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Ninth Circuit Prohibits Bankruptcy Courts from Entering Judgments on Fraudulent Conveyance Claims Against Non-Claimants

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The Ninth Circuit recently held that: (1) bankruptcy courts lack the constitutional authority to enter a final judgment on all fraudulent transfer claims against non-claimants, whether brought under state or federal law, and (2) a defendant can waive such an argument by not asserting the applicability of *Stern v. Marshall*¹ at the trial level.² Further, in dicta, the court noted that bankruptcy courts may issue proposed findings of fact and conclusions of law in matters in which the bankruptcy court cannot issue final orders. The Ninth Circuit thus becomes the first circuit court to apply *Stern* to fraudulent transfer claims brought under federal law, not just state law. By extending this application, it could be argued that bankruptcy courts lack the authority to enter final judgments in *all* avoidance actions brought against a non-claimant.

In *Bellingham*, the bankruptcy trustee brought several claims, including both state and bankruptcy law fraudulent transfer claims, against the Executive Benefits Insurance Agency (EBIA), a non-creditor that had not filed a proof of claim in the underlying bankruptcy case. The bankruptcy court granted summary judgment on the fraudulent transfer claims in favor of the trustee, which the district court affirmed. On appeal to the Ninth Circuit, EBIA moved to vacate the judgment, arguing that *Stern* precluded the bankruptcy court from entering a final judgment on the bankruptcy law fraudulent transfer claim.

The Supreme Court held in *Stern* that even though bankruptcy courts have statutory authority to enter a final judgment on a state law counterclaim, such authority is unconstitutional unless the claim falls under the “public rights” exception³ or it would be resolved in the claims allowance process. Further, the Court held that a party may always consent to final adjudication by the bankruptcy court on any type of claim, noting that consent may take several forms, including participation in litigation before the bankruptcy court.⁴ The filing of a proof of claim may constitute consent for adjudication of private rights, but only when those private rights would necessarily be resolved in the claims allowance process.⁵

Since *Stern*'s holding limiting bankruptcy court authority, bankruptcy and district courts alike have struggled with determining the limits and extent of bankruptcy court jurisdiction.⁶ However, prior to *Bellingham*, no circuit court had addressed whether *Stern* applies to fraudulent transfer claims brought under federal law, not just state law. While *Bellingham* thus increased the scope of the *Stern* ruling in terms of the types of claims to which it is applicable, *Bellingham* also limits the practical implications of *Stern* by finding that bankruptcy courts can enter findings of fact and conclusions of law on all types of claims.⁷

¹ 564 U.S. ___, 131 S. Ct. 2594 (2011).

² *Executive Benefits Ins. Agency v. Arkison (In re Bellingham Ins. Agency, Inc.)*, No. 11-35162 (9th Cir. Dec. 4, 2012). The second holding regarding waiver, which is in direct opposition to the Sixth Circuit's holding in *Waldman v. Stone*, 698 F.3d 910 (6th Cir. 2012), constitutes the first *Stern* jurisprudence circuit split.

³ In *Stern*, the Supreme Court stated that a claim falls under the public rights exception if it derives from a federal regulatory scheme or if it is a case in which “resolution of the claim by an expert government agency is deemed essential to a limited regulatory objective within the agency's authority.”

⁴ See, e.g., *In re Titus*, 467 B.R. 592 (Bankr. W.D. Pa. 2012) (noting consent when litigant removed proceeding to the bankruptcy court).

⁵ See, e.g., *In re Coudert Bros., LLP*, 2011 WL 5593147 (S.D.N.Y. 2011).

⁶ Compare *In re Kimball Hill*, 480 B.R. 894 (Bankr. N.D. Ill. 2012) (holding all fraudulent transfer claims derive from federal bankruptcy law, and thus they all fall under the public rights exception, even against non-claimants) with *In re Lyondell Chem. Co.*, 467 B.R. 712, 721-22 (S.D.N.Y. 2012) (holding no fraudulent transfer claims fall under the public rights exception).

⁷ Significantly, the Ninth Circuit further limited *Stern* by holding that a *Stern* claim could be waived by the litigant through implied consent, directly opposing the holding of the Sixth Circuit in *Waldman*.

Fraudulent Transfer Claims

In *Bellingham*, the Ninth Circuit became the first circuit court to hold that bankruptcy judges lack the power to enter final judgments in fraudulent transfer claims brought under the Bankruptcy Code⁸ against non-claimants, notwithstanding the fact that such claims are “core” proceedings by virtue of arising under the Bankruptcy Code. As such, the Ninth Circuit eschewed the reasoning of several lower courts that fraudulent transfer claims arising under the Bankruptcy Code, as opposed to state law, “flow from a federal statutory scheme” by virtue of their creation under federal law, and thus fall under the public rights exception.⁹ Citing case law addressing jury trial rights in fraudulent transfer actions,¹⁰ the Ninth Circuit noted that the public rights exception requires the “restructuring of debtor-creditor relations.” The *Bellingham* court also noted that the only purpose of fraudulent transfer claims brought against a non-claimant is to augment the estate, notwithstanding the scope of law under which it is brought. Thus, the court concluded that such claims did not fall under the public rights exception. If, however, the fraudulent transfer action was brought against a creditor who had filed a proof of claim, and the action would be “necessarily resolved” by such proof of claim, then the bankruptcy court would have constitutional authority to enter a final judgment on the action. As such, the *Bellingham* decision suggests that a bankruptcy court cannot issue a final order in any claim, whether arising under state or bankruptcy law, that seeks to augment the debtor’s estate, or in which the right to a jury trial exists. To its logical extreme, this ruling could apply to all avoidance powers under the Bankruptcy Code, not the least of which would be preference actions, as the argument could be made that the sole purpose of any avoidance action against a non-claimant is to augment the estate.

Waiver

Importantly, the Ninth Circuit also held that a non-claimant not only can explicitly consent to jurisdiction of the bankruptcy court, but also can impliedly consent to jurisdiction through its own inaction. In fact, in *Bellingham*, the court affirmed summary judgment against EBIA, as the court held that EBIA had impliedly consented through waiver by failing to raise the applicability of *Stern* prior to its final appeal, even though *Stern* had not been decided until after EBIA’s appeal to the Ninth Circuit.

In *Waldman*, the Sixth Circuit reached the opposite conclusion, noting that Article III of the Constitution provides protections both as a personal right and as a structural principle. In the context of bankruptcy, the structural principle of Article III safeguards against the diminution of the judiciary’s Article III power that would occur upon transferring jurisdiction to a non-Article III bankruptcy court. Thus, the defendant cannot waive this structural principle, as it protects the judiciary instead of the individual litigant. As a result, the Sixth Circuit held that an objection to a bankruptcy court’s adjudicative power cannot be waived and may be raised at any time.

The “Statutory Gap”

Finally, the Ninth Circuit discussed the “statutory gap” within 28 U.S.C. Section 157. This section provides for adjudicatory power to bankruptcy courts when the matter is a core proceeding, but allows bankruptcy courts power to only issue proposed findings of fact and conclusions of law when the matter is non-core. Post-*Stern*, the question arises whether a subcategory of core but unconstitutional claims exists, and if so, what the extent of the bankruptcy court’s authority is on such claims. The Ninth Circuit followed the majority view, noting in dicta that the authority of the bankruptcy court to “hear and determine” core claims under Section 157(b)(1) includes the authority to submit proposed findings of fact and conclusions of law.

While only dicta, this creates another circuit split, as the Sixth and Seventh Circuits both follow the minority view that bankruptcy courts have no authority over core but unconstitutional claims.¹¹

⁸ 11 U.S.C. § 548.

⁹ See, e.g., *In re Kimball Hill*, 480 B.R. at 906-907; *In re Kingston*, 2012 WL 632398, at *2 (Bankr. D. Idaho Feb. 27, 2012).

¹⁰ *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989).

¹¹ See *Waldman*, 698 F.3d at 916-17, 921-22; *Ortiz v. Aurora Health Care, Inc. (In re Ortiz)*, 665 F.3d 906, 915 (7th Cir. 2011).

Implications of *Bellingham*

The Ninth Circuit in *Bellingham* made no distinction between state and bankruptcy law fraudulent transfer claims against non-claimants, holding that the only question is whether such claim would require the “restructuring of debtor-creditor relations.” *Bellingham* thus creates a circuit split: In the Ninth Circuit, mere implied consent is all that is necessary to waive the argument under *Stern* that the bankruptcy court lacks the authority to enter a final judgment. If such an argument is not brought up prior to trial in the bankruptcy court, that argument is conclusively waived. Accordingly, defendants in such actions need to consider the implications of *Stern* immediately to ensure that defenses relating to *Stern* are not waived. Additionally, in light of the distinction made in some circuits between claimants and non-claimants, creditors should consider the potential risk of waiver from filing a claim in the bankruptcy court.

Finally, bankruptcy courts within the Ninth Circuit may continue to issue findings of fact and conclusions of law on both core and non-core claims, adding further credence to the majority view regarding the “statutory gap.”

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