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# Mind the Gap: Supreme Court Partially Resolves Procedural Uncertainty Created by *Stern v. Marshall*

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On June 9, 2014, the U.S. Supreme Court issued its decision in *Executive Benefits Ins. Agency v. Arkison*,[1] which partially resolved procedural uncertainty created by the Court's prior decision in *Stern v. Marshall*.[2]

In *Stern*, the Supreme Court analyzed the constitutionality of 28 U.S.C. § 157, which in relevant part defines certain matters as "core" or "non-core," and authorizes bankruptcy courts to finally adjudicate "core" matters but only to issue findings and conclusions subject to *de novo* review in "non-core" matters. The Court held that Article III of the U.S. Constitution prohibits Congress from vesting bankruptcy judges with the authority to finally adjudicate certain claims that it had designated as "core." The Court did not, however, address how bankruptcy courts should proceed in such cases.

The Court considered that procedural question in *Executive Benefits*, a case which was highly anticipated because it ostensibly presented the question not just of how bankruptcy courts should deal with such claims, but also whether a bankruptcy court could, with the consent of the parties, enter final judgments even when doing so without the parties' consent would be unconstitutional under *Stern*. The Court held that bankruptcy judges should deal with such claims as they would in "non-core" proceedings; that is, by issuing findings and conclusions subject to *de novo* review by district courts. The Court, however, did not address whether Article III permits a bankruptcy court, with the consent of the parties, to enter final judgment when it could not do so absent consent.

## Background

Nicolas Paleveda and his wife owned and operated Bellingham Insurance Agency, Inc. ("**BIA**" or the "**Debtor**"). BIA became insolvent and the company ceased operations by January 2006. After BIA ceased operations, Paleveda used BIA funds to incorporate Executive Benefits Insurance Agency, Inc.

[1] 573 U.S. __ (2014).
[2] 564 U.S. __, 131 S. Ct. 2594 (2011).

(“**EBIA**”) and implemented a scheme under which assets were transferred from BIA to EBIA.

On June 1, 2006, BIA filed a voluntary chapter 7 petition in the United States Bankruptcy Court for the Western District of Washington (the “**Bankruptcy Court**”). BIA’s chapter 7 trustee (the “**Trustee**”) filed a complaint against EBIA in the Bankruptcy Court alleging, among other things, that Paleveda fraudulently transferred certain of the Debtor’s assets to EBIA. The Bankruptcy Court granted summary judgment in favor of the Trustee. EBIA appealed that determination to the U.S. District Court for the Western District of Washington.

The District Court reviewed the Bankruptcy Court’s decision *de novo* and entered judgment in favor of the Trustee. EBIA then appealed the District Court’s decision to the United States Court of Appeals for the Ninth Circuit.

After EBIA filed its opening brief, the Supreme Court issued its decision in *Stern v. Marshall*. The Court of Appeals observed that the Supreme Court’s decisions in *Stern* and *Granfinanciera, S.A. v. Nordberg*,[3] taken together, stand for the proposition that bankruptcy courts do not have the authority to enter final judgments on fraudulent transfer claims asserted against non-creditors of the debtor’s estate unless the parties consent. Nevertheless, the Court of Appeals affirmed the District Court decision on the basis that by failing to raise a constitutional objection to the Bankruptcy Court’s entry of final judgment until after briefing in its appeal was complete, EBIA impliedly consented to the Bankruptcy Court’s jurisdiction to adjudicate the fraudulent transfer claims. The Court of Appeals also noted that the Bankruptcy Court’s judgment could instead be treated as proposed findings of fact and conclusions of law subject to *de novo* review by the District Court. EBIA sought a writ of certiorari.

## The Supreme Court Decision

The Supreme Court unanimously affirmed the Court of Appeal’s decision, holding that when a bankruptcy court is presented with a *Stern* claim, it should issue proposed findings of fact and conclusions of law in lieu of a final judgment.

The Court began its analysis by describing the evolution of bankruptcy legislation leading up to the enactment of the Federal Judgeship Act of 1984 (the “**1984 Act**” or the “**Act**”), the Act at issue in *Executive Benefits*. Under the 1984 Act, federal district courts have “original and exclusive jurisdiction of all cases under title 11.”[4] District courts may refer to Article I bankruptcy judges “proceedings arising under title 11 or arising in or related to a case under title 11.”[5] Congress designated matters that may be referred to bankruptcy courts as either “core” or “non-core”

[3] In *Granfinanciera, S.A. v. Nordberg*, the Supreme Court held that a fraudulent transfer claim under Title 11 is not a matter of “public right” for purposes of Article III and that the defendant to such a claim is entitled to a jury trial under the Seventh Amendment. 492 U.S. 33, 109 S. Ct. 2782, 106 L. Ed. 2d 26 (1989).

[4] 28 U.S.C. § 1334(a).

[5] 28 U.S.C. § 157.

proceedings.[6] For "core" proceedings, the 1984 Act authorizes the bankruptcy court to enter final judgment on the claim subject to appellate review by the district court.[7] For "non-core" proceedings, Congress provided that the bankruptcy court can hear the matter, but not enter final judgment; instead, the bankruptcy court must enter proposed findings of fact and conclusions of law, which the district court then must review *de novo* and enter final judgment.[8] The statute also provides that the parties may consent to final adjudication of a "non-core" proceeding by the bankruptcy court.[9]

*Stern* held that absent consent, bankruptcy courts lack constitutional authority under Article III of the Constitution to finally adjudicate certain claims that Congress designated as "core." However, *Stern* did not provide any guidance as to how bankruptcy and district courts were to handle such claims.

Post-*Stern*, some lower courts had observed that *Stern* created a statutory "gap," because the requirement in the 1984 Act that a bankruptcy court issue findings and conclusions applies only to "non-core" claims. Because the Act does not explicitly authorize bankruptcy courts to issue findings and conclusions in "core" matters, some lower courts posited that bankruptcy courts could not act with respect to *Stern* claims, and that district courts were required to hear such claims in the first instance.

The Supreme Court rejected this position. It relied on the severability provision of the 1984 Act, which provides that if any provision of the Act or its application is held invalid, the remainder of the Act or its application to other facts and circumstances "is not affected thereby."[10] The Court reasoned that when a court identifies a claim as one to which *Stern* applies, it has "held invalid" the application of the "core" label and the procedures set forth in the Act for resolving such claims with respect to that claim. In that case, the 1984 Act provides that "'the remainder of th[e] Act . . . is not affected thereby,'" and the Court reasoned that this "remainder" includes the portion of the Act which governs procedures for "non-core" proceedings. Since the "core" label is no longer valid, the Court instructed bankruptcy courts to look next to whether the claim may be adjudicated as a "non-core" claim, defined in the Act as "not a core proceeding" but that is "otherwise related to a case under title 11." If so, the bankruptcy court should treat the claim as "non-core" and submit proposed findings of fact and conclusion of law to the district court for *de novo* review and entry of final judgment.

Because the lower courts had effectively treated the bankruptcy court's decision as findings and conclusions, and the district court had reviewed the decision *de novo* and entered judgment (which is all that the Court held the Petitioner was

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6 *Id.*
7 28 U.S.C. § 157(b)(1).
8 28 U.S.C. § 157(c)(1).
9 28 U.S.C. § 157(c)(2).
10 98 Stat. 344, note following 28 U.S.C. § 151.

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entitled to), the Court declined to address an alternate argument before it: whether Article III permits a bankruptcy court, with the consent of the parties, to enter final judgment on a claim to which *Stern* applies. The Court also did not take the opportunity to decide whether the fraudulent transfer claims before it fit within the category of *Stern* claims for which bankruptcy courts may not issue final judgment, instead simply assuming – because the parties before it had not contested the proposition – that they did.

## Impact

*Executive Benefits* clarifies the procedure that should be used to resolve claims that Congress classified as "core," but which *Stern* held could not constitutionally be finally adjudicated by a bankruptcy court. It did not, however, resolve other important questions raised by *Stern*, including whether Article III permits a bankruptcy court to enter final judgment on a Stern claim with the consent of the parties. As a result, the debate regarding bankruptcy courts' constitutional authority is far from over, and parties likely will continue to vigorously litigate this and other open issues.

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