

## BANKRUPTCY LAW

### What Are the Limits of a Bankruptcy Court's Authority?

The uncertainty continues after last year's Supreme Court decision in *Stern v. Marshall*

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The Supreme Court recently addressed again the power of bankruptcy courts to adjudicate certain disputes that arise in debtors' bankruptcy cases. *Stern v. Marshall*, 131 S. Ct. 2594 (2011). The Court's opinion, announced by a 5-4 majority, is perhaps better described as a continuation, rather than a resolution, of the uncertainty that has blurred the limits of a bankruptcy court's authority under the Constitution since the enactment of the Bankruptcy Code in 1978.

In *Stern*, the Court held that a 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

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proof of claim." This holding creates doubt about the constitutional authority of bankruptcy courts to hear and decide the numerous adversary proceedings that are routinely brought by trustees and debtors-in-possession seeking to avoid preferential or fraudulent transfers under Sections 547 and 548 of the code.

The uncertainty about the authority of the bankruptcy court can be traced back to the drafting of the code, when the Senate overrode the House's attempt to grant the bankruptcy judiciary the benefits of life tenure and a salary immune from reduction. The House Judiciary Committee issued a report that considered whether the requirements of Article III applied to bankruptcy judges. Article III requires that judges must receive life tenure and salaries that are immune from diminishment in order to exercise the judicial power of the United States. After reviewing Supreme Court precedent which had recognized exceptions to Article III's requirements, and finding that precedent inapplicable to bankruptcy courts, the committee recommended that bankruptcy judges receive Article III sta-

tus, which included life tenure and secure salaries. The House draft of the code followed that recommendation.

Opposition by the Judicial Conference of the United States, and telephone calls from Chief Justice Warren E. Burger to several senators, led the Senate to reject the House's proposed Article III status. The Senate Judiciary Committee issued a report that stated a limited term for bankruptcy judges would be preferable to life tenure, and dismissed concerns about "certain perceived constitutional impediments." The final version of the code incorporated the Senate's preference for limited-term judicial appointments while granting the bankruptcy courts broad adjudicatory power.

In 1982, the Supreme Court issued its initial opinion on the constitutionality of the bankruptcy courts established by the code, which comprised a plurality opinion, a concurrence, and two dissenting opinions. *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982). In *Marathon*, a debtor haled a party who had not filed a claim against the bankruptcy estate into bankruptcy court on account of a state law breach-of-contract claim. The defendant challenged the constitutional authority of the bankruptcy court to adjudicate the dispute, and the issue rose through the appellate

process to the Supreme Court. Justice Brennan's plurality opinion shared substantial similarities with the analysis contained in the House Judiciary Committee's report. Justice Brennan conducted a similar inventory of Supreme Court precedent recognizing exceptions to Article III, and similarly found that these exceptions did not apply to the new courts established by the Code. The Court held the bankruptcy court lacked constitutional authority to exercise jurisdiction over the case.

In response to the *Marathon* decision, Congress amended Title 28 of the United States Code to create the referral system currently in place between district and bankruptcy courts, and restricted bankruptcy judges' authority to enter final judgments to "core proceedings." 28 U.S.C. § 157.

Subsequent to this statutory amendment, the Court entertained another constitutional challenge to the authority of bankruptcy courts in *Granfinanciera v. Nordberg*, 492 U.S. 33 (1989). In *Granfinanciera*, a defendant in a fraudulent conveyance action brought by the trustee of the bankruptcy estate asserted a right to a jury trial under the Seventh Amendment, which was denied by the bankruptcy judge, who conducted a bench trial and entered judgment in the trustee's favor. As in *Marathon*, the defendant had not filed a proof of claim against the estate, or consented in any way to the jurisdiction of the bankruptcy court. The Court held the defendant was entitled to a jury trial under the Seventh Amendment, because (i) the trustee's claim for fraudulent conveyance had a clear analogue to the 18th century "[s]uits at common law" referenced in the Seventh Amendment, and (ii) the trustee sought monetary damages instead of equitable relief.

One year after *Granfinanciera*, in a brief per curiam opinion, the Court reiterated the distinction drawn in *Granfinanciera* between the Seventh Amendment rights of a creditor who submits a claim against the bankruptcy estate, and a party who steers clear of a debtor's bankruptcy case. *Langenkamp v. Culp*, 498 U.S. 42 (1990). In *Langenkamp*, unlike *Marathon* or *Granfinanciera*, the defendant in a preference avoidance action filed a proof of claim against the bankruptcy estate. The

Court, in denying the creditor's right to a jury trial, held that "by filing a claim against a bankruptcy estate the creditor triggers the process of 'allowance and disallowance of claims,'" in which both "the creditor's claim and the ensuing preference action by the trustee become integral to the restructuring of the debtor-creditor relationship through the bankruptcy court's *equity jurisdiction*," and thus lie outside the scope of the Seventh Amendment.

Now, two decades after *Langenkamp*, the Supreme Court has introduced a new element to the *Granfinanciera/Langenkamp* analysis. In *Stern*, a creditor who had sued the debtor for defamation and filed a claim against the bankruptcy estate found himself defending against a counterclaim for over \$400 million for his alleged tortious interference with the debtor's expectancy of a gift. The Court held that because the adjudication of the debtor's counterclaim required the bankruptcy court to make "factual and legal determinations that were not 'disposed of in passing on objections' to [the creditor's] proof of claim," the debtor's counterclaim was not "integral to the restructuring of the debtor-creditor relationship" provided for by the code. Rather, the debtor's claim was a state tort action "in no way derived from ... bankruptcy law." This position was anticipated in *Granfinanciera*, where the Court noted that, "actions to recover preferential or fraudulent transfers were often brought at law in late 18th century England," and "were conducted before juries." The *Stern* Court stated that the debtor's counterclaim for tortious interference and the fraudulent conveyance action in *Granfinanciera* were both actions seeking "to augment the bankruptcy estate" in contrast to actions "stem[ming] from the bankruptcy itself."

The Court provided a further basis for distinguishing *Langenkamp* by pointing out that in *Langenkamp*, "the preference action was asserting a right of recovery created by federal bankruptcy law." The Court did not address the fact that in *Granfinanciera*, the fraudulent transfer action was also a creature of federal bankruptcy law under Section 548. In a concurring opinion, Justice Scalia expressed misgivings that "something is seriously

amiss with our jurisprudence in this area" because of the varying rationales supporting the Court's decision.

This ambiguity has led subsequent courts to disagree on whether the *Stern* decision strips bankruptcy courts of authority to render final judgments on preference actions and fraudulent conveyance actions that seek recoveries exceeding the amount of a claim filed by a creditor. See *In re Refco*, Chapter 11, Case No. 05-60006, 2011 WL 5974532 (Bankr. S.D.N.Y. Nov. 30, 2011) (in the course of upholding the bankruptcy court's adjudicatory power, analyzing conflicting cases).

In *Refco*, the Bankruptcy Court for the Southern District of New York made perhaps the most persuasive case to date that bankruptcy courts still retain authority to render final judgments on all preference and fraudulent conveyance actions. The court observed that preference and fraudulent conveyance actions are embedded "within a unique statutory framework" which affects "how such cases are developed, paid for, litigated and resolved in the multi-party bankruptcy context, which differs significantly from the two-party state law setting." The court stressed that the pursuit of preference and fraudulent transfer claims has long been a routine and primary function of bankruptcy courts. Additionally, the court highlighted *Stern's* approving description of the trustee's preference action in *Langenkamp* as "a right of recovery created by federal bankruptcy law" over which the bankruptcy court properly exercised jurisdiction. These facts, combined with *Stern's* statement that it was only resolving a "narrow" question, led the court to conclude that its authority to hear and dispose of preference and fraudulent transfer actions remains intact after *Stern*.

In conclusion, bankruptcy courts are divided on the scope of *Stern's* consequences for preference and fraudulent transfer actions, and litigants in such actions will doubtless seek to use the issue to their advantage in the coming months and years. It would appear, however, that the *Refco* court has presented a strong case for leaving bankruptcy court authority undisturbed, and we expect that over time, a majority of bankruptcy courts will gravitate toward its reasoning. ■