuit Courts, the Supreme Court grabs the opportunity to weigh in on the matter. This is precisely the case in *Executive Benefits*. With the inclusion of the *Executive Benefits* case, four Circuit Courts of Appeals have addressed the issue of litigant consent to a bankruptcy judge's final decision. The Ninth Circuit's decision in this case stands alone in its view that the parties may consent to a final adjudication of the bankruptcy court. The Fifth, Sixth and Seventh Circuits have all ruled that parties may object to the bankruptcy court's jurisdiction and that the right to proceed before an Article III court is not waivable. In fact, the Fifth Circuit has already ruled twice on this particular matter. However, these cases will become historical fodder once the Supreme Court issues its decision in *Executive Benefits*.

The effect of a ruling in *Executive Benefits* may reach well beyond the bankruptcy courts and impact all other non-Article III judges, including federal magistrate judges, who sit alongside district court judges and assist in the litigation process. The hope is that the Supreme Court will take the time to address and explain in broad terms how the *Stern* ruling is to be interpreted and applied to the complex issues raised in *Executive Benefits*.

### Sideline Views

*Executive Benefits* is viewed by many practitioners as the most anticipated case to be decided by the Supreme Court this term. Practitioners, as well as scholars, are hanging by the seat of their pants waiting for a decision. In fact, many scholars filed *amici* (friend of the court) briefs in the case. This is common in Supreme Court cases, as scholars and interest groups weigh in on the matter, especially on issues that impact litigants' rights.

Seventeen *amici* briefs were filed. This is a large number and indicates how important this intended decision is expected to be for practitioners. A good portion of these scholarly briefs supported the trustee's position. Of particular note was the brief of Irving Picard, the bankruptcy trustee in the Madoff case, filed in support of the trustee's position. Of course, Picard has a personal interest in preserving his own fraudulent conveyance cases in the bankruptcy



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court. An adverse ruling may very well send much of his caseload to a less friendly district court. The United States, itself, has an interest in the case, and the Solicitor General filed a brief and requested the opportunity to argue before the Supreme Court. It is interesting to note that the United States also supported the position of the bankruptcy trustee.

Thus, many of those watching from the sidelines are hoping that the Supreme Court will maintain the status quo for bankruptcy litigation and permit trustees to obtain a final decision in bankruptcy court, leaving the district court to serve only as an appellate court.

### Pending Supreme Court Decision

Most importantly, most practitioners are interested in what the Supreme Court will have to say regarding its decision in *Stern*. Even though bankruptcy courts are specialized courts that are limited to certain issues, the Supreme Court in *Stern* noted that it did not intend to shift the division of labor between the bankruptcy courts and district courts. However, some practitioners believe that the Supreme Court's decision in *Stern* has added unnecessary time and expense to the bankruptcy litigation process. Additionally, if the power is shifted to the district courts, some practitioners believe that the results of litigation will be unpredictable 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, some practitioners feel that the district court may get bogged down with issues that a bankruptcy court would have expertise in addressing quickly and efficiently. The potential for an increased workload of the district courts has already been noted by the Supreme Court. Other practitioners, however, would welcome the shift as it promotes practice before the district courts where they feel their defendant client would be better treated. If the Supreme Court rules that a party may consent (even by implied consent indicated merely by filing a proof of claim) to the bankruptcy court's jurisdiction, things will, to a great extent, remain much the same.

However, certain lenders who have had to defend themselves in bankruptcy litigation have questioned whether they would have received better treatment had their case been heard in a district court. *Executive Benefits* may very well provide them with the opportunity to have these cases heard by a district court judge and perhaps obtain a more favorable outcome. If so, practitioners representing lenders will be able to press the right to litigate before the district courts unless the lender elects to proceed before a bankruptcy judge. *Stern* opened more issues than it resolved. *Executive Benefits* gives the Supreme Court the opportunity to provide guidance on the reach of the jurisdiction of the bankruptcy court. Or, perhaps, the Court will further complicate these issues. abfj

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