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ALERT

U.S. SUPREME COURT DRAMATICALLY CURTAILS BANKRUPTCY COURTS' POWERS

Decision casts doubt on certain judgments entered against debtors in bankruptcy court

By Brett A. Axelrod

The United States Supreme Court recently narrowed the scope of the authority of bankruptcy courts, with potential far-reaching implications on past, present and future bankruptcy matters. The case, *Stern v. Marshall*, 131 S.Ct. 2594 (2011), began as a dispute between Anna Nicole Smith and the son of her late husband. After several years of litigation and one previous trip to the U.S. Supreme Court, the Court ruled bankruptcy courts lack the authority to enter judgments on counterclaims against a debtor that are based on state law. The decision limits the jurisdiction of bankruptcy courts to consider or decide certain matters. The decision will have significant and broad implications that will require certain types of claims to be decided by non-bankruptcy courts.

In *Stern*, the Supreme Court decided Congress exceeded its authority when it statutorily authorized bankruptcy courts to hear certain cases. Bankruptcy courts are creatures of statute, created by Congressional legislation, in which Congress determines the scope of authority of bankruptcy courts. Bankruptcy courts can only rule on issues when Congress gives them authority to do so. Congress' authority is, however, limited by the U.S. Constitution. The Supreme Court held Congress' election to give statutory authority to bankruptcy courts to decide certain cases exceeded Congress' authority under the Constitution.

In *Stern*, the Supreme Court recognized the bankruptcy court had statutory authority to render a final judgment on the debtor's compulsory counterclaim because it was a core proceeding under the bankruptcy code, but held the exercise of that authority an unconstitutional usurpation of the judiciary's power under Article III. ("Article III of the Constitution provides that the judicial power of the United States may be vested only in courts whose judges enjoy the protections set forth in that Article. We conclude today that Congress, in one isolated respect, exceeded that limitation in the Bankruptcy Act of 1984.")

The Constitution's system of separation of powers prohibits Congress from removing cases from the judiciary that are "the subject of a suit at the common law, or in equity, or admiralty." *Stern* at 2609. Discussing historical precedent, the Court held that "when a suit is made of 'the stuff of the traditional actions at common law tried by the courts at Westminster in 1789,' and is brought within the bounds of federal jurisdiction, the responsibility for deciding that suit rests with Article III judges in Article III Courts." *Stern* at 2609.

Article III courts are creations of the U.S. Constitution. Article III judges are appointed by the President of the United States, have lifetime appointments, and their salaries cannot be reduced by acts of Congress. Bankruptcy courts are not Article III courts. The *Stern* Court reasoned that because non-Article III courts do not offer the same assurances of an independent judiciary as Article III courts, they do not offer the same

protections for both the judicial branch and individuals and therefore cannot hear all of the same claims an Article III federal court may hear.

Additionally, bankruptcy courts, in exercising jurisdiction over core proceedings, do not act as adjuncts of Article III courts. Based on the authority Congress granted them, bankruptcy courts adjudicating core proceedings have broad authority to hear "all matters of fact and law in whatever domains of the law" and can enter final judgments, meaning they are not merely acting as adjuncts to the district courts. *Stern* at 2618-19. Since the bankruptcy courts are neither Article III courts nor adjuncts thereof, they generally may not hear claims that must be adjudicated by Article III courts.

There are exceptions to that rule. In order for Congress to allow a non-Article III court, like a bankruptcy court, to adjudicate claims that must normally be heard by an Article III court, the claim must fall within a recognized exception to Article III. The exception most frequently relied on is known as the "public rights" exception. Cases within the public rights exception historically involved disputes "between the Government and persons subject to its authority in connection with the performance of the constitutional functions of the executive or legislative departments," *Stern* at 2612, but has more recently evolved to include cases involving rights "integrally related to particular federal government action." *Stern* at 2613.

A strong argument exists that fraudulent conveyance claims in bankruptcy do not fall within the public rights exception. Although codified by the Bankruptcy Reform Act of 1978, fraudulent conveyance claims are "quintessentially suits at common law that more nearly resemble state law contract claims brought by a bankrupt corporation to augment the bankruptcy estate than they do creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res." *Granfinanciera, S. A. v. Nordberg*, 492 U.S. 33, 56 (1989). That reasoning was reaffirmed by *Stern* as the Court rejected the contention that the debtor's compulsory counterclaim fell under the public rights exception:

> *Granfinanciera's* distinction between actions that seek "to augment the bankruptcy estate" and those that seek "a pro rata share of the bankruptcy res," reaffirms that Congress may not bypass Article III simply because a proceeding may have some bearing on a bankruptcy case; the question is whether the action at issue stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process.

Stern, 131 S.Ct. at 2618. Such language implies that bankruptcy actions tied to the claims allowance process would fall within the public rights exception as integrally related to federal administration of bankruptcy, while actions to augment the estate would not. Since a fraudulent conveyance claim is essentially a common law claim attempting to augment the estate, and it does not stem from the bankruptcy itself and would not be resolved in the claims allowance process, it is arguably a private right that must be adjudicated by an Article III court.

Since bankruptcy courts may not constitutionally hear fraudulent conveyance claims as a core proceeding, and bankruptcy courts do not have statutory authority to hear them as non-core proceedings, any judgment entered by the bankruptcy court on such claims is arguably void. The fact that a bankruptcy court does not have the constitutional authority to decide such cases means the bankruptcy court lacks subject matter jurisdiction that can be challenged even after judgment.

If you had a fraudulent conveyance claim entered against you in a bankruptcy proceeding, that judgment may be open to attack, even if the judgment was entered long ago. Our attorneys are well-versed in bankruptcy and attendant litigation. After analyzing your particular case, we can advise you as to the strategy to follow.

For more information, please contact Brett A. Axelrod at 702.699.5901 or baxelrod@foxrothschild.com or any member of our Financial Restructuring & Bankruptcy Department.

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