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Supreme Court to rule on adjudicatory authority of bankruptcy judges

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Background

In *Executive Benefits Insurance Agency v Arkison*,(1) to be decided this term, the Supreme Court will confront questions arising in a bankruptcy trustee's fraudulent conveyance action that go to the scope and meaning of its much-noted decision in *Stern v Marshall*:(2) may a party to a dispute that the Constitution assigns to Article III courts consent by implication to entry of final judgment by a bankruptcy judge, who by definition sits outside of Article III? By answering affirmatively to that question,(3) the Ninth Circuit Court of Appeals placed itself in conflict with decisions of the Fifth, Sixth and Seventh Circuits.(4) How the Supreme Court reacts will go far to determining whether *Stern* "does not change all that much", as that opinion describes itself,(5) or is instead a watershed ruling that greatly diminishes the authority of bankruptcy judges and compounds the burdens of the district courts.

In *Stern*, the Supreme Court divided five to four, with the majority holding that Article III prohibited a bankruptcy judge from deciding a compulsory counterclaim for tortious interference raised by a debtor against a putative creditor. The creditor had filed suit for defamation against the debtor in the bankruptcy court and had submitted a proof of claim based on that action. In purporting to enter final judgment on the counterclaim, the bankruptcy court had exercised explicit statutory authority found in 28 USC § 157(b). The nub of the Supreme Court's decision was that the counterclaim was a matter of private rights that was not bound up in the bankruptcy claims allowance process, and that Congress could not constitutionally relegate such a matter to a bankruptcy judge for decision,(6) even though bankruptcy judges are subject to significant oversight and control by federal district courts by means of the bankruptcy reference system in place since 1984 (discussed further below). Bankruptcy judges are not Article III judges because, among other things, they do not hold office during good behaviour, but only for limited terms, and are not protected against having their compensation diminished while in office.(7) Under *Stern*, broadly speaking, when a dispute of private rights falls within bankruptcy jurisdiction, but not as part of the essential bankruptcy function of adjusting debtor-creditor relations, the Constitution allocates decision-making power to "Article III judges in Article III courts".(8) Certain language in *Stern*, however, seems to imply that there would have been no constitutional impediment if both parties had consented to the bankruptcy court's adjudication of the counterclaim.(9)

In *Arkison*, the Ninth Circuit Court of Appeals took up the thread of that suggestion and held not only that Article III admits of such consent, but also that a party's consent may be implied by its course of conduct in the litigation. The *Arkison* trustee won summary judgment against a non-creditor, Executive Benefits Insurance Agency (EBIA), on theories of fraudulent conveyance and successor liability. EBIA moved to withdraw the reference so that the matter could be tried to a jury in the district court, but did not specifically object to litigating the summary judgment motion to conclusion in the bankruptcy court. EBIA lost there and on appeal in the district court, and its further appeal was pending in the Ninth Circuit when the Supreme Court handed down its decision in *Stern*; whereupon EBIA supplemented its appellate briefs to assert for the first time that the bankruptcy court had violated Article III by rendering final judgment. The Ninth Circuit recognised that the dispute was one of private rights under the Supreme Court's *Granfinanciera* decision,(10) and accordingly that the litigants could properly have demanded decision by an Article III court; but it held that EBIA had waived its right by failing to object in a timely fashion to the rendering of final judgment by the bankruptcy court. The Ninth Circuit concluded that the intermediate appellate decision in *Stern* and the Supreme Court's decision in *Granfinanciera* had put EBIA on notice of the Article III issue, despite that circuit's own post-*Granfinanciera* precedents upholding

the constitutionality of broad delegations of adjudicatory authority to bankruptcy judges.(11) It ruled that, by failing to press the motion for withdrawal of the bankruptcy reference, EBIA had impliedly consented to the bankruptcy judge's exercise of adjudicatory authority in the case.(12) Indeed, the Ninth Circuit's opinion went so far as to treat EBIA as having attempted to "sandbag" the bankruptcy court by not raising an Article III objection until after that court had decided the summary judgment motion against it.(13) EBIA had left itself open to such an inference by failing to specify in its answer to the complaint, as required by Bankruptcy Rule 7008(a),(14) whether the claims against it were "non-core" matters and, if so, whether it consented to their resolution by the bankruptcy judge.

Points and counterpoints

In Section 157(b)(2), Congress has codified a non-exclusive list of bankruptcy "core proceedings" that bankruptcy judges may "hear and determine" and in which they are authorised by statute to "enter appropriate judgments and orders".(15) In such proceedings, the statutory role of the district courts is that of appellate tribunals,(16) which under normal standards must give deference to findings of fact by the court below, absent clear error. If a matter is "non-core" under the statute, by contrast, the bankruptcy judge's role is limited to rendering proposed findings and conclusions, and it is for the district court to enter any final order or judgment upon *de novo* review,(17) unless that court refers the matter to the bankruptcy judge for final disposition "with the consent of all parties to the proceeding".(18) The statute, however, does not purport to address the question whether such consent may validly be given where a matter is statutorily core, but falls within the province of Article III courts as a constitutional matter.

The statutory core proceedings include estate counterclaims, such as that considered in *Stern*, and fraudulent conveyance claims, such as that now coming before the Supreme Court in *Arkison*.(19) Under *Stern* and *Granfinanciera*, however, Article III trumps the statute with respect to such matters of private right and ordinarily entitles the parties to have these disputes decided by the district courts. Now the Supreme Court is poised to determine in *Arkison* whether these strictures of Article III give way if the parties consent to entry of final judgment by a bankruptcy judge or are deemed to consent by implied waiver or forfeiture of the right to insist upon an Article III tribunal.

Supreme Court precedent teaches that Article III:

> "*serves both to 'protect the role of the independent judiciary within the constitutional scheme of tripartite government,' and to safeguard litigants' 'right to have claims decided before judges who are free from potential domination by other branches of government.'*"(20)

Some have argued that "the structural and individual interests served by Article III are inseparable";(21) but at least since *Commodity Futures Trading Commission v Schor*,(22) the contrary view has prevailed. The distinction for Article III purposes between structural or institutional interests and individual or personal interests has led the Supreme Court to recognise that, "as a personal right, Article III's guarantee of an impartial and independent federal adjudication is subject to waiver, just are other personal constitutional rights that dictate the procedures by which civil and criminal matters must be tried".(23) On the other hand, where the powers of the federal judiciary are at stake, the litigants are not free to waive because they cannot be expected to protect the structure of tripartite government.(24)

How, then, are courts to discern whether Section 157(b)(2) and related provisions governing the interplay of bankruptcy judges and district courts implicate the constitutional role and powers of the Article III judiciary, rather than just the personal interests of litigants? *Schor* focuses the analysis on three factors:

- "the extent to which the 'essential attributes of judicial power' are reserved to Article III courts, and, conversely, the extent to which the non-Article III forum exercises the range of jurisdiction and powers normally vested only in Article III courts";
- "the origins and importance of the right to be adjudicated"; and
- "the concerns that drove Congress to depart from the requirements of Article III".(25)

An analysis of these factors as bearing on the consent issue in *Arkison* may be sketched out as follows:

- Extent to which "essential attributes of judicial power" are reserved to Article III courts - because the claim litigated in *Arkison* was "core" under Section 157(b), the statutory delegation of judicial power to the bankruptcy judge was complete: the bankruptcy judge wielded all of the powers that a district court would possess in sitting as the court of first instance. Under the statutory structure, of course, the delegation was permissive, not mandatory, in that matters are referred to bankruptcy judges by the district courts, who also retain authority to withdraw the reference "for cause".(26) In general, however, the reference is automatic under standing orders of the district courts, under the authority of Section 157(a).(27)

- Origins and importance of right to be adjudicated - the right adjudicated in *Arkison* was a trustee's suit against a non-creditor for fraudulent conveyance and successor liability. Under *Granfinanciera*, a claim of this kind is a matter of private rights, the adjudication of which goes to the heart of judicial power, rather than one involving the essential bankruptcy function of adjusting relations between debtors and creditors. In such a matter, the Supreme Court has emphasised, any "congressional attempt to control the manner in which those rights are adjudicated" calls for a "searching" examination under Article III.(28)
- Concerns that drove Congress - Congress assigned fraudulent conveyance claims to the statutory category of "core" proceedings as part of the 1984 amendments aimed at conforming the bankruptcy laws to the Supreme Court's teaching in *Northern Pipeline*.(29) That decision struck down the 1978 legislative overhaul of the bankruptcy laws precisely because Congress, in an effort to transform the bankruptcy courts into independent tribunals, had purportedly given bankruptcy judges judicial power over matters of private rights that traditionally fell within the province of Article III courts. When Congress bowed to *Northern Pipeline* in the 1984 amendments, it nevertheless adhered to the view that bankruptcy judges should exercise as much power as would be constitutional, with a view to easing the dockets of district courts and promoting speed and efficiency in bankruptcies and the myriad litigations that they entail.(30) Congress devised the bankruptcy reference system in an attempt to accomplish those ends without encroaching on the independence of the Article III judiciary. By giving district courts the prerogative to refer all manner of bankruptcy proceedings, in whole or in part, to bankruptcy judges, but also the ability to withhold or withdraw such a reference, Congress sought to place the delegation of power under the control of Article III courts themselves, so as to obviate any question of congressional usurpation of judicial power.(31)

This brief sketch suggests that the statutory designation of fraudulent conveyance claims as "core proceedings" cannot fairly be said to affect only waivable individual rights, as distinct from the non-waivable role of Article III courts in the US system of tripartite government. Indeed, in the similar context of *Stern*, the bankruptcy reference system did not prevent the Supreme Court from perceiving, and condemning, a statutory intrusion upon the separation of powers, or from signalling that it will be vigilant against even seemingly minor violations of Article III:

> "*If our decision today does not change all that much, then why the fuss? Is there really a threat to the separation of powers where Congress has conferred the judicial power outside Article III only over certain counterclaims in bankruptcy? The short but emphatic answer is yes. A statute may no more lawfully chip away at the authority of the Judicial Branch than it may eliminate it entirely.*"(32)

One cannot read Section 157(b) in context without recognising that the bankruptcy reference system heavily favours the delegation of decision-making authority to bankruptcy judges. To cite one telling indication, Section 157(d) mandates that a district court may withdraw the reference only "for cause shown",(33) implying a limitation on the discretion of the Article III court; whereas the making of the reference to bankruptcy judges is automatic under standing administrative orders of the district courts whenever litigation arises in or is related to a bankruptcy case, no matter what the specific subject matter. It is possible to view the statutory scheme as an invitation to district courts to abdicate their traditional judicial role. Does Article III permit district courts to cede their powers voluntarily, with or without a nudge from Congress? That way of posing the question suggests that a truly "searching" examination would discern a real structural issue in *Arkison*. At a minimum, the sharp dichotomy drawn in *Schor* between the personal interests of litigants and the structural interests of the courts seems unrealistically stark. In a case such as *Arkison*, both sets of interests are inevitably at stake.

Still, there are strong reasons to doubt that the Supreme Court will rule that the constitutional assignment of decision-making power to Article III courts in fraudulent conveyance cases cannot be waived by agreement of the parties. Even leaving aside the substantial practical considerations weighing against it, such a rule would seem unduly rigid, unless the statutory scheme of Section 157(b) is thought to pose a substantial threat to Article III courts that could be avoided only by forcing the parties in a private rights dispute to proceed in district court if their case falls within federal jurisdiction. Yet parties are free to submit such disputes to binding arbitration or to resolve them by settlement; nothing compels them to go to the lengths of a trial in a district court. If parties choose instead to litigate, there seems to be no compelling reason to force them into the district court if they are unanimous in preferring to submit their private rights dispute to a bankruptcy judge for ultimate disposition - much as the American College of Bankruptcy has suggested, as an amicus in *Arkison*, that parties were permitted (but not required) to do in the days of bankruptcy referees and commissioners.(34)

Comment

The bankruptcy reference system undoubtedly encourages district courts to delegate

power to bankruptcy judges, and some district courts may be only too willing to cede their traditional role in adjudicating matters of private right that happen to be disputed in a bankruptcy context. On any realistic view, this system does implicate the structural interests surrounding the role of Article III courts in the US constitutional scheme, but not so heavily or so inflexibly as to justify a rule forbidding parties to litigate such matters on consent before a non-Article III decision maker - namely, a bankruptcy judge. And where express consent is permissible, it is just a small step to recognise that litigation conduct may fairly imply consent in some circumstances. However, consent should not be implied lightly; nor should parties who have a constitutional right to insist upon an Article III forum be penalised, subtly or overtly, for standing on that right.

In cases such as *Arkison*, the challenge for courts is to devise a rule that protects the constitutional right of access to an Article III forum where that right exists, while preventing unfair and inefficient gamesmanship by parties who were content to take their chances before a bankruptcy judge until the outcome proved disappointing. For practitioners litigating in a bankruptcy context, the issues being aired in *Arkison* serve as a healthy reminder to look beyond the statutory core/non-core distinction by carefully considering whether the litigation is one that may be conducted as of right in an Article III court, and to press that right by appropriate means unless the client knowingly and voluntarily elects to proceed before a bankruptcy judge.

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Endnotes

(1) *Exec. Benefits Ins Agency v Arkison*, No 12-1200 (S Ct petition for cert granted June 24 2013).

(2) *Stern v Marshall*, 131 S Ct 2594 (2011).

(3) *Bellingham Ins Agency, Inc v Arkison* (*In re Bellingham Ins Agency*), 702 F3d 553, 569-70 (9th Cir 2012), cert granted, No 12-1200 (S Ct June 24 2013).

(4) *Wellness Int'l Network Ltd v Sharif*, 727 F3d 751, 771 (7th Cir 2013); *Frazin v Haynes & Boone, LLP* (*In re Frazin*), 732 F3d 313 (5th Cir 2013); *Waldman v Stone*, 698 F3d 910 (6th Cir 2012).

(5) *Stern*, 113 S Ct at 2620.

(6) See *id.*

(7) US Const, art III, § 1.

(8) *Stern*, 113 S Ct at 2608, 2620.

(9) *Id* at 2614-15.

(10) *Granfinanciera, SA v Nordberg*, 492 US 33 (1989).

(11) See *Arkison*, 702 F3d at 569 (citing *Marshall v Stern*, 600 F3d 1037 (9th Cir 2010)).

(12) *Arkison*, 702 F3d at 568.

(13) *Id* at 570.

(14) Fed R Bankr P 7008(a).

(15) 28 USC § 157(b)(1)–(2).

(16) *Id* § 158(a).

(17) *Id* § 157(c)(1).

(18) *Id* § 157(c)(2).

(19) *Id* § 157(b)(2)(C), (H).

(20) *Commodity Futures Trading Comm'n v Schor*, 478 US 833, 848 (1986) (quoting *Thomas v Union Carbide Agricultural Prods Co*, 473 US 568, 583 (1985), and *United States v Will*, 499 US 200, 218 (1980) (citation omitted)).

(21) *Schor*, 478 US at 867 (Brennan, J, joined by Marshall, J, dissenting).

(22) *Schor*, 478 US at 848.

(23) *Id* at 848-49.

(24) *Id* at 850-51.

(25) *Id* at 851 (citing *Thomas*, 473 US at 587, 589-93, and *Northern Pipeline Constr Co v Marathon Pipe Line Co*, 458 US 50, 84-86 (1982)).

(26) 28 USC § 157(d).

(27) 28 USC § 157(a).

(28) *Schor*, 478 US at 854.

(29) See 28 USC § 157(b)(2)(H).

(30) See generally, eg, Hon William L Norton, Jr & William L Norton III, 1 *Norton Bankr L & Prac* 3d § 4:41 (2013); C Richard McQueen & Jack F Williams, *Tax Aspects of Bankruptcy Law* 3d §§ 3:5 & 3:6 (2013); E-1 *Collier on Bankruptcy* app pt 6(b), at app pt 6-111 (Lawrence P King *et al*, eds, 16th ed 2012).

(31) See generally, eg, *id.*

(32) *Stern*, 113 S Ct at 2620.

(33) 28 USC § 157(d).

(34) Brief of Amicus Curiae The American College of Bankruptcy in Support of Respondent, *Executive Benefits Ins Agency v Arkison*, No 12-1200 (S Ct filed Nov 15 2013).