Chapman and Cutler LLP

Chapman Sidebar

Updates from Chapman's Litigation, Bankruptcy and Restructuring Group June 24, 2014

Executive Benefits Ins. Agency, Inc. v. Arkison – More Questions than Answers

In a much anticipated decision that could have significantly changed the landscape of our federal courts and agencies, the United States Supreme Court's recent decision in Executive Benefits Ins. Agency, Inc. v. Arkison[1] left the bankruptcy world in the status quo, leaving many of the larger constitutional issues unanswered.

In its 2011 decision in Stern v. Marshall,[2] the Supreme Court found it unconstitutional for a bankruptcy judge to issue final rulings on certain matters despite statutory authority over such claims. The Stern decision, however, did not provide any guidance as to how such claims were to be handled, if at all, by the bankruptcy courts going forward.

While the decision in Executive Benefits affirmed the process generally utilized by the courts since Stern, the Supreme Court did not tackle the constitutional issue of whether parties to a bankruptcy proceeding can consent, explicitly or impliedly, to the bankruptcy court's jurisdiction over such matters. The Supreme Court also did not define the scope of such claims. Both issues could have serious implications for the magistrate system as well as many federal agencies, guaranteeing further litigation of these issues to come.

Bankruptcy Court Jurisdiction: "Core" vs. "Non-Core" and the Statutory Gap

Under 28 U.S.C. § 157(b)(1), Congress vested bankruptcy judges with the power to enter final orders in all "core" proceedings, subject only to appellate review. Under 28 U.S.C. § 157(c)(1), however, Congress granted bankruptcy judges the authority, absent consent of the parties, only to submit proposed findings of fact and conclusions of law to the district court in "non-core" proceedings. The district court then reviews the bankruptcy court's findings *de novo* (i.e., anew and without deference) before entry of final judgment in the non-core proceeding.[3]

Congress enumerated sixteen nonexclusive examples of "core proceedings" under 28 U.S.C. §§ 157(b)(2)(A)-(P). These examples include, among others, "counterclaims by the estate against persons filing claims against the estate" and "proceedings to determine, avoid, or recover fraudulent conveyances."[4]

In *Stern*, however, the Supreme Court found that vesting the power to adjudicate an estate's counterclaim for tortious interference in the bankruptcy court had violated Article III of the Constitution. The Supreme Court determined that there was no exception for such counterclaim but that it was merely a "private right" - a claim under state common law between two private parties - that must be decided by an Article III judge even though it is a "core" proceeding.[5] As a result, many courts found a statutory "gap," in that Article III barred bankruptcy judges from entering final decisions on certain "core" proceedings specifically referenced under 28 U.S.C. § 157(b)(2) but the bankruptcy courts were also not explicitly authorized to propose findings of fact and conclusions of law in a "core" proceeding in the way that 28 U.S.C. § 157(c)(1) authorized for "non-core" proceedings.[6]

Responding to the Stern Gap -- Executive Benefits Ins. Agency, Inc. v. Arkison

The Ninth Circuit Court of Appeals considered the statutory "gap" issue in its decision in *Exec. Benefits Ins. Agency, Inc. v. Arkison (In re Bellingham Ins. Agency, Inc.)*,[7] the case underlying the *Executive Benefits* decision.

Case History

Nicholas Paleveda and his wife operated a series of companies, including Aegis Retirement Income Services, Inc. ("ARIS") and the Bellingham Insurance Agency, Inc. ("BIA"). In January 2006, BIA became insolvent, and immediately after, Paleveda incorporated Executive Benefits Insurance Agency ("EBIA") using BIA funds. Paleveda and others then deposited BIA assets equaling $373,291.28 (the "Transferred Funds") in an account controlled by ARIS and EBIA, with the money eventually credited to EBIA. On June 1, 2006, BIA filed a voluntary Chapter 7 bankruptcy.

The trustee appointed in BIA's bankruptcy case, Peter Arkison, filed a complaint against EBIA alleging both federal and state-law preferential and fraudulent conveyance claims for recovery of the Transferred Funds. EBIA brought a motion before the district court seeking to enforce its demand for a jury trial. The district court construed the motion as a motion to withdraw the reference (*i.e.* to remove the case from the bankruptcy court). Subsequently, Arkison moved for summary judgment in front of the bankruptcy court on his claims against EBIA.

EBIA petitioned the district court to stay consideration on its motion to withdraw the reference to allow the bankruptcy court sufficient time to adjudicate Arkison's motion for summary judgment. A month later the bankruptcy court granted summary judgment in favor of Arkison on the fraudulent conveyance claim in the amount of the Transferred Funds. EBIA appealed to the district court which conducted a *de novo* review of Arkison's claims and thereafter entered judgment in favor of Arkison.

EBIA then appealed to the Ninth Circuit Court of Appeals, and during the pendency of the appeal, the Supreme Court issued its opinion in *Stern v. Marshall*. In light of *Stern*, EBIA filed a motion to vacate the bankruptcy court's judgment, raising for the first time a constitutional challenge to the bankruptcy judge having entered judgment on Arkison's complaint.[8]

Ninth Circuit Closes the Gap

In *Bellingham*, the Ninth Circuit affirmed the district court's judgment holding that the bankruptcy court's judgment could be treated as proposed findings of fact and conclusions of law, subject to *de novo* review by the district court. While acknowledging that 28 U.S.C. § 157(b)(1) only specifically authorized that procedure for "non-core" proceedings, the Ninth Circuit closed the statutory "gap" by finding the language of 28 U.S.C. § 157(b)(1) expansive enough to also allow the submission of proposed findings of fact and conclusions of law to the district court even in "core" proceedings.[9]

Alternatively, the Court of Appeals held that even if a party has the right to have a matter determined by an Article III judge, such right is waivable. Further, the Ninth Circuit found that EBIA had consented to the bankruptcy judge's determination of the fraudulent conveyance claims through EBIA's failing to pursue its motion to withdraw the reference and allowing the bankruptcy judge to rule on Arkison's motion for summary judgment.[10] In other words, a party's consent to final judgment by a non-Article III judge does not need to be explicit but can be implied from that party's actions.

Supreme Court *Executive Benefits* Decision

The Supreme Court granted *certiorari* and ultimately affirmed the Ninth Circuit's decision in *Bellingham* in a unanimous opinion. The Supreme Court in *Executive Benefits*, however, did not believe a statutory "gap" resulted from *Stern*. Instead, the Supreme Court found that while *Stern* held 28 U.S.C. § 157(b) unconstitutional as to certain "core" proceedings (the "*Stern* claims"), the bankruptcy court could simply proceed with the Stern claims as "non-core" proceedings under 28 U.S.C. § 157(c)(1) and issue memorandum of findings of fact and conclusions of law to the district court. In determining this fix, the Supreme Court relied on the 1984 Act's severability provision, which provides that if a provision of the 1984 Act is held invalid the remainder of the 1984 Act will remain in effect and can be applied. In other words, when a bankruptcy court identifies a matter as a *Stern* claim, it has necessarily held invalid the definition of such matter as a "core" proceeding under 28 U.S.C. § 157(b), making such claim in essence "non-core" and subject to the procedures under 28 U.S.C. § 157(c).[11]

While that was not the procedure followed by the bankruptcy court in connection with EBIA, the Supreme Court held that the district court's *de novo* review and entry of its own judgment cured any potential error resulting from the bankruptcy court's entry of judgment.

Stern Claim Left Undefined

Stern claims are a new defined category of matters that a bankruptcy court may encounter. While noting in *Executive Benefits* that it is the bankruptcy court's responsibility to determine whether each claim before it is "core" or "non-core," the Supreme Court provided no guidance as to the criteria the bankruptcy court should follow to determine if a *Stern* claim is involved.[12] To the contrary, the Supreme Court relied upon the Ninth Circuit's determination in *Bellingham* that the fraudulent conveyance claims against EBIA are *Stern* claims without making its own determination.[13]

A majority of the Supreme Court may have not been ready to define a *Stern* claim as simply deciding between a "public" and "private" right as discussed by the plurality in *Northern Pipeline Contr. Co. v. Marathon Pipe Line Co*.[14] Other Supreme Court decisions have blurred the distinction between so-called "public rights" versus "private rights." The dissent in *Stern* noted the Supreme Court's decision in *Commodity Futures Trading Comm'n v. Schor*, stating that where "private rights," rather than "public rights" are involved, the danger of encroaching on the judicial powers of the Article III courts is greater (*i.e.* while non-Article III adjudication of "private rights" is not necessarily unconstitutional, the court's constitutional examination of such a scheme must be more "searching").[15]

Additionally, the impact of defining specific criteria for determining what claims bankruptcy judges are or are not authorized to decide as non-Article III judges could have much more far-reaching effects than just the bankruptcy world. As noted by the dissent in *Stern*, Congress has not only delegated authority to adjudicate disputes among private parties to bankruptcy judges, but also to federal agencies such as the National Labor Relations Board, the Commodity Futures Trading Commission, the Surface Transportation

Board, and the Department of Housing and Urban Development.[16] While the Supreme Court may not have been ready to provide further direction in *Executive Benefits*, without such guidance, further litigation over what is a *Stern* claim can be expected.

Supreme Court Avoids Consent

The Supreme Court also declined to decide whether parties to a dispute involving a *Stern* claim can consent, either explicitly or impliedly, to the bankruptcy court's jurisdiction to enter final judgment on such claim.[17] As discussed above, in *Bellingham* the Ninth Circuit held that the allocation of adjudicative authority between bankruptcy courts and Article III courts is waivable, a position disputed by EBIA in its briefs before the Supreme Court.

EBIA argued the preservation of the separation of powers among the three branches of government would not allow consent to the bankruptcy court's entry of judgment on the fraudulent conveyance claims.[18] In other words, if the bankruptcy court is constitutionally prohibited from entering final judgment, then the consent of the parties will not cure the improper vesting of such authority by Congress. If EBIA is correct, then 28 U.S.C. § 157(c)(2), which authorizes a bankruptcy court to enter final orders in non-core proceedings with the consent of the parties, may also be unconstitutional. This would also call into question the use of federal magistrate judges, which are also non-Article III judges.

While there is some case history that suggests consent to have a non-Article III judge determine a matter is constitutional, the issue as framed by EBIA has not been clearly answered and may require guidance from the Supreme Court. Until then, should a party desire to have a potential *Stern* claim heard by the bankruptcy court, explicit consent of all parties should be sought early in the proceedings. If, on the other hand, moving directly to the district court makes sense, the party should seek withdrawal of the reference immediately and not wait until after the bankruptcy court has conducted substantial proceedings.

For More Information

For more information, please contact Todd Dressel (415.278.9088), Michael Friedman (212.655.2508), Steve Tetro (312.845.3859) or your primary Chapman attorney, or visit us online at chapman.com.

1. *Executive Benefits Ins. Agency v. Arkison, No. 12-1200 (U.S. June 9, 2014)* ("Executive Benefits").
2. *564 U.S. __, 131 S.Ct. 2594 (2011) ("Stern").*
3. *28 U.S.C. § 157(c)(1).*
4. *28 U.S.C. § 157(b)(2)(C) & (H).*
5. *Stern, 131 S.Ct. at 2614.*
6. *Executive Benefits, slip op. at 9.*
7. *702 F.3d 553 (9th Cir. 2012).*
8. *Id., at 556-58.*
9. *Id., at 565-66.*
10. *Id., at 566-70.*
11. *Executive Benefits, slip op. at 9-10.*
12. *Executive Benefits, slip op. at 6-7.*
13. *Id., slip op. at 11.*
14. *458 U.S. 50 (1982) (plurality opinion).*
15. *Stern, 131 S.Ct. at 2625 (citing Commodity Futures Trading Comm'n v. Schor, 478 U.S. 833, 841 (1986)).*
16. *Id., at 2623.*
17. *Executive Benefits, slip op. at ft. n. 4.*
18. *Executive Benefits, Brief for Petitioner at 24-28.*

Chapman and Cutler LLP

Attorneys at Law · Focused on Finance®