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Supreme Court Closes Statutory Hole Post-Stern v. Marshall

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A. Background – Core Claims from *Marathon* to *Stern v. Marshall*

Yesterday, the United States Supreme Court, in *Executive Benefits Insurance Agency v. Arkison*, issued a unanimous decision that will allow bankruptcy courts to make proposed findings of fact and conclusions of law to district courts on fraudulent conveyance, tort claims, and other state law actions commenced by a debtor or bankruptcy trustee against creditors and other parties. Over thirty years ago, in *Northern Pipeline Construction Company v. Marathon Pipe Line Company*, the Supreme Court declared the grant of expansive jurisdictional power to bankruptcy judges under the Bankruptcy Code of 1978 unconstitutional because such judges were not considered Article III judges under the Constitution. The Court in *Marathon* held that bankruptcy judges could only adjudicate actions labeled as “public rights” (matters under the Bankruptcy Code) and not private rights (state law actions such as breach of contract, tort claims, etc.). In 1984, congress enacted legislation consistent with *Marathon* that set up a statutory procedure whereby bankruptcy judges could decide upon matters labeled as “core” (“public” rights) and issue proposed recommendations to the district court for “non-core” matters (“private” rights) with the consent of all parties.

In *Stern v. Marshall* the Supreme Court threw a wrench into the 1984 legislative scheme when it held that a bankruptcy court could not issue a final decision over a counterclaim by a party against a bankruptcy trustee.

Under the 1984 legislation, the counterclaim was defined as a core matter. But because the counterclaim was grounded under state law, the Supreme Court held that even though the 1984 legislation designated the matter as "core", the bankruptcy court did not have constitutional authority to issue a final decision over the matter ("*Stern* Claims"). The Supreme Court, however, did not elaborate on whether and how *Stern* Claims should be procedurally addressed by bankruptcy courts. At issue was whether only district courts could hear *Stern* Claims or whether the bankruptcy court could, in the first instance, hear such claims and propose recommendations to the district court. Many practitioners and judges viewed the latter approach as far more efficient and less disruptive to the bankruptcy court system. While the Supreme Court left some critical issues open in *EBIA*, it gave clear approval for bankruptcy courts to hear and issue proposed recommendations on *Stern* Claims.

B. The Supreme Court's Decision in *EBIA*

In contrast to *Stern*—which involved a Playboy playmate, an octogenarian billionaire, and multiple proceedings in two different states—the underlying facts and procedural history in *EBIA* are relatively straightforward. EBIA was formed by Nicolas Paleveda and his wife with assets that belonged to the debtor. Paleveda and others then initiated a scheme to transfer assets from the debtor to EBIA, ultimately depositing funds in an account for which EBIA was a beneficiary. After the debtor filed for chapter 7, the trustee sued EBIA to recover those funds. The bankruptcy court granted the trustee summary judgment on a fraudulent conveyance claim he brought against EBIA, and the district court affirmed after conducting a *de novo* review. The Ninth Circuit affirmed the district court, holding that *Stern*, when taken together with the Supreme Court's ruling in *Granfinanciera, SA v. Nordberg*, 492 U.S. 33 (1989)[1], mandate that fraudulent conveyance claims are *Stern* Claims, and thus, Article III does not permit a bankruptcy judge to enter a final judgment unless the parties consent. The Ninth Circuit further held that the bankruptcy court's decision could instead be treated as proposed findings of fact and conclusions of law subject to the district court's *de novo* review.

A unanimous Supreme Court, while reserving on whether the parties can consent to the bankruptcy court's authority to decide the case (more on that below), found that the Ninth Circuit was correct in that the bankruptcy court decision could be treated as proposed findings of fact and conclusions of law subject to *de novo* review, which is exactly what happened here. The Court found that the 1984 legislation's severability provision—which provides that if any provision of the statute is held invalid, the remaining provisions of the statute are unaffected—closes the statutory hole and resolves the uncertainty created by the *Stern* decision. And even though the bankruptcy court did not label its summary judgment ruling "proposed findings of fact and conclusions of law," since the district court conducted a full *de novo* review of the bankruptcy court's decision, the

judgment was not constitutionally infirm.

C. Where Do We Go From Here?

While the *EBIA* decision is an important step in getting more clarity post-*Stern*, the question of whether the parties can consent to the bankruptcy court entering final judgment or issuing proposed findings of fact over a *Stern* Claim still remains. The logic of *EBIA* suggests that the parties should be permitted to consent, at least in principle. Thus, while the Supreme Court did not expressly reach the consent issue, it would seem that consent is a valid basis for a bankruptcy court to enter proposed findings of fact and conclusions of law or a final judgment. Critically, however, what constitutes consent—including whether a creditor who files a proof of claim can be deemed to have consented to an action brought against it by the debtor or a trustee—is very much an open issue after *EBIA*.

Finally, while it is black-letter federal jurisprudence that parties cannot consent to subject matter jurisdiction, *Stern* and *EBIA* only implicate a bankruptcy court's *constitutional authority* to enter final judgments or issue proposed findings of fact and conclusions of law, not its *subject matter jurisdiction* to consider such matters. Indeed, magistrate judges—who, like bankruptcy judges, are Article I judges—regularly preside over jury trials in which the parties consent. Similarly, arbitrators adjudicate disputes on consent under the Federal Arbitration Act. Under *EBIA*, there does not seem to be any reason why bankruptcy judges should be any different.

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[1] The Supreme Court in *Granfinanciera* held that a fraudulent conveyance claim is not a matter of "public right" and that a defendant to such a claim is entitled to a jury trial.
