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Do The Bankruptcy Code's Safe Harbors Engulf Individual Creditor Rights?

By Paul D. Leake and Susheel Kirpalani[1]

I. Introduction

In a traditional leveraged buyout (an "LBO"), the transaction is financed, at least in part, with debt secured by the assets of the target company rather than assets of the acquiror. Proceeds from the newly-acquired debt are typically used to pay existing loans (if any) and the shareholders of the target company.[2] The biggest litigation risk of an LBO transaction is that the debt burden from financing the transaction is too heavy for the target company to bear, resulting in the company filing for bankruptcy typically to restructure that debt. In the event that the target seeks bankruptcy protection, the Bankruptcy Code's avoidance powers provide a potential litigation tool for challenges to the LBO (or other leveraged financing transaction) as a fraudulent transfer.

The ability of an LBO to be successfully challenged as a constructive fraudulent transfer has been substantially reduced as a result of the expansive view that courts have taken with respect to the application of the "safe harbor" provided in section 546(e) of the Bankruptcy Code for "settlement payments" made by or to "financial institutions." However, the reach of section 546(e) and its potential application to claims brought by or on behalf of *individual creditors* (and not the bankruptcy estate) has been a hotly disputed topic in a series of recent, and conflicting, decisions issued by three lower courts in the Southern District of New York. Two of those decisions (*SemGroup* and *Tribune*) were heard jointly on appeal by the U.S. Court of

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[2] *See, e.g.*, *Weisfelner v. Fund 1 (In re Lyondell Chem. Co.*), 503 B.R. 348, 353 (Bankr. S.D.N.Y 2014) ("Lyondell took on approximately $21 billion of secured indebtedness in the LBO, of which $12.5 billion was paid out to Lyondell stockholders.").

Appeals for the Second Circuit in November 2014. The outcome of those cases may significantly impact the ability even of individual creditors pursuing long-standing state law remedies to challenge LBO and similar transactions in the future.

II. The Addition of Section 546(e) to the Bankruptcy Code

Congress amended the Bankruptcy Code in 1982 to create section 546(e) (then codified as section 546(d)) with a view toward preventing "the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market."[3] The provision was "intended to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries."[4]

Section 546 of the Bankruptcy Code imposes absolute limitations (*i.e.*, "the trustee may not") on a bankruptcy trustee's avoidance powers, including the power to avoid constructive fraudulent transfers (*i.e.*, in the absence of actual intent to hinder, delay, or defraud creditors), whether under federal or state law. Section 546(e) provides, in relevant part:

> Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a . . . settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a . . . financial institution . . . or that is a transfer made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract, as defined in section 741(7) . . . that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.[5]

If a transaction falls within the scope of section 546(e), it cannot be avoided by the trustee as, among other things, a fraudulent transfer, unless it was an actual fraudulent transfer with the intent to hinder, delay, or defraud creditors. In determining whether LBO transfers are protected from avoidance as a constructive (as distinguished from an actual) fraudulent transfer under

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3 H.R. Rep. No. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583, 1982 L 25042.

4 *Id.*

5 11 U.S.C. § 546(e).

section 546(e), the two key inquiries are whether: (i) the transfer qualifies as a "settlement payment"; and (ii) the transfer was made by or to (or for the benefit of) a "financial institution" under a "securities contract."

Although there remains some disagreement on the application of section 546(e) to LBOs, in general, both "settlement payment" and "financial institution" have been defined broadly, and a majority of federal courts of appeals that have decided the issue have held that the transfer made as part of an LBO transaction can, generally speaking, be shielded from fraudulent transfer avoidance pursuant to the section 546(e) safe harbor.[6]

III. The Applicability of Section 546(e) to Creditor Claims

While most courts have tended to agree on the broad applicability of section 546(e) to claims brought by bankruptcy trustees on behalf of the debtor's estate, courts recently have differed as to whether the section 546(e) safe harbor, and the analogous 546(g) safe harbor that covers certain swaps, extend beyond claims brought by or on behalf of a bankruptcy estate to include, and to immunize defendants against, claims brought by or on behalf of creditors in their own right.

A. *SemGroup*

In *Whyte v. Barclays Bank PLC*,[7] which involved the safe harbor of section 546(g) that immunizes certain "swap agreements," Judge Rakoff of the U.S. District Court for the Southern District of New York held that the safe harbor, when applicable, protects defendants against avoidance actions brought by a chapter 11 plan litigation trustee asserting state law claims on

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[6] *See, e.g.*, *Brandt v. B.A. Capital Co. (In re Plassein Int'l Corp.)*, 590 F.3d 252 (3d Cir. 2009); *QSI Holdings, Inc. v. Alford (In re QSI Holdings Inc.)*, 571 F.3d 545 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009); *Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.)*, 181 F.3d 505 (3d Cir. 1999); *In re Kaiser Steel Corp.*, 952 F.2d 1230 (10th Cir. 1991). *But see Munford v. Valuation Research Corp. (In re Munford, Inc.)*, 98 F.3d 604 (11th Cir. 1996).

[7] 494 B.R. 196 (S.D.N.Y. 2013).

behalf of creditors, even though on its face section 546(g), like section 546(e), applies only to actions brought by a bankruptcy trustee or other estate representative.

In *Barclays*, a litigation trustee was appointed to oversee a litigation trust established under a chapter 11 plan in the *SemGroup* bankruptcy to pursue prepetition claims, some of which belonged to the estate and others of which belonged to SemGroup's lenders, as was provided for in the agreement that created the litigation trust.[8] Among the claims assigned to the trust was a fraudulent transfer claim relating to a prepetition swap transaction, pursuant to which Barclays acquired SemGroup's portfolio of commodities derivatives traded on the New York Mercantile Exchange.[9] The litigation trustee alleged that the transaction was a fraudulent transfer avoidable under New York's Debtor and Creditor Law (N.Y. DEBT. & CRED. LAW §§ 270-281 (McKinney 2014)).[10] Importantly, the litigation trustee did not seek to avoid the transaction under section 544 of the Bankruptcy Code, which empowers a bankruptcy trustee (subject to the limitations of section 546) to avoid transfers that are avoidable by creditors under state law. Instead, in the complaint, the litigation trustee asserted avoidance causes of action under New York law *as assignee of the lenders.*[11]

The litigation trustee argued that the 546(g) safe harbor applies only to a bankruptcy trustee or other estate representative (*e.g.*, an official committee or other party conferred by the court with "derivative standing") exercising avoidance powers under the Bankruptcy Code, such as section 544. Since the litigation trustee was asserting a state law claim as the contractual

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8 *Id.* at 198.

9 *Id.*

10 *Id.*

11 *Id.* at 198-99.

assignee of the debtor's lenders rather than on behalf of the estate, the trustee argued that the section 546(g) safe harbor did not apply.[12]

The *Barclays* court disagreed and held that the avoidance action should be dismissed, reasoning that, while section 546(g) does not expressly apply to an assignee of creditor claims, the provision *implicitly preempts* the litigation trustee's attempt to "resuscitate [the] fraudulent avoidance claims" that the litigation trustee would otherwise be prohibited from bringing as a bankruptcy trustee.[13]

The district court explained that implied preemption takes two forms: (1) "field preemption," where Congress has manifested an intent to "occupy the field" in a certain area; and (2) "conflict preemption," where state law "actually conflicts with federal law."[14] The court applied "conflict preemption" and determined that the state law avoidance cause of action was preempted by 546(g) because its application was "an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[15]

The court reasoned that permitting the litigation trustee to prosecute the same claims that the section 546(g) safe harbor precludes a bankruptcy trustee from asserting would circumvent Congress's intent to prevent such claims for the purpose of "protect[ing] securities markets from the disruptive effects that unwinding such transactions would inevitably create."[16] The court stated that "Congress intended to place swap transactions totally beyond the inherently destabilizing effects of a bankruptcy and its attendant litigation," which would be "totally

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12 *Id.* at 199.

13 *Id.*

14 *Id.* at 199-200.

15 *Id.* at 200. While the court believed that "conflict preemption" may also be met on the basis that "federal law is in irreconcilable conflict with state law," the court declined the opportunity to reach the issue. *Id.*

16 *Id.*

undercut if, at the same time that a trustee in bankruptcy was prohibited from avoiding swap transactions, a Chapter 11 'litigation trustee' could hold swap-related avoidance actions in abeyance for eventual litigation as the mere assignee of creditors' claims."[17]

B. *Tribune*

Three months after the district court's preemption decision in *Barclays*, in September 2013, Judge Sullivan of the U.S. District Court for the Southern District of New York reached the opposite conclusion in *In re Tribune Co. Fraudulent Conveyance Litigation*.[18] Distinguishing *Barclays*, the court in *Tribune* held, among other things, that section 546(e) does not preempt constructive fraudulent conveyance claims brought by individual creditors.[19]

In *Tribune*, both the official unsecured creditors' committee and several individual creditors acting on their own behalf sought to claw back funds distributed to investors as part of a prepetition LBO under separate, but related, causes of action. The creditors' committee (conferred with standing to represent the bankruptcy estate) alleged that the LBO was an actual fraudulent transfer under section 548(a)(1)(A), and, therefore, a bankruptcy trustee (and a creditors' committee on a derivative basis) can assert such a cause of action because actual fraudulent transfers are expressly carved out from the scope of the section 546(e) safe harbor. The individual creditors sought to avoid the LBO themselves under a constructive fraudulent transfer theory because the creditors' committee (acting on behalf of the estate) could not pursue those claims since the 546(e) safe harbor applied.[20]

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17 *Id.*

18 499 B.R. 310 (S.D.N.Y. 2013).

19 *Id.* at 325.

20 *Id.* at 315.

The defendants in *Tribune* argued that section 546(e) and the construct of the Bankruptcy Code barred individual creditors from asserting their constructive fraudulent transfer claims.[21] Similar to the defendants in *Barclays*, the defendants in *Tribune* asserted that section 546(e) impliedly preempts individual creditors from bringing constructive fraudulent transfer claims following a bankruptcy since allowing prosecution of the state law claims would "assuredly frustrate the purposes" of section 546(e) and stand "as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[22]

Contrary to the court in *Barclays*, the district court in *Tribune* concluded that section 546(e) does not preempt individual creditors from asserting constructive fraudulent transfer claims.[23] The *Tribune* court reasoned that section 546(e), on its face, applies only to a bankruptcy trustee and, therefore, does not prohibit claims brought by individual creditors. According to the court, if Congress had intended section 546(e) to apply more broadly, it would have said so in the statute.[24] Instead, the court explained, Congress limited 546(e) to restrict only a particular party—the bankruptcy trustee.[25] Nevertheless, the court held that individual creditors were stayed from prosecuting the constructive fraudulent transfer claims because the creditors' committee was concurrently seeking to avoid the same transfers on an actual fraudulent transfer theory. The *Tribune* court held that the stay prevented individual creditors

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[21] *Id.*

[22] *Id.* at 315, 317.

[23] *Id.* at 325.

[24] *Id.* at 316.

[25] *Id.*

from competing with the estate's claims unless and until the creditors' committee abandoned those claims.[26]

The *Tribune* court also concluded, after reviewing the legislative history of 546(e), that there was insufficient evidence to suggest that Congress intended the section 546(e) safe harbor to preempt claims brought by individual creditors.[27] While the court acknowledged that lawmakers enacted section 546(e) to protect the stability of the securities markets, the court did not interpret the legislative history to suggest that protection of the markets outweighed other bankruptcy policy objectives, such as making creditors whole.[28] Furthermore, the court noted, Congress had several opportunities to extend the scope of section 546(e) to individual creditor claims, but never did so.[29] Finally, the court reasoned that "Congress has demonstrated elsewhere in the Bankruptcy Code that it knows how to—and is willing to—expressly preempt an individual creditor's state law claims," such as in section 544(b)(2),[30] but declined to do so in section 546(e).[31]

The court distinguished *Barclays* on the ground that the litigation trustee in *Barclays*, who was empowered by a chapter 11 plan to prosecute both estate claims and the claims of individual creditors, was more closely akin to a bankruptcy trustee than are the individual creditors asserting claims on their own behalf in *Tribune*.[32]

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[26] Section 554 of the Bankruptcy Code, in part, provides that "[a]fter notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate." 11 U.S.C. § 554(a). For instance, a trustee may seek to abandon a claim that is too costly to pursue and/or unlikely to succeed.

[27] *Id.* at 317.

[28] *Id.* at 317.

[29] *Id.* at 318.

[30] Section 544(b)(2) expressly preempts claims asserted by individual creditors to avoid charitable contributions. 11 U.S.C. § 544(b)(2).

[31] *Id.*

[32] *Id.* at 319.

Although the *Tribune* court held that section 546(e) does not preempt individual creditors from asserting constructive fraudulent transfer claims, the court dismissed the claims on account of the automatic stay, holding that individual creditor claims were actions "to recover a claim against the debtor."[33] The court stated that, unless the litigation trustee (as successor to the creditors' committee) abandoned the avoidance claims and was no longer seeking to reverse the payouts made to the LBO beneficiaries, individual creditors lacked standing to bring their own fraudulent transfer claims targeting the very same transactions.[34] In accordance with section 362(a)(1) of the Bankruptcy Code, the court concluded, litigation involving state law avoidance claims asserted by individual creditors is stayed for so long as a bankruptcy trustee (or its successor) prosecutes the bankruptcy estate's corresponding avoidance claims.[35]

Thus, the *Tribune* court concluded, contrary to the court in *Barclays*, that section 546(e) does not preempt individual creditors from asserting constructive fraudulent claims, but that the individual creditors lacked standing to prosecute the constructive fraudulent transfer claims unless and until the litigation trustee unequivocally abandoned those claims (which it ultimately did not).

C. *Lyondell*

Whereas the court in *Tribune* distinguished *Barclays*, in January 2014, Judge Gerber of the U.S. Bankruptcy Court for the Southern District of New York went further in *Weisfelner v. Fund 1 (In re Lyondell Chem. Co.)*,[36] calling into question the "correctness of the 'bottom-line' judgment" in *Barclays*.

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33 *Id.* at 325.

34 *Id.*

35 *Id.* at 323.

36 *Weisfelner v. Fund 1 (In re Lyondell Chem. Co.*), 503 B.R. 348, 376 (Bankr. S.D.N.Y. 2014).

In *Lyondell*, a litigation trust was formed for the benefit of unsecured creditors under the debtors' chapter 11 plan. The litigation trustee brought several constructive fraudulent transfer actions against certain of the debtors' former stockholders in relation to a prepetition LBO.[37] The defendants moved to dismiss on the ground that the shareholders were immunized from constructive fraudulent transfer claims pursuant to section 546(e), even though such claims were brought by a litigation trustee under state law rather than under the Bankruptcy Code.[38]

Expressly agreeing with *Tribune*, Judge Gerber held that section 546(e) does not bar constructive fraudulent transfer claims brought by a creditor litigation trust in the LBO context because: (i) the creditors' fraudulent conveyance claims were not asserted on behalf of the estate, rendering section 546(e) inapplicable; and (ii) section 546(e) does not preempt state law fraudulent transfer claims brought on behalf of individual creditors.[39]

Judge Gerber adopted the *Tribune* court's reasoning that if section 546(e) were intended to apply more broadly to parties other than a bankruptcy trustee, Congress "could simply have said so."[40] Judge Gerber agreed with the *Tribune* court with respect to preemption. He explained that the history and policy concerns underlying the Bankruptcy Code and fraudulent transfer laws predate the policy concerns underlying section 546(e).[41] Judge Gerber wrote that "federal policies also include—in addition to protecting markets from systemic risk—the avoidance of insolvent entities' transfers, for the benefit of all creditors, when they come at the expense of the creditor community."[42] Moreover, he explained, "[p]resumably Congress could,

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37 *Id.* at 354.

38 *Id.* at 355.

39 *Id.* at 358-59.

40 *Id.* at 358 (quoting *Tribune*, 499 B.R. at 316).

41 *Id.* at 367-69.

42 *Id.* at 368.

if it wanted, determine that its interest in protecting markets (or market participants, which is not the same thing), should trump the historical priority of creditors over stockholders, and all of the other historic concerns noted above . . . . [b]ut Congress did not do so."[43]

Judge Gerber also analyzed the purpose and legislative history of section 546(e), reasoning that the safe harbors serve important goals in preventing actions "against exchanges or clearing institutions" and actions "against depositories for investors or those in the middle of a transaction chain where claims against one could lead to problems of falling dominoes."[44] However, Judge Gerber noted that "[a]t the other extreme, where safe harbors are at least arguably absurd, are LBOs and other transactions involving privately held companies" because allowing creditors to prosecute claims to avoid such transactions does not create a "systemic risk."[45] Furthermore, Judge Gerber drew a distinction between protecting the financial markets and protecting investors in the public markets, stating that "[n]othing in the legislative history of the existing law evidences a desire to protect individual investors who are beneficial recipients of insolvents' assets."[46]

The court distinguished *Barclays* on the basis that the litigation trust in *Barclays* had been assigned both estate and creditor claims (thus blurring the line between the trust's role as a representative of creditors and of the bankruptcy estate), whereas the litigation trust in *Lyondell* held only creditor claims.[47] However, Judge Gerber went further, expressing doubt concerning

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43 *Id.* at 369.

44 *Id.* at 372.

45 *Id.*

46 *Id.* at 373.

47 *Id.* at 375-76.

the analysis and reasoning by Judge Rakoff in *Barclays*.[48] Specifically, Judge Gerber took issue with what he perceived as the *Barclays* court's lack of consideration of historical background regarding countervailing bankruptcy policies and objectives. "It is difficult to see how the *Barclays* court," he wrote, "could appropriately analyze these issues without attention to the other historic concerns."[49] Judge Gerber was similarly unpersuaded by the *Barclays* court's assertion that avoiding the LBO payments would "inevitably" disrupt the markets.[50]

IV. Second Circuit Appeal

Both *SemGroup* and *Tribune* were heard on appeal in tandem by the Court of Appeals for the Second Circuit on November 5, 2014.[51] Ultimately, the issue before the Second Circuit was whether individual creditors or their assignees can pursue fraudulent transfer claims when a bankruptcy trustee is precluded from doing so, or whether the Bankruptcy Code preempted such actions. The Second Circuit panel consisted of Circuit Judge Droney, Senior Circuit Judge Winter, and District Judge Hellerstein, sitting by designation.

The plaintiff in *SemGroup* urged that the safe harbor only applies to a bankruptcy trustee's own congressionally granted power, and that the scaling back of that power did not affect state law creditor rights. The panel seemed dubious of the plaintiff's construction. Judge Hellerstein commented that the rights to bring claims on behalf of creditors vested with the bankruptcy trustee upon a bankruptcy filing. Judge Droney questioned how the safe harbor would ever be honored if a private assignee could still bring claims. Plaintiff argued that congressional intent is to be gleaned from the text of the safe harbor, which stands in stark

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48 *Id.* at 376 ("Respectfully, the Court considers the Barclays analysis to be less thorough than that of Tribune, and considers a number of the elements of the Barclays analysis to be flawed").

49 *Id.* at 378.

50 *Id.*

51 *See* Amended Order, *In re Tribune Co. Fraudulent Conveyance Litig.*, No. 13-3992(L) (2d Cir. Nov. 12, 2013).

contrast to the express preemption Congress imposed in the context of avoiding charitable contributions. Judge Droney pressed on the evidence of congressional intent to preserve or preempt state law with respect to swap transactions that are relevant to the commodities industry. Judge Winter asked why Congress would delay creditors for two years if creditors could just bring the claims in their own right after such period. Judge Hellerstein pressed on that it seems to him that if the bankruptcy trustee has the power to settle, then it has title to the claims and creditors do not. Barclays' counsel essentially called the action before the Court a "subterfuge" because Congress never foresaw the ability of creditors to step back into their own fraudulent transfer claims, and that the Supreme Court had eliminated those rights in cases under the Bankruptcy Act. In response to these arguments, plaintiff urged that the Second Circuit's own decisions in this area could be harmonized by holding that a bankruptcy trustee does not own the creditor claims, but rather may assert them on creditors' behalf, but that if the bankruptcy trustee does not assert them, and the two-year period during which it could assert them expires (as happened in *SemGroup*), then individual creditors were not deprived of claims that had been part of their rights for hundreds of years.

In the *Tribune* argument segment, the plaintiffs addressed Judge Droney's lingering questions, and cited the tension of upholding the policy of insulating markets versus the competing policy of maximizing creditor recoveries through avoidance actions. Plaintiffs stressed the "strong clue" in the text that Congress was not singularly focused on insulating markets from the disruption of bankruptcy because the safe harbor limitation applied only to the bankruptcy trustee. Plaintiffs further explained that there have been numerous amendments to the safe harbor, but Congress never expanded the universe of plaintiffs that would be subject to it. Judge Hellerstein probed plaintiffs as to whether every bankruptcy would conclude with an assignment back to creditors. Plaintiffs explained that in *Tribune* there had been no assignment and further that the bankruptcy court had the power—as had been done in the *Madoff* bankruptcy—to issue an injunction under section 105(a) of the Bankruptcy Code to prevent creditors from asserting their own claims if that is the best interest of the estate. Judge Hellerstein said he "cannot think of a more direct context of defiance of congressional purpose" than the types of claims brought in the *Tribune* case. Judge Droney added that this type of litigation seemed to be an "obstacle" to Congressional purpose. Plaintiffs explained that intent must be understood from the text, not from what counsel or even the judiciary feels was Congress' intent, and Congress spoke to the issue *expressly* in the charitable contributions context and chose not to do so with respect to the settlement payments provision of the safe harbors. The Court reacted that inferring congressional intent from silence is not the same as choosing. In conclusion, plaintiffs explained that there are numerous cases that recognize a creditor's right to pursue fraudulent transfers if an action is not brought by the bankruptcy trustee within two years. Holding otherwise in this context would appear to deviate from the uniform reasoning of other circuits.

V. Conclusion

As of the date of this writing, the Second Circuit has not rendered its decision on the twin appeals arising from the *SemGroup* and *Tribune* bankruptcies. The *Lyondell* case is proceeding in the Bankruptcy Court and oral argument on motions to dismiss the latest amended complaint concerned other issues, it being law of the case that the safe harbors did not preempt that litigation. The decision from the Court of Appeals from the Second Circuit will significantly impact the pending *Lyondell* case, as well as the breadth of the safe harbors across the nation. In all likelihood, the decision will result in further requests for review by the United States Supreme

Court and perhaps proposed amendments to the Bankruptcy Code regardless of which side prevails.

EVOLUTION OF FIDUCUARY DUTIES UNDER DELAWARE LAW

By John H. Bae
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The directors of corporations facing financial distress often are required to make critical decisions on behalf of the corporation, such as whether to approve a merger or sale, to take on greater debt to finance the corporation's costs of operation, or other decisions that could impact the overall viability of the corporation and ultimately the interests of the corporation's shareholders and creditors. Because many, if not the majority, of U.S. corporations are incorporated under the Delaware General Corporation Law ("DGCL"), an understanding of the developments in Delaware jurisprudence is critical when advising directors of corporations that are facing financial distress.

This presentation reviews the evolution of Delaware law on the fiduciary duties of directors for financially distressed corporations. It also examines the potential liabilities professionals face when advising directors of troubled companies.

I. Fiduciary Duties of Directors of a Solvent Company

- Under Delaware law, the directors of a solvent corporation owe their fiduciary obligations, such as the duty of care and the duty of loyalty, to the corporation and its shareholders.
  - The duty of care generally requires directors to exercise the degree of care that an ordinarily prudent person would exercise under the same or similar circumstances.
    - Pursuant to section 102(b)(7) of the DGCL, corporations are permitted to include provisions in their certificates of incorporation exculpating directors from monetary damages for breach of duty of care except in very limited circumstances. Most companies have included such provisions, thereby limiting suits based on breaches of duty of care.
  - The duty of loyalty obligates directors to act in good faith in the best interests of the corporation and prohibits self-dealing and the usurpation of corporate opportunities.
- In the discharge of their fiduciary duties, directors generally have the benefit of the "business judgment rule," which is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.

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II. Ambiguity in the Law When Company is Insolvent or in the Zone of Insolvency

- The Delaware Supreme Court's 1944 decision in *Bovay v. H.M. Byllesby & Co.*, 38 A.2d 808 (Del. 1944), was often interpreted to hold that upon insolvency, the beneficiaries of the directors' fiduciary duties shifted from stockholders to creditors, and that once the company became insolvent, directors had a fiduciary obligation to preserve value for the benefit of creditors. *Id.* at 813 ("An insolvent corporation is civilly dead in the sense that its property may be administered in equity as a trust fund for the benefit of creditors.").

- The oft-cited footnote 55 of Vice Chancellor Allen's opinion in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp*., 17 Del. Corp. L. 1099 (Del. Ch. Dec. 30, 1991), spurred debate regarding the nature of directors' duties when their corporation is in the "zone of insolvency." The Court noted that "[t]he possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors." *Id.* at 1159 n. 55. The decision recognized that "the right (both the efficient and fair) course" for directors of an insolvent corporation might diverge from what stockholders would want. *Id.*

- Although the *Credit Lyonnais* court afforded the traditional business judgment protection while recognizing that the strategy might prove harmful to creditors, footnote 55 raised questions as to whether directors have expanded fiduciary duties when a company is in the zone of insolvency that can be enforced directly by creditors.

- The theory of "deepening insolvency" is a related concept pursuant to which plaintiffs sought to impose liability on boards of directors for forcing their corporation into insolvency. The Court in *Trenwick America Litig. Trust v. Ernst & Young, L.L.P*., 906 A.2d 168 (Del. Ch. 2006), rejected an independent cause of action for deepening insolvency, but left open questions relating to the scope and focus of directors' duties.

- In *Production Resources Group, LLC v. NCT Group, Inc*., 863 A.2d 772 (Del. Ch. 2004), the court attempted to provide guidance in the wake of *Credit Lyonnais* and *Trenwick*. The court explained that following insolvency, "directors continue to have the task of attempting to maximize the economic value of the firm." *Id.* at 791. Once a corporation is insolvent, creditors become the initial residual claimants, and may bring derivative claims for breach of fiduciary duties. *Id.* at 791-93. However, the decision in *Production Resources* left open the possibility that under limited circumstances a creditor may be able to bring a direct claim if the board of an insolvent company took action that frustrated the ability of a particular creditor to recover, to the benefit of other stakeholders.

III. Clarification by Delaware Courts

- In 2007, the Delaware Supreme Court clarified that the duties of directors of corporations in the zone of insolvency do not change and that directors must continue to discharge their fiduciary duties to the corporation and its shareholders. *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

- Once a company reaches the point of insolvency – as distinct from the zone of insolvency – fiduciary duties inure to the benefit of creditors. *See In re USDigital, Inc*., 443 B.R. 22 (Bankr. D. Del. 2011) (stating that after *Gheewalla*, the actual point of insolvency becomes integral to assessing the director's duty to creditors).

- However, in *Gheewalla*, the Delaware Supreme Court clarified that creditors of a corporation that is insolvent have no right to assert direct claims against corporate directors for breach of fiduciary duty. Instead, creditors may bring derivative claims against directors on behalf of the corporation for a breach of fiduciary duty.

- The court explained that recognizing a right for creditors to bring direct fiduciary duty claims against directors of insolvent corporations would create a conflict between the directors' duty to maximize value for the benefit of all interested parties and a direct fiduciary duty to individual creditors.

- Although the *Gheewalla* decision provided some much-needed clarity regarding the scope of directors' duties while a corporation is either in a zone of insolvency or insolvent, the decision left open questions as to whether directors' duties shifted to the corporation's creditors, or whether the duties continued to be owed to the shareholders, with the directors able to take into account the interests of the creditors.

- As clarified by later decisions such as *Quadrant Structured Products*, 102 A.3d 155, 176 (Del. Ch. 2014), following *Gheewalla*, it is clear that directors of an insolvent corporation do not owe direct fiduciary duties to creditors, but rather, owe duties to the corporation for the benefit of creditors and shareholders as the residual risk bearers.

- In *Quadrant Structured Products,* Athilon Capital Corp. ("Athilon") and its wholly-owned subsidiary were engaged in the business of selling credit protection to financial institutions. In order to obtain and maintain a AAA/Aaa credit rating, which was essential to Athilon's business model, Athilon was required to have a limited business purpose and to adopt and follow certain operating guidelines. Under these guidelines, Athilon's investment activities were limited to investing in only short-term, low-risk debt securities. In addition, if certain adverse events occurred, Athilon would go into "runoff," which required Athilon to wind down and liquidate.

- Like so many businesses, Athilon was damaged by the 2008 financial crisis. By August 2010, Athilon went into "runoff." EBF & Associates ("EBF") purchased all of Athilon's junior subordinated notes and all of Athilon's equity. After gaining control of the company, EBF appointed a new board of directors, which amended the operating guidelines, in part to allow Athilon to engage in riskier business activities. Subsequently, Quadrant Structured Products Company, Ltd. (the "Plaintiff") purchased other subordinated notes that had been previously issued by Athilon.

- Plaintiff filed a complaint against Athilon's board of directors alleging various claims, including derivative claims for breach of fiduciary duties. Plaintiff argued that Athilon was insolvent by the time EBF took control, and because the credit default industry had collapsed and Athilon was prohibited under its operating guidelines from engaging in other lines of business, there was no opportunity for the company to become solvent again. Plaintiff alleged that the board should have maximized the value of the company for the benefit of its stakeholders during the "runoff" by liquidating the company, rather than using Athilon's assets to engage in a high risk business strategy.

- Ruling on a motion to dismiss, the *Quadrant Structured Products* court ruled that the board's decision to engage in the high risk business strategy was protected by the business judgment rule. *Id*. at 192. In so holding, the court determined that there is no "conflict between the interests of the primary residual claimants (the creditors) and the interests of secondary residual claimants (the stockholders)." *Id.*

- The court in *Quadrant Structured Products* clarified that "The fiduciary duties that creditors gain derivative standing to enforce are not special duties to creditors, but rather the fiduciary duties that directors owe to the corporation to maximize its value for the benefit of all residual claimants." *Id.* at 193.

IV. <u>So What Happens Upon Insolvency?</u>

- When a company is solvent → duties run to the corporation and its shareholders. Shareholders of a solvent corporation may enforce the directors' fiduciary duties by way of a derivative action on behalf of the corporation.

- When a company is in the "zone of insolvency" → duties continue to run to the corporation and its shareholders.

> When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners. *Gheewalla*, 930 A.2d at 101.

- When a company is insolvent → duties run to the corporation and its residual claimants, which now include creditors as well as shareholders. There is a shift not in the directors' duties, but rather in the parties that have standing to sue. Specifically, creditors, as the corporation's residual claimants, now have the ability to bring derivative (though not direct) actions for breaches of fiduciary duty. Creditors do not have this standing when the corporation is solvent or in the "zone of insolvency." *Quadrant Structured Prods.,* 102 A.3d at 176 (quoting Robert J. Stearn, Jr. & Cory D. Kandestin, *Delaware's Solvency Test: What is it and Does It Make Sense? A Comparison of Solvency Tests Under the Bankruptcy Code and Delaware Law,* 36 Del. J. Corp. L. 165, 171 (2011)).

V. <u>Practical Implications for Directors</u>

- Having greater clarity regarding directors' fiduciary duties when the company is insolvent or in the zone of insolvency should make it easier for directors to perform their duties. Rather than having to focus on whether their decisions will better serve the interests of shareholders or creditors, directors can now focus on the interests of the corporation and its community of interests as a whole, which include the interests of both shareholders and creditors as the corporation's residual risk bearers. In addition, directors are now shielded from derivative actions by creditors when the company is in the nebulous "zone of insolvency."

- On the flip side, trustees and creditors' committees will have greater difficulty in asserting breach of fiduciary duty claims. Claims for breaches occurring during the "zone of insolvency" are no longer permitted. And even when the corporation's challenged actions occurred during insolvency, so long as directors can show that they acted for the interests of the corporation and its residual risk bearers, plaintiffs will have difficulty asserting claims based on the notion that directors preferred the interests of shareholders over the interests of creditors.

- The recent Delaware decisions could also have an impact on the ability of creditors' committees to get *STN* standing on the ground that the debtor-in-possession has "unjustifiably fail[ed]" to bring claims that are "likely to benefit the reorganization estate," since the claims may no longer be "colorable" under current Delaware law. *See In re STN Enterprises,* 779 F.2d 901, 904 (2d Cir. 1985), *remanded,* 73 B.R. 470 (Bankr. D.Vt. 1987). For example, a bankruptcy court may not be inclined to grant standing to a creditors' committee to sue the debtor's board of directors when the directors' alleged breaches appear to have occurred when the company was in the zone of insolvency, or when the directors can show that they focused on the interests of the corporation and not solely on creditors' interests.

- In addition to the clarification provided by these Delaware decisions, directors are still protected by the business judgment rule defense. So long as they act on an informed basis and consider the interests of the corporation and its residual risk bearers in making their decisions, they will be protected, even if their decisions are later criticized. So long as the directors have exercised their business judgment, committees and litigation trusts will have difficulty pursuing breach of fiduciary duty claims against them.

VI. <u>Fiduciary Considerations for Advisors</u>

- In two recent opinions relating to the sale of Rural/Metro Corporation ("<u>Rural</u>"), the Delaware Court of Chancery highlighted the importance of advisors avoiding conflicts of interest and fully informing boards of directors in furtherance of their fiduciary duties.

- In March 2014, the Court of Chancery found that the board of directors of Rural breached its fiduciary duties to its stockholders in connection with its sale, and found RBC Capital Markets, LLC ("<u>RBC</u>") liable for aiding and abetting these breaches of fiduciary duties. *See In re Rural Metro Corporation Stockholders Litigation*, 88 A.3d 54 (Del. Ch. 2014). Since the board of directors and Moelis & Company (Rural's other financial advisor) settled with the plaintiff stockholders prior to trial, only the plaintiffs' case against RBC went to trial.

- The attacks on RBC were two-pronged, relating to (1) the sale process and (2) disclosure violations. Because RBC had undisclosed conflicts of interest in connection with the sale transaction, the decision was viewed skeptically by the court.

- The court found that three of the directors had personal circumstances that inclined them towards a quick sale, and that the special committee formed to consider the sale began the process without approval of the full board of directors. Ultimately, RBC misled the board and attempted to use its position as the sell-side advisor to secure buy-side roles with private equity firms that were bidding for a competitor. The court held:

  > If the third party knows that the board is breaching its duty of care and participates in the breach by misleading the board or creating the informational vacuum, then the third party can be liable for aiding and abetting. *Id*. at 97.

- The court ultimately found that RBC's actions proximately caused the board's breach of their fiduciary duty and damaged Rural's stockholders by causing the company to be sold at a price below its fair value. *Id*. at 101.

- Importantly, the court held that the exculpatory provision in the company's certificate of incorporation does not apply to aiders and abetters pursuant to Section 102(b)(7) of the Delaware General Corporation Law.

- In October 2014, the court assessed damages and determined that RBC is required to pay 85% of the damages to the stockholder class. *See In re Rural/Metro Corp. Stockholders Litig.,* 102 A.3d 205 (Del. Ch. 2014).

  - Relying on a discounted cash flow analysis, the court determined that the fair value of Rural on a quasi-appraisal basis fell short of the merger price by $4.17 per share, and that the damages to the class of stockholders not affiliated with the defendants totaled approximately $91.3 million.

  - Rural, its directors and Moelis had settled before trial and obtained "joint tortfeasor" releases, under which the plaintiff class agreed that the damages recoverable against other tortfeasors would be reduced to the extent of the settling defendants' respective pro rata shares.

  - The court held that the unclean hands doctrine barred RBC from claiming a settlement credit as to claims involving that RBC's adjudicated "fraud upon the board," but that it could claim a settlement credit as to other claims. The court determined that the record at trial supported a finding that two of Rural's directors were joint tortfeasors, but did not support such a finding as to the other directors or the settling financial advisor. Allocating responsibility for the various claims on which liability had been previously found, the court entered judgment for approximately $75.8 million against RBC.

VII. Practical Implications for Advisors

- Proper disclosure of relationships with interested parties by professionals retained in chapter 11 cases is crucial and should provide a degree of protection from the type of claims RBC faced.

- However, the aiding and abetting claim upheld in *Rural/Metro Corp.* decision is not limited to breaches resulting from failure to disclose conflicts of interest. The focus of the decision is whether the advisors were aware that the directors were breaching their fiduciary duty, and whether they knowingly aided the breach.

- As noted above, these Delaware decisions will have an impact on courts throughout the country. Many courts, including those in New York, often look to Delaware jurisprudence for guidance on fiduciary duties of directors.

Stern v. Marshall and Its Progeny[1]
By Hon. Martin Glenn
U.S. Bankruptcy Judge
Southern District of New York

Supreme Court decisions strongly shape what bankruptcy judges can and can't do, particularly the decisions in *Murray's Lessee*, 59 U.S. 272 (1855); *Katchen v. Landy*, 382 U.S. 323 (1966); *Northern Pipeline v. Marathon Pipeline Co.*, 458 U.S. 50 (1982); *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833 (1986); *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989); *Stern v. Marshall*, 131 S. Ct. 2594 (2011); and, most recently, *Executive Benefits Ins. Agency v. Arkison*, 134 S. Ct. 2165 (2014).

A. Cases Imposing Limitations on the Authority of Bankruptcy Judges

Courts have grappled with constitutional and statutory limits on bankruptcy jurisdiction since before the current bankruptcy court system was created in the Bankruptcy Act of 1978 (the "1978 Act"). The inquiry commonly focused on whether a bankruptcy estate's affirmative claim against a third party involved the claims allowance process. For example, in *Katchen v. Landy*, 382 U.S. 323 (1966), the Supreme Court held that a bankruptcy judge had authority to enter judgment on a bankruptcy estate's preference action against a creditor that filed a proof of claim in the bankruptcy case, *and* to enter judgment against the creditor for an amount in excess of its proof of claim. The Court held that the preference action in question was, like any other claims objection, "part and parcel" of the claims allowance process, and therefore subject to adjudication by a bankruptcy court. *Id.* at 330. The Court explained: "he who invokes the aid of the bankruptcy court by offering a proof of claim and demanding its allowance must abide the consequences of that procedure." *Id.* at 333 n.9. "[O]ne of those consequences was resolution of the preference issue as part of the process of allowing or disallowing claims . . . ." *Stern*, 131 S. Ct. at 2616 (explaining *Katchen*).

The contours of bankruptcy jurisdiction remained unclear after enactment of the 1978 Act. In the landmark *Marathon* decision, the Supreme Court struck down as unconstitutional the provisions of the 1978 Act that granted bankruptcy courts final adjudicative authority over certain state law claims brought against third parties who were not otherwise part of the bankruptcy proceeding. The Court explained that Article III of the Constitution required those matters to be adjudicated by an Article III court, not an Article I bankruptcy court. 458 U.S. at 71–72. Notably, the defendant in *Marathon* had not filed a proof of claim in the bankruptcy case—an important distinction from *Katchen*. *See Stern*, 131 S. Ct. at 2615–18 (discussing *Katchen* and *Marathon*).

In 1984, after the delayed congressional response to the 1982 decision in *Marathon*, Congress adopted the Bankruptcy Amendments and Federal Judgeship Act of 1984 (BAFJA), Pub. L. No. 98-353, 98 Stat. 333 (codified in sections of titles 11 and 28). BAFJA amended the 1978 Bankruptcy Code, effectively repealing sections of the Code that the Court found unconstitutional in the *Marathon* decision. That enactment set the structure for our bankruptcy courts today. It codified the "core," "non-core" division that, until *Stern v. Marshall*, largely defined how bankruptcy judges determined their authority to act in the specific matters before them. On the basis of *Marathon*, Congress thought that the "core," "non-core" distinction was workable. Congress provided a non-exhaustive list of core proceedings in section 157(b)(2) of the 1984 Act. Non-core proceedings are those that are not core "but that [are] otherwise related to a case under title 11." 28 U.S.C. § 157(c)(1). Bankruptcy judges were given statutory authority to enter final judgments in core proceedings, *id.* § 157(b)(1), but were limited in non-core proceedings to submitting proposed findings of fact and conclusions of law to the district court for de novo review. *Id.* § 157(c)(1).

Proceedings involving the "allowance or disallowance of claims" are listed as core proceedings under 28 U.S.C. § 157(b)(2)(B). Even after *Marathon*, it remained clear—as it has been since *Katchen*—that bankruptcy courts could constitutionally determine matters that were part of the claims allowance process. *See, e.g.*, *Langenkamp v. Culp*, 498 U.S. 42, 44 (1990) ("[B]y filing a claim against a bankruptcy estate the creditor triggers the process of 'allowance and disallowance of claims,' thereby subjecting himself to the bankruptcy court's equitable power.") (citing *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 58–59 (1989)). This authority is codified in 28 U.S.C. § 157(b)(2)(B). But it was unclear whether Congress, by listing counterclaims as core in section 157(b)(2)(C), had provided that the filing of a proof of claim subjected a creditor to final adjudication by the bankruptcy court of *all* counterclaims by the estate (regardless of connection to the proof of claim), and, if so, whether that act was constitutional. *See* 1 Collier on Bankruptcy ¶ 3.02[d][i] (16th ed. rev. 2014).

The Supreme Court addressed this issue in *Stern v. Marshall*. In *Stern*, a creditor filed a proof of claim for defamation in the debtor's bankruptcy case, and the debtor defended the complaint and filed a counterclaim for tortious interference. *See Stern*, 131 S. Ct. at 2601. The bankruptcy court treated the counterclaim as core and entered judgment in favor of the debtor. *See id.* at 2601–02. The district court disagreed that the counterclaim was core and conducted a de novo review of the record as if the claim was non-core. *See id.* at 2602. On further appeal, the Ninth Circuit held that the debtor's counterclaim, although compulsory, was not a core proceeding under section 157(b)(2)(C). *Marshall v. Stern (In re Marshall)*, 600 F.3d 1037, 1057–58 (9th Cir. 2010). Specifically, the Ninth Circuit stated that

> a counterclaim under § 157(b)(2)(C) is properly a core proceeding arising in a case under the Code only if the counterclaim is so closely related to the proof of claim that the resolution of the counterclaim is necessary to resolve the allowance or disallowance of the claim itself. Such a construction of § 157(b)(2)(C) takes into account the whole of the statute, avoids rendering any terms superfluous, follows *Katchen*, and comports with the principles of *Marathon* and Congress' desire to revise the Bankruptcy Code in a manner consistent with the Constitution.

Id. at 1058 (internal quotation marks omitted).

On appeal to the Supreme Court, one of the questions presented was "[w]hether the Ninth Circuit opinion, which render[ed] § 157(b)(2)(C) surplusage in light of § 157(b)(2)(B), contravene[d] Congress' intent in enacting § 157(b)(2)(C)." Petition for Writ of Certiorari at ii, *Stern*, 131 S. Ct. 2594 (No. 05-1631), 2010 WL 3068082. The Supreme Court answered this question in the affirmative, rejecting the Ninth Circuit's reasoning. The Court held that the counterclaim at issue was indeed statutorily core under section 157(b)(2)(C) as a "counterclaim by the estate against persons filing claims against the estate." *Stern*, 131 S. Ct. at 2604. *See also* 1 Collier on Bankruptcy ¶ 3.02[d][i]. But even though the counterclaim was statutorily core, the Court concluded that Congress could not constitutionally authorize bankruptcy courts to finally determine the counterclaim, since the bankruptcy court "lacked the constitutional authority to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim." *Stern*, 131 S. Ct. at 2620. Thus, "*Stern* made clear that some claims labeled by Congress as 'core' may not be adjudicated by a bankruptcy court in the manner designated by § 157(b)." *Arkison*, 134 S. Ct. at 2172. *Stern* explicitly held that the debtor's counterclaim was "core" under section 157(b)(2)(C). *See Stern*, 131 S. Ct. at 2605 ("[W]e agree with [the creditor] that designating all counterclaims as 'core' proceedings raises serious constitutional concerns. . . . We would have to 'rewrit[e]' the statute, not interpret it, to bypass the constitutional issue § 157(b)(2)(C) presents. That we may not do.") (alteration in original) (quoting *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833, 841(1986)). Importantly, *Stern* did not alter the subject matter jurisdiction of the bankruptcy courts. As the Supreme Court stated, "[s]ection 157 allocates the authority to enter final judgment between the bankruptcy court and the district court. That allocation does not implicate questions of subject matter jurisdiction." *Stern*, 131 S. Ct. at 2607.

As discussed above, the core/non-core distinction generally does not bear on the question of federal subject matter jurisdiction—federal courts have jurisdiction to hear *both* core matters *and* non-core matters. *See* 28 U.S.C. § 1334(b). If a proceeding qualifies as one of the core proceedings enumerated in section 157(b)(2), the court has subject matter jurisdiction over the action as one "arising under" or "arising in" a bankruptcy case. The applicable test for determining whether the court may exercise related-to jurisdiction over non-core claims may depend on whether the claim is asserted before or after confirmation of a chapter 11 plan and whether the confirmed plan provides for reorganization or liquidation of the debtor.

After the 2011 decision in *Stern v. Marshall*, the distinction between core and non-core issues no longer completely determines the authority of bankruptcy judges to act, particularly for what the Court in *Arkison* described as "*Stern* claims"—statutorily core claims for which Article I bankruptcy judges may not enter final orders or judgment. Post-*Stern* decisions from lower federal courts have added to the uncertainty, particularly whether a bankruptcy judge may enter final orders or judgment with respect to core and non-core claims with the consent of the parties. However, on July 1, 2014, the Supreme Court granted *certiorari* from the Seventh Circuit's decision in *Wellness Int'l Network,* *Ltd. v. Sharif*, 727 F.3d 751 (7th Cir. 2013), *cert. granted*, 134 S. Ct. 2910 (2014), including the question "Whether Article III permits the exercise of the judicial power of the United States by the bankruptcy courts on the basis of litigant consent, and if so, whether implied consent based on a litigant's conduct is sufficient to satisfy Article III." The Supreme Court argument in *Wellness* took place on January 14, 2015. As it did in *Arkison*, however, the Court may decline to address the consent issue in *Wellness* if it rules in favor of the bankruptcy trustee on another issue on which *certiorari* was granted. The consent issue is important for the authority of both bankruptcy judges and magistrate judges to enter final orders and judgment with the consent of the parties.

Because the effectiveness of consent is dependent upon a referral of the *Stern* claim from the district court, many district courts have responded to the decision in *Stern* by amending their orders of reference—the means by which cases and proceedings are assigned to the bankruptcy courts.[2] These amendments have clarified that not only statutorily noncore matters, but also *Stern* claims are referred to the bankruptcy courts for resolution. Many bankruptcy courts have adopted local rules changes as well.

The issue whether consent is effective to permit a bankruptcy judge to enter final orders or judgments is discussed further below.

B. The Authority of Article I Judges to Decide Disputes

Marathon, *Stern v. Marshall*, and *Arkison* deal with the constitutional limitations placed on Article I judges. Article III, section 1 of the Constitution provides that the "judicial power of the United States shall be vested in one Supreme Court, and in such inferior courts as the Congress may from time to time ordain and establish." It also protects Article III judges (but not bankruptcy or magistrate judges) against diminution in salary.

In 1856, the Supreme Court in *Murray's Lessee*, 59 U.S. 272, 284 (1855), concluded that Article III does not permit Congress to "withdraw from [Article III]

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[2] At least 16 districts amended their orders of reference in light of *Stern*. For example, the U.S. District Court for the Southern District of New York adopted an amended standing order of reference on February 1, 2012, continuing to refer all bankruptcy cases or proceedings to the bankruptcy court, and specifying how the bankruptcy court or district court may deal with rulings in matters impacted by *Stern*. The order provides as follows:

> Pursuant to 28 U.S.C. Section 157(a) any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11 are referred to the bankruptcy judges for this district.
>
> If a bankruptcy judge or district judge determines that entry of a final order or judgment by a bankruptcy judge would not be consistent with Article III of the United States Constitution in a particular proceeding referred under this order and determined to be a core matter, the bankruptcy judge shall, unless otherwise ordered by the district court, hear the proceeding and submit proposed findings of fact and conclusions of law to the district court. The district court may treat any order of the bankruptcy court as proposed findings of fact and conclusions of law in the event the district court concludes that the bankruptcy judge could not have entered a final order or judgment consistent with Article III of the United States Constitution.

M-431 (Bankr. S.D.N.Y. Feb. 1, 2012).

judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty . . . ."

The Supreme Court applied this principle in *Marathon*, where it struck down as unconstitutional the 1978 Bankruptcy Act's provisions vesting final adjudicative authority in the bankruptcy court—an Article I court—over certain state-law claims asserted by the debtor against a third party. The Court held that Article III required final adjudicative authority over matters within the competence of the Article III judiciary to be vested in an Article III court. They must not be removed to tribunals where judges lack the Article III protections of life tenure and non-diminution of salary. The Court stated:

> Article III bars Congress from establishing under its Art. I powers legislative courts to exercise jurisdiction over all matters arising under the bankruptcy laws. The establishment of such courts does not fall within any of the historically recognized situations—non-Art. III courts of the Territories or of the District of Columbia, courts-martial, and resolution of "public rights" issues—in which the principle of independent adjudication commanded by Art. III does not apply.

Marathon, 458 U.S. at 51.

The Court explained the public rights doctrine as follows:

> The [public rights] doctrine extends only to matters arising between the Government and persons subject to its authority in connection with the performance of the constitutional functions of the executive or legislative departments, and only to matters that historically could have been determined exclusively by those departments. The understanding of these cases is that the Framers expected that Congress would be free to commit such matters completely to nonjudicial executive determination, and that as a result there can be no constitutional objection to Congress' employing the less drastic expedient of committing their determination to a legislative court or an administrative agency.

Marathon, 458 U.S. at 67–68 (internal quotation marks and citations omitted).

Bankruptcy judges may hear and determine (enter final judgment) on any issue that is "part and parcel" of the claims-allowance process. For example, in *Katchen v. Landy*, 382 U.S. 323 (1966), the Supreme Court upheld the authority of a bankruptcy judge, as part of the claims allowance process, to adjudicate and enter final judgment on a bankruptcy estate's claim to avoid and recover a preference against a creditor that filed a proof of claim in the bankruptcy case, *and* to enter judgment against the creditor for an amount in excess of the proof of claim the creditor filed. Bankruptcy judges may also enter final judgments on discharge matters. *See Cent. Va. Cmty. College v. Katz,* 546 U.S. 356, 363–64 (2006) ("Critical features of every bankruptcy proceeding are the exercise of exclusive jurisdiction over all of the debtor's property, the equitable distribution of that property among the debtor's creditors, and the ultimate discharge that gives the debtor a 'fresh start' by releasing him, her, or it from further liability for old debts."); *Tenn. Student Assistance Corp. v. Hood,* 541 U.S. 440, 447 (2004) ("The discharge of a debt by a bankruptcy court is similarly an in rem proceeding."); *Local Loan Co. v. Hunt*, 292 U.S. 234, 244–45 (1934) ("This purpose of the act has been again and again emphasized by the courts as being of public as well as private interest, in that it gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.").

This focus on what is necessarily part of the claims-allowance process is one of the crucial factors in understanding the implications of *Stern v. Marshall* for the authority of bankruptcy judges to enter final orders and judgments. The claims allowance process—including preference avoidance and recovery against a creditor that filed a proof of claim—is integral to the restructuring of the debtor-creditor relationship and invokes the bankruptcy court's equity jurisdiction. Therefore, there is no right to trial by jury.

Section 157(b)(2)(A)–(P) provides a non-exhaustive list of examples of core matters, including avoidance actions (§ 157(b)(2)(F) & (G)) and counterclaims by the estate against persons filing claims against the estate (§ 157(b)(2)(C)).

The statute provides that bankruptcy courts may hear core matters and non-core matters that are "otherwise related" to a case under title 11. But bankruptcy judges only have statutory authority to enter final judgments in core proceedings (§ 157(b)(1) ("hear and determine all cases . . . and all core proceedings"); in non-core proceedings, absent consent, bankruptcy judges may only enter proposed findings of fact and conclusions of law, with final orders or judgments entered by the district courts (§ 157 (c)(1) ("the bankruptcy judge shall submit proposed findings of fact and conclusions of law to the district court, and any final order or judgment shall be entered by the district judge")). The district court enters a final order or judgment after reviewing de novo any matters to which a party objects following the procedure set forth in Bankruptcy Rule 9033. In *Arkison*, the Supreme Court decided in a 9-0 decision that for "*Stern* claims"—for which section 157(b)(1) provides that bankruptcy judges may hear and determine all core proceedings and enter final orders and judgment but Article III does not permit a bankruptcy judge to do so—bankruptcy judges may enter proposed findings of fact and conclusions of law under section 157(c)(1), with final judgment entered by the district court after de novo review to the extent of any objections to the bankruptcy judge's proposed disposition following the procedure in Fed. R. Bankr. P. 9033. *Arkison* resolved the issue of the "statutory gap," since the statute only provides for proposed findings and conclusions for non-core, related-to claims, and not for core claims—in effect, after *Arkison,* the *Stern* claims are channeled to the procedure applicable for non-core claims. *See Residential Funding Co., LLC v. UBS Real Estate Securities, Inc. (In re Residential Capital, LLC)*, 515 B.R. 52, 66 (Bankr. S.D.N.Y. 2014) ("[A]djudication of *Stern* claims is channeled to section 157(c), permitting the bankruptcy court to submit proposed findings of fact and conclusions of law, *as if* the claim was non-core. The Court does not read *Arkison* to re-write the statute such that *Stern* claims are no longer statutorily core under 157(b)(2)—something the *Stern* court itself explicitly did not do.") (citation omitted).

Section 157(c)(2) provides that the parties may consent to a bankruptcy court's final adjudication of non-core matters. 28 U.S.C. § 157(c)(2) ("Notwithstanding the provisions of paragraph (1) of this subsection, the district court, with the consent of all the parties to the proceeding, may refer a proceeding related to a case under title 11 to a bankruptcy judge to hear and determine and to enter appropriate orders and judgments, subject to review under section 158 of this title."). As already mentioned, post-*Stern* circuit court cases are split over whether express or implied consent is sufficient to provide authority for bankruptcy judges to enter final orders or judgments on *Stern* claims or non-core matters with the consent of the parties. While the Supreme Court granted *certiorari* on the consent issue in *Arkison*,[3] the Court did not reach the question in resolving the case. The Supreme Court may resolve the issue in *Wellness* that was argued in January 2015, but as in *Arkison*, it may be unnecessary for the Court to reach the consent issue. The consent issue is important not only for bankruptcy judges, but also for Article I magistrate judges who currently may enter final orders and judgments based on the parties' consent.

C. The Framework for Analyzing the Consent Issue

In *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833, 847–49 (1986), the Supreme Court found two components inherent in the constitutional right to an Article III judge: (1) the individual constitutional right of litigants to insist on an Article III decision-maker; and (2) the structural constitutional right, stemming from the separation of powers doctrine which requires an Article III decision-maker. The individual constitutional right to an Article III decision-maker may be lost through waiver or express or implied consent. The structural right, however, assures that the executive and legislative branches will not encroach on the authority to enter a final judgment in certain matters. It is derived from the core separation of powers principle.

The major issue regarding consent is whether Congress removed from Article III judicial cognizance any cases in bankruptcy court for which the right to an Article III decision maker exists. *See Executive Sounding Board Assoc. Inc. v. Advanced Mach. &*

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[3] The *Bellingham* cert. petition raised the following two questions:

> The court of appeals' decision presents the following questions, about which there is considerable confusion in the lower courts in the wake of *Stern*:
>
> > 1. Whether Article III permits the exercise of the judicial power of the United States by bankruptcy courts on the basis of litigant consent, and, if so, whether "implied consent" based on a litigant's conduct, where the statutory scheme provides the litigant no notice that its consent is required, is sufficient to satisfy Article III.
> >
> > 2. Whether a bankruptcy judge may submit proposed findings of fact and conclusions of law for de novo review by a district court in a "core" proceeding under 28 U.S.C. 157(b).

Petition for Writ of Certiorari, Executive Benefits Ins. Agency v. Arkison, 2013 WL 1329527 (Apr. 3, 2013).

Engineering Co. (In re Oldco M Corp.), 484 B.R. 598, 604–05 (Bankr. S.D.N.Y. 2012) ("The right to an Article III judge does not always invoke both the individual and structural components of the right. The touchstone for the non-waivable structural right is that Congress may not withdraw from [Article III] judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty. In *Stern,* the Court set forth limitations on a bankruptcy judge's authority to enter a final judgment in certain matters; Congress did not remove from Article III judicial cognizance any cases in bankruptcy court for which the right to an Article III decision-maker exists. As a result, only the individual right is at issue and it can be lost through waiver or consent.") (internal quotations marks and citations omitted). The circuit courts are split in addressing the consent issue. The Supreme Court will have to resolve the issue.

D. The Circuit Courts Are Split on the Consent Issue

Post-*Stern* circuit court decisions have reached conflicting results on the consent issue. In *Bellingham* (now referred to as *Arkison*), the Ninth Circuit concluded that, based on express or implied consent, a bankruptcy judge may enter a final order or judgment in a core proceeding that would otherwise require that the district court enter final orders or judgment. *See Bellingham*, 702 F.3d at 567 ("Following the genesis of the modern bankruptcy system, the Supreme Court clarified that Article III, § 1's guarantee of an independent and impartial adjudication by the federal judiciary of matters within the judicial power of the United States . . . serves to protect primarily personal, rather than structural, interests. *Stern* further made clear that § 157 does not implicate questions of subject matter jurisdiction. Accordingly, as a personal right, Article III's guarantee of an impartial and independent federal adjudication is subject to waiver. And in fact, § 157(c)(2) expressly provides that bankruptcy courts may enter final judgments in non-core proceedings with the consent of all the parties to the proceeding. If consent permits a non-Article III judge to decide finally a non-core proceeding, then it surely permits the same judge to decide a core proceeding in which he would, absent consent, be disentitled to enter final judgment. We have previously held that a bankruptcy litigant impliedly consents to the bankruptcy court's jurisdiction when he fails to timely object." (internal quotation marks and citations omitted)). In *Mastro v. Rigsby*, 764 F.3d 1090 (9th Cir. 2014), the Ninth Circuit concluded that its earlier decision in *Executive Benefits Ins. Agency v. Arkison (In re Bellingham Ins. Agency, Inc.)*, 702 F.3d 553 (9th Cir. 2012), remains controlling law in the circuit. Therefore, the bankruptcy court in *Mastro* properly entered final judgment on a *Stern*-type fraudulent conveyance claim based on the parties' consent.

In a pre-*Stern* case that addressed the Article III issue based on the Supreme Court *Marathon* decision, the Second Circuit held that a bankruptcy judge may enter a final order or judgment based on express or implied consent in core or non-core proceedings. *Men's Sportswear, Inc. v. Sasson Jeans, Inc. (In re Men's Sportswear, Inc.)*, 834 F.2d 1134, 1137–38 (2d Cir. 1987) ("[E]ven if the instant action was not a 'core' proceeding, 28 U.S.C. § 157(c)(2) empowers the bankruptcy court to enter final judgment in a 'non-core' but 'related' matter, providing both parties consent to the court's jurisdiction. We conclude that [defendant's] failure to object to Judge Lifland's assumption of 'core jurisdiction' at any point in these extensive proceedings before the bankruptcy court and the further failure to object to any part of the appeal process in the district court constitutes consent to the final adjudication of this controversy before the bankruptcy court. . . . . We are cognizant that a court should not lightly infer from a litigant's conduct consent to have private state-created rights adjudicated by a non-Article III bankruptcy judge. Indeed, to do so would violate the spirit of *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.,* 458 U.S. 50 (1982), which emphasizes that the power to adjudicate private rights, such as the right to recover contract damages, cannot be lodged in a court lacking 'the essential attributes of the judicial power.' However, in the instant case, [defendant's] silence on the jurisdictional issue before both Judge Lifland and the district judge can only be construed as implied consent.") (citations omitted); *see also In re Oldco M Corp.*, 484 B.R. at 604–05 (concluding that a bankruptcy court may enter final orders or judgment in core and non-core matters based on express or implied consent).

The Fifth and Sixth Circuits have reached the opposite result. *See BP RE, L.P. v. RML Waxahachie Dodge, L.L.C. (In re BP RE, L.P.)*, 735 F.3d 279, 285–86 (5th Cir. 2013) ("Turning to whether the bankruptcy court had the *constitutional* authority to enter final judgment, we are bound to apply *Stern,* which held that, regardless of statutory authority, the bankruptcy court did not have the constitutional authority to enter a final judgment on claims that are so deeply at the heart of the federal judiciary's Article III powers and are not necessary to the resolution of the bankruptcy estate. What is plain here is that this case involves the most prototypical exercise of judicial power: the entry of a final, binding judgment by a court with broad substantive jurisdiction, on a common law cause of action, when the action neither derives from nor depends upon any agency regulatory regime. Construing *Stern,* the Sixth Circuit convincingly reached a similar conclusion involving non-core claims in *Waldman v. Stone,* 698 F.3d 910, 919 (6th Cir. 2012), *cert. denied,* 133 S. Ct. 1604 (2013): '[W]hen a debtor pleads an action arising only under state-law, as in *Northern Pipeline;* or when the debtor pleads an action that would augment the bankrupt estate, but not necessarily be resolved in the claims allowance process, then the bankruptcy court is constitutionally prohibited from entering final judgment.'" (internal quotation marks and citations omitted)). *See also Frazin v. Haynes & Boone, L.L.P. (In re Frazin)*, 732 F.3d 313, 319 (5th Cir. 2013) ("*Hudson's* holding that bankruptcy courts can enter final judgments in *all* core proceedings is clearly inconsistent with *Stern's* holding that bankruptcy courts cannot enter final judgments in one type of core proceeding, namely, state-law counterclaims that are not necessarily resolved in the claims-allowance process. We therefore conclude that *Stern* has unequivocally *sub silentio* overruled *Hudson* as to that type of core proceeding."); *Waldman v. Stone*, 698 F.3d at 918 ("The argument takes too narrow a view of the interests preserved by Article III. The issue here is not so much the aggrandizement of the Legislative or Executive Branches, as it is the diminution of the Judicial one. Article III could neither serve its purpose in the system of checks and balances nor preserve the integrity of judicial decisionmaking if the other branches of the Federal Government could confer the Government's judicial Power on entities outside Article III. Article III envisions—indeed it mandates—that the judicial Power will be vested in judges whose tenure and salary are protected as set forth in that Article. To the extent that Congress can shift the judicial Power to judges without those protections, the Judicial Branch is weaker and less independent than it is supposed to be. Waldman's objection thus implicates not only his personal rights, but also the structural principle advanced by Article III. And that principle is not Waldman's to waive.") (internal quotation marks and citations omitted).

The outcome on the consent issue is unclear in the Seventh Circuit. *See Peterson v. Somers Dublin Ltd.,* 729 F.3d 741, 747 (7th Cir. 2013) ("*Wellness International Network* did not discuss this circuit's decisions in *Geras* or *Gibson,* which hold that consent on the record authorizes decision by an untenured magistrate judge, even though the parties' failure to object does not. The panel also reserved judgment on the constitutionality of 28 U.S.C. § 157(c)(2), which authorizes the parties to consent to adjudication by a bankruptcy judge of certain proceedings that otherwise would go to a district judge. So we think the effect of an express and mutual waiver open in this circuit. Given the grant of *certiorari* in *Executive Benefits Insurance Agency,* the fact that the parties have not filed briefs discussing the distinction between waiver and forfeiture, and the fact that the bankruptcy court's authority over these proceedings does not depend on consent, we do not try to resolve today whether waiver and forfeiture should be treated the same way." (internal quotation marks and citations omitted)); *Wellness Int'l Network, Ltd. v. Sharif,* 727 F.3d 751, 771 (7th Cir. 2013) ("We think the Sixth Circuit has the better view under current law. *Schor* holds that waiver or consent may be a factor in determining whether delegation of judicial business to non-Article III tribunals is unconstitutional, but it cannot be dispositive because of the structural role of Article III, § 1. And *Stern* unequivocally holds that 28 U.S.C. § 157(b) violates the structural protections of Article III, § 1, in permitting a bankruptcy judge to enter final judgment in certain 'core proceedings.' In other words, unlike *Schor*, where party consent was permissible because the statutory scheme at issue did not implicate structural concerns, the Supreme Court has already held that the statutory scheme granting bankruptcy judges authority to enter final judgment in core proceedings *does* implicate structural concerns where the core proceeding at issue is the stuff of the traditional actions at common law tried by the courts at Westminster in 1789. Therefore, we cannot agree with our colleagues on the Ninth Circuit that the allocation of authority between bankruptcy courts and district courts with regard to core proceedings does not implicate structural interests.") (internal quotation marks and citations omitted).[4]

E. Many Issues Remain Regarding What Are "*Stern* Claims"

The Supreme Court's decision in *Stern v. Marshall* has impacted the bankruptcy court's ability to issue final judgments in core proceedings by holding that a bankruptcy court lacks constitutional authority to make final determinations on certain types of core matters. The *Stern* Court held that the bankruptcy court "lacked the constitutional

[4] The Seventh Circuit's conclusion in *Wellness* that a bankruptcy court cannot enter proposed findings and conclusions for *Stern* claims (effectively based on the statutory gap) was rejected by the Supreme Court in *Arkison*, channeling treatment of such claims to 28 U.S.C. § 157(c)(1). *See also Residential Capital*, 515 B.R. at 66.

authority to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim."

What this analysis makes clear is that the core, non-core division is not sufficient to resolve the question of bankruptcy judge authority to enter final orders or judgment. On a whole range of issues since *Stern v. Marshall* was decided, the lower federal courts have split on the issue whether a bankruptcy judge may enter final orders or judgment absent consent. For example, absent consent or the filing of a proof of claim by a creditor, courts are split over whether bankruptcy judges may enter final orders or judgment on preference and fraudulent conveyance claims.[5] They have also split over whether bankruptcy judges can enter final default judgments on preference and

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[5] For cases upholding the authority of bankruptcy judges to enter final judgments on preference avoidance claims, *see, e.g., Post–Confirmation Comm. v. Tomball Forest, Ltd. (In re Bison Bldg. Holdings, Inc.),* 473 B.R. 168, 171 (Bankr. S.D. Tex. 2012) (Isgur, J.) ("This Court may not issue a final order or judgment in matters that are within the exclusive authority of Article III courts. The Court may, however, exercise authority over essential bankruptcy matters under the 'public rights exception.' Actions to recover preferential transfers under § 547 fall within the Bankruptcy Court's constitutional authority.") (citations omitted); *Burtch v. Seaport Capital, LLC (In re Direct Response Media, Inc.),* 466 B.R. 626, 644 (Bankr. D. Del. 2012) (Gross, J.) ("This Court disagrees that the *Stern* decision stands for the . . . proposition that a non-Article III court does not have authority to enter a final judgment on a preference . . . claim brought by the Debtor to augment the estate, or any other core claim (as defined in 28 U.S.C. § 157(b)(2)) that is not a state law counterclaim. . . . By extension, the Court concludes that *Stern* does not remove the bankruptcy courts' authority to enter final judgments on other core matters, including the authority to finally adjudicate preference . . . actions like those at issue before this Court."); *West v. Freedom Med., Inc. (In re Apex Long Term Acute Care–Katy, L.P.),* 465 B.R. 452, 463 (Bankr. S.D. Tex. 2011) (Isgur, J.) ("The Court concludes that preference actions both stem from the bankruptcy itself and are decided primarily pursuant to *in rem* jurisdiction. The cause of action for preferential transfers is established by the Bankruptcy Code. The provision for recovering preferences is integrally bound up in the overall scheme for ensuring equitable distribution among creditors. Preferential transfers are payments for legitimate debts. Preferences are avoidable precisely because they enable some creditors to receive more than their fair distribution under the Bankruptcy Code. The entire purpose of the cause of action, then, is to enforce the Bankruptcy Code's equality of distribution. In this respect, preferential transfer actions are fundamentally different from fraudulent transfer actions, although the two causes of action superficially resemble.").

For cases rejecting the authority of bankruptcy judges to enter final judgments on preference avoidance claims, *see, e.g., Penson Fin. Servs. Inc. v. O'Connell (In re Arbco Capital Mgmt., LLP),* 479 B.R. 254, 264–66 (S.D.N.Y. 2012) (Oetken, J.) ("Most recently the Supreme Court concluded that the public rights exception is limited to 'cases in which the claim at issue derives from a federal regulatory scheme, or in which resolution of the claim by an expert government agency is deemed essential to a limited regulatory objective within the agency's authority.' . . . The Court . . . concludes that claims for avoidance of preferential transfers, where the creditor has filed no proof of claim, are not subject to the public right[s] exception. . . . While the Supreme Court has not expressly held that actions to avoid preferential transfers are matters of private right, the Supreme Court has examined the authority of the bankruptcy court to adjudicate preferential transfer claims in the Seventh Amendment context and determined that preference defendants are entitled to a trial by jury. . . . *Stern's dicta* similarly support the conclusion that where a creditor has not submitted a proof of claim, preference actions may be finally adjudicated only by an Article III court. . . . Accordingly, this Court concludes that preferential transfer claims, where, as here, the preference defendant has filed no proof of claim against the bankruptcy estate, are matters of private right.") (citations omitted); *Tabor v. Kelly (In re Davis),* 2011 WL 5429095, at *12 (Bankr. W.D. Tenn. Oct. 5, 2011) (Latta, J.) ("Using this test, when a creditor who has not filed a proof of claim is sued by the bankruptcy trustee to recover a preferential transfer, it is a matter of private right, which, as we have seen, requires the exercise of the judicial power of the United States, a power that cannot be exercised by a non-Article III judge.").

fraudulent conveyance claims.[6] Cases have generally upheld the authority of bankruptcy judges to enter final judgments on such things as dischargeability of debts and objections to discharge; determinations of the validity, extent, and priority of liens; confirmation of plans; orders approving the use, sale, or leasing of property; turnover of property of the estate (so long as it is not a disguised breach of contract action); approval of settlements; assumption and rejection of contracts; distribution of property of the estate; and many others.

F. The Bankruptcy Rules Require Parties to Identify "Core" and "Non-Core" Claims

Bankruptcy Rule 7008 makes Federal Rule of Civil Procedure 8 applicable in adversary proceedings. It also requires that "in an adversary proceeding before a bankruptcy judge, the complaint, counterclaim, cross-claim, or third-party complaint shall contain a statement that the proceeding is core or non-core and, if non-core, that the pleader does or does not consent to entry of final orders or judgment by the bankruptcy judge." Fed. R. Bankr. P. 7008(b). After *Stern v. Marshall*, the core vs. non-core division does not accurately determine a bankruptcy judge' authority to act without consent of the parties.

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[6] In the wake of the Supreme Court's decision in *Stern,* bankruptcy courts have split on the issue whether bankruptcy judges have the authority to enter default judgments based on a defendant's failure to respond to an adversary complaint in which a *Stern* claim is asserted. In *Oldco M Corp.*, 484 B.R. at 609–11, I concluded that a bankruptcy judge may enter a default judgment when a defendant fails to respond to the summons and adversary complaint in core and non-core matters based on implied consent. The conclusion in *Oldco* regarding implied consent is based on the official form of the summons that states (in all capital letters and in bold):

> **IF YOU FAIL TO RESPOND TO THIS SUMMONS, YOUR FAILURE WILL BE DEEMED TO BE YOUR CONSENT TO ENTRY OF A JUDGMENT BY THE BANKRUPTCY COURT AND JUDGMENT BY DEFAULT MAY BE TAKEN AGAINST YOU FOR THE RELIEF DEMANDED IN THE COMPLAINT.**

Official Bankruptcy Forms B 250A and B 250B.

Some courts have entered default judgments in preference actions, reasoning that preference avoidance and recovery actions under sections 547 and 550 of the Bankruptcy Code are not affected by the *Stern* decision. *See Hagan v. Classic Prods. Corp.* (*In re Wilderness Crossings, LLC*), 2011 WL 5417098 (Bankr. W.D. Mich. Nov. 8, 2011); *White v. Pugh (In re Butler Innovative Solutions),* 2011 WL 4628746 (Bankr. D.D.C. Oct. 4, 2011); *see also Apex,* 465 B.R. at 463 (preference recovery involves equality of distribution, an essential attribute of bankruptcy proceedings, rather than simply augmentation of the estate).

Other courts have taken what is arguably the safest path by submitting proposed findings of fact and conclusions of law to the district court for entry of a final judgment, thus avoiding the question whether a bankruptcy judge has the authority to enter the final order. *See, e.g., Best Western Int'l Inc. v. Richland Hotel Corp.,* 2012 WL 608016 (D. Ariz. Jan. 18, 2012); *Mich. State Univ. Fed. Credit Union v. Ueberroth (In re Ueberroth),* 2011 Bankr. LEXIS 5136 (Bankr. W.D. Mich. Dec. 19, 2011); *Hagan v. e–Limidebt, Inc. (In re Gifford*), 2011 U.S. Dist. LEXIS 104488 (W.D. Mich. Sept. 15, 2011); *Reed v. Johnson (In re Johnson),* 2011 Bankr. LEXIS 3542 (Bankr. W.D. Mich. Aug. 22, 2011).

Judge Hughes in the Eastern District of Michigan has written at length on the topic of bankruptcy judge authority to enter default judgments, ultimately concluding that bankruptcy judges lack the authority to enter final default judgments for claims that would be covered by the *Stern* decision. *See Moyer v. Koloseik (In re Sutton),* 470 B.R. 462 (Bankr. W.D. Mich. 2012); *Meoli v. Huntington Nat'l Bank (In re Teleservices Grp., Inc.),* 456 B.R. 318 (Bankr. W.D. Mich. 2011). However, Judge Dales, his colleague in the same district, has disagreed. *See In re Wilderness Crossings,* 2011 WL 5417098.

Bankruptcy Rule 7012 makes Federal Rule of Civil Procedure 12 applicable in adversary proceedings. But it also requires that "[a] responsive pleading shall admit or deny an allegation that the proceeding is core or non-core. If the response is that the proceeding is non-core, it shall include a statement that the party does or does not consent to the entry of final orders or judgment by the bankruptcy judge. In non-core proceedings final orders and judgments shall not be entered on the bankruptcy judge's order except with the *express* consent of the parties." Fed. R. Bankr. P. 7012(b) (emphasis added). The rule requires a party to disclose whether it consents to entry of final orders or judgment by a bankruptcy judge in non-core matters; the rule does not address consent in core matters, because section 157 provides that a bankruptcy judge may enter final orders or judgment in all core matters. Absent consent of the parties in non-core matters, the statute requires the bankruptcy judge to submit proposed findings of fact and conclusions of law, and then requires that final orders or judgment only be entered by the district court. After *Stern v. Marshall*, the bankruptcy judge may not enter final orders or judgment in core matters unless the issues will be resolved as part of the claims-allowance process or unless the matter determines the debtor's right to a discharge.

The issue whether bankruptcy judges may enter proposed findings of fact and conclusions of law in the absence of statutory authority for bankruptcy judges to enter proposed findings of fact and conclusions of law in core matters was resolved in *Arkison*. This issue is often referred to as the statutory gap—Congress in drafting section 157 of the Judicial Code assumed (incorrectly, as it turned out) that bankruptcy judges could enter final orders or judgments in all core matters, so there was no need to provide for entry of proposed findings of fact and conclusions of law, as Congress provided for non-core matters, where absent consent, only the district court may enter final orders or judgments.

Circuit case law was split over whether bankruptcy judges could issue proposed findings of fact in core matters: the Ninth Circuit answered *yes* in *Bellingham*; the Seventh Circuit answered *no* in *Wellness*. The Supreme Court, in the 9-0 decision in *Arkison*, resolved the issue, concluding that *Stern* claims may be treated as if they are non-core claims. The bankruptcy court should follow the procedure set forth in section 157(c)(1), submitting proposed findings of fact and conclusions of law, with a final judgment entered by a district court following de novo review.

Even before the *Arkison* decision, some district courts sought to fill the "statutory gap" through the adoption of general orders of reference authorizing bankruptcy judges to enter proposed findings of fact and conclusions of law in matters in which the bankruptcy judge may not enter final orders or judgment.[7]

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[7] *See* M-431 (Bankr. S.D.N.Y. Feb. 1, 2012 ("If a bankruptcy judge or district judge determines that entry of a final order or judgment by a bankruptcy judge would not be consistent with Article III of the United States Constitution in a particular proceeding referred under this order and determined to be a core matter, the bankruptcy judge shall, unless otherwise ordered by the district court, hear the proceeding and submit proposed findings of fact and conclusions of law to the district court. The district court may treat any order of the bankruptcy court as proposed findings of fact and conclusions

A number of bankruptcy courts, including my court in the Southern District of New York, have amended the local rules to require a statement whether the party filing the pleading consents to the entry of final orders or judgments in the event that a final order or judgment cannot be entered absent consent. *See* N.Y.S.B. Local Rules 7008-1 and 7012-1. Of course, whether the local rule can work as intended depends on the resolution of the consent issue.

Two further observations: First, counsel frequently ignore the requirements in Bankruptcy Rules 7008 and 7012, and in my court's amended local rules, requiring a statement about consent. Second, adversary complaints frequently contain a statement that "this complaint is a core proceeding," without focusing on separate causes of action within the complaint. But consider, for example, an adversary complaint filed by a debtor that contains two causes of action: one for recovery of a preference under Bankruptcy Code sections 547 and 550 that is statutorily "core" under section 157(b)(2)(F)); and the other for breach of contract for an alleged prepetition breach that is a non-core "related to" claim. The bankruptcy judge may enter final orders or judgment with respect to the preference avoidance claim if the creditor also filed a proof of claim. But the bankruptcy judge may not enter final orders or judgment absent consent with respect to the breach of contract claim (which was essentially the issue decided in *Marathon*) unless the resolution is part and parcel of the claim determination.

G. Determining Whether Claims Are Core or Non-Core

The bankruptcy judge must determine whether a proceeding is core or non-core. *See* 28 U.S.C. § 157(b)(3) ("The bankruptcy judge shall determine, on the judge's own motion or on timely motion of a party, whether a proceeding is a core proceeding under this subsection or is a proceeding that is otherwise related to a case under title 11. A determination that a proceeding is not a core proceeding shall not be made solely on the basis that its resolution may be affected by State law."). The core vs. non-core determination must be made on a claim-by-claim basis. And now, even for core proceedings, the determination whether a bankruptcy judge, absent consent, may enter final orders or judgment must be made on a claim-by-claim basis.

The precise determination that this section directs is no longer sufficient, since the bankruptcy judge may not be able to enter final orders or judgment, absent consent, on some matters that are statutorily core. The question which must be answered is whether a bankruptcy judge may enter final orders or judgment on each claim in the adversary complaint. The answer may not be simple.

Additionally, some proceedings are treated as non-core solely as a matter of congressional policy, not constitutional law. For example, wrongful death and personal injury claims against the estate are subject to mandatory withdrawal to the district court *for trial* under 28 U.S.C. § 157(b)(5). But even answering the question of what is a

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of law in the event the district court concludes that the bankruptcy judge could not have entered a final order or judgment consistent with Article III of the United States Constitution.").

personal injury or wrongful death action may not be simple. Courts apply different standards in making this determination. *See, e.g., Stranz v. Ice Cream Liquidation, Inc. (In re Ice Cream Liquidation, Inc.)*, 281 B.R. 154 (Bankr. D. Conn. 2002) (discussing the different approaches courts apply in resolving the question whether the claim is for personal injury or wrongful death). One of the overlooked portions of the decision in *Stern v. Marshall* is its holding that section 157(b)(5) is *not* jurisdictional and the parties may consent to the trial of personal injury and wrongful death claims in bankruptcy court. *Stern*, 131 S. Ct. at 2606 ("We need not determine what constitutes a 'personal injury tort' in this case because we agree with Vickie that § 157(b)(5) is not jurisdictional, and that Pierce consented to the Bankruptcy Court's resolution of his defamation claim.")

H. Does *Stern* Lead to Withdrawal of the Reference?

Section 157(d) provides that "[t]he district court may withdraw, in whole or in part, any case or proceeding referred under this section, on its own motion or on timely motion of any party, for cause shown. The district court shall, on timely motion of a party, so withdraw a proceeding if the court determines that resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce." 28 U.S.C. § 157(d).

The first sentence provides for withdrawal of the reference "for cause shown" and is permissive. The second sentence provides for mandatory withdrawal of the reference, but it is only mandatory if one of the parties moves to withdraw the reference.

After *Stern v. Marshall* was decided, there was a flood of motions to withdraw the reference in some districts. The motions generally argued that because the bankruptcy judge couldn't finally resolve the proceeding, judicial efficiency supported moving the case to the district court promptly. An almost unbroken line of district court cases all across the country now deny such motions to withdraw the reference without prejudice to renewing the motion when the case is trial ready. Bankruptcy judges may handle all pretrial proceedings and enter interlocutory orders on all motions before the reference is withdrawn and the proceeding is returned to the district court for trial if a jury is properly demanded.

In non-core cases in which consent has not been given, absent a timely jury demand in a case triable to a jury, the bankruptcy judge may try the case and submit proposed findings of fact and conclusions of law under Bankruptcy Rule 9033. Rule 9033 sets forth the procedure for objections to the proposed findings of fact and conclusions of law. The district court enters final orders or judgment.

With respect to motions to withdraw the reference, the motions are filed in the bankruptcy court, which then transmits them to the district court. Only the district court can decide the motion. Some district courts have local rules permitting or even requiring the bankruptcy judge to make a recommendation to the district court about the appropriate disposition of the motion.

Section 157(b)(3) provides that "the bankruptcy judge shall determine, on the judge's own motion or on timely motion of a party, whether a proceeding is a core proceeding under this subsection or is a proceeding that is otherwise related to a case under title 11." 28 U.S.C. § 157(b)(3). Bankruptcy Rule 5011(c) specifically provides that a motion to withdraw the reference or to abstain shall not stay the administration of the case or proceeding.