Bellingham

In *re Bellingham Insurance Agency*: To "Protect" the Article III Jurisdiction of the District Courts, the Supreme Court May Radically Alter the Bankruptcy System (and Toss Out the Federal Magistrate System To Boot)

By Stephen Lerner & Colter Paulson

Bankruptcy lawyers and judges across the United States are waiting for a decision that might move thousands of disputes from the bankruptcy courts to the district courts. In *Executive Benefits Insurance Agency v. Arkison (In re Bellingham Insurance Agency)*, Case No. 12-1200, the Supreme Court faces the question of whether a party can consent to give a bankruptcy court powers broader than Article III may arguably allow. Just three years ago in *Stern v. Marshall*, 131 S. Ct. 2594 (2011), the Court held that bankruptcy courts do not have jurisdiction to enter final judgments on fraudulent conveyance claims against non-creditors. This reversed longstanding Federal law that such matters were "core" claims as to which bankruptcy courts had jurisdiction to resolve. In *Stern,* the Supreme Court held that because those disputes involve third-parties and state law, they were not "core" bankruptcy claims and were therefore outside of bankruptcy jurisdiction. While the decision could be read to stop bankruptcy courts from deciding fraudulent transfer claims—which are at the heart of many bankruptcies—*Stern* cautioned that the decision "does not change all that much."

Bankruptcy courts had two primary responses to *Stern* to ensure that not much did change. Many bankruptcy judges simply submitted proposed findings of fact and conclusions of law for final review by a district court, much like a magistrate judge. Many district court judges, naturally, deferred to the bankruptcy judge's particular expertise and affirmed these decisions. In this way, *Stern's* prohibition on bankruptcy court's entering final judgment was followed while still allowing bankruptcy courts to retain control over the principal bankruptcy case. Some courts also relied on consent of the litigants, including implied consent, to administer non-core claims. They reasoned that the right to an Article III judge in non-core proceedings was just as waivable as any other right.

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The Ninth Circuit explicitly approved of these practices in *Executive Benefits Insurance Agency v. Arkison (In re Bellingham Insurance Agency),* 702 F.3d 553 (9th Cir. 2012). In its decision, the Ninth Circuit explained that the day before Bellingham ceased doing business, its CEO had used its funds to incorporate Executive Benefits Insurance Agency, Inc. ("EBIA")—and then assigned Bellingham's right to receive commissions from its largest client to an employee that forwarded the commissions to EBIA. After Bellingham filed for chapter 7 bankruptcy, the trustee naturally sued EBIA to avoid its receipt of commissions as fraudulent transfers. While EBIA did initially request to move the case to the district court, it then asked the bankruptcy court to first decide the trustee's pending motions for summary judgment. After the court granted summary judgment to the trustee and entered a money judgment, EBIA appealed to the district court. EBIA then attempted to get around the summary judgment decision by claiming for the first time on appeal that the bankruptcy court did not have jurisdiction and that it did not consent to such jurisdiction.

The Ninth Circuit was not pleased with EBIA's "sandbagging" of the bankruptcy court and held that EBIA had impliedly consented to entry of a final judgment by the bankruptcy judge because it had sat on its right to seek withdrawal of the case to the district court until after it lost on the merits. It then held that this implied consent was sufficient to preserve the bankruptcy court's jurisdiction. The court held that because *Stern* compared the right to an Article III tribunal to the right to a jury trial under the Seventh Amendment, that the Article III right should be subject to waiver just the same. As we know, despite being one of our most fundamental rights, the right to a jury trial can be waived by failure to make a timely objection. Similarly, the Supreme Court has championed and expanded arbitration—which also arguably takes power away from Article III tribunals. What then is the problem

with using consent and waiver to avoid constitutional issues?

The other circuits to look at this question have answered that "structural separation of powers" means that bankruptcy judges may not decide non-core matters even where the parties consent. The Sixth Circuit explained that Article III is a "non-waivable structural principle" that "serves as an inseparable element of the constitutional system of checks and balances." *Waldman v. Stone*, 698 F.3d 910, 917-18 (2012). It disapproved of Congress' decision to allow bankruptcy judges to decide non-core issues, explaining that, "to the extent that Congress can shift the judicial Power to judges without those protections, the Judicial Branch is weaker and less independent than it is supposed to be." *See also In BP RE, LP v. RML Waxahachise Dodge, LLC*, 735 F.3d 279 (5th Cir. 2013) (applying this reasoning to some core bankruptcy issues as well); *Wellness Int'l Network, Ltd. v. Sharif*, 727 F.3d 751 (7th Cir. 2013).

If the Supreme Court agrees with the Fifth, Sixth, and Seventh Circuits, the consequences of these nuances of Article III could be far-reaching—and not just on bankruptcy courts. Placing fraudulent transfer and other avoidance claims beyond the jurisdiction of bankruptcy courts would require most bankruptcies to be litigated in two courts. This would not be a mere inconvenience for companies in Chapter 11. Bankruptcy cases often require approvals of matters such as debtor-in-possession financing or use of cash collateral within days because a viable business may have to shut down if it cannot quickly obtain court approval to fund its operations during the bankruptcy. Similarly, the sale of substantially all assets and other transactions often require immediate attention by the court if an ongoing business is to be preserved. Burdened by a heavy criminal docket that requires constant attention, district court judges are only used to relatively quick (and rare) motions for temporary restraining orders. The far more focused docket of bankruptcy judges allows them to address financing, business and transactional motions in a matter of days—not to mention their decades of experience with both. The delay necessitated by withdrawing the claims to the district court, and then waiting for an open hearing day, could threaten the viability of businesses, their employees and creditors.

This problem would not be rare—district courts would be faced with a significant overall increase in their caseload. At the end of 2012, more than 70,000 adversary proceedings were pending in bankruptcy courts across the country—many of which would have to be shifted to the district courts if the Supreme Court reverses the Ninth Circuit in *Bellingham*. District court judges would be faced with thousands of additional fraudulent transfer and avoidance actions that were traditionally decided by bankruptcy judges. They might also have to take on the burdens of the Bankruptcy Appellate Panels, three-judge panels of bankruptcy judges that, with consent of all parties, hear bankruptcy appeals in the First, Sixth, Eighth, Ninth, and Tenth Circuits. A reversal in *Bellingham* would undermine the constitutional foundation of these courts as well.

Perhaps even more worryingly, magistrate judges also operate on a system where parties opt out of Article

III adjudication. Section 636(c)(1)'s broad grant of authority to magistrates, pursuant to litigant consent, would be directly threatened by a holding that consent is constitutionally insufficient for bankruptcy court jurisdiction. Indeed, the Magistrate Act has essentially the same structural protections as the bankruptcy statute, including oversight by an Article III judge. If the Supreme Court holds that it is unconstitutional for litigants to consent to adjudication before bankruptcy judges, there is little reason to think that magistrate judges should be seen any differently.

These concerns have led to an overwhelming amicus response asking the Supreme Court to avoid finding that bankruptcy courts violate Article III and to preserve the current system, including briefs by the United States, various States, and the American Bar Association. Due to the structural and systemic issues at stake, the American College of Bankruptcy filed its first-ever amicus brief, for which our firm was lead counsel. The brief focuses primarily on the history of Supreme Court jurisprudence concerning Article III adjudication in bankruptcy, well-recognized principles of litigant consent to non-Article III adjudication of otherwise constitutionally mandated Article III matters, and the practical implications on the bankruptcy system and other non-Article III tribunals (such as the Bankruptcy Appellate Panel and U.S. Magistrates) if litigant consent is not upheld. On *Bellingham*, all parties interested in an efficient and meaningful bankruptcy system are encouraging the Supreme Court to follow existing constitutional principles to preserve litigant consent in this context. (Indeed, the only parties to support the petitioner are those that, as they disclose in their amicus briefs, are now litigating large fraudulent transfer claims in bankruptcy court and would like a change of scenery.)

The Justices are well aware of the potential consequences, but have been hard-pressed to figure out what to do. The Supreme Court held oral argument in *Bellingham* on January 14, 2014, and it looks like the decision will be a close one. Chief Justice Roberts, the author of *Stern v. Marshall*, was clear that parties cannot "come off the street" and decide that their case will not be heard by an Article III judge. Justice Scalia was likewise unwilling to bend Article III to escape the practical consequences of such a decision, explaining that the problem was created by Congress and that Congress would have to fix it. (Unfortunately, recent history shows that Congress may be unable to provide a meaningful fix anytime soon, let alone a logical or comprehensive solution.) Justice Breyer, for his part, noted that the Supreme Court has a long line of cases emphasizing the importance of consent. Other judges seemed comfortable with the distinction between a bankruptcy court entering judgment itself and submitting findings of fact and conclusions of law to the district court. A number of justices specifically commented that any decision on the jurisdiction of bankruptcy judges would have implications for magistrate judges as well.

We believe that the Supreme Court will find a way to avoid making an unnecessary mess of the lower courts, whether through consent or a practical interpretation of Article III. Regardless, *Bellingham*'s impact is already being felt. Defendants in fraudulent transfer actions and other preference claims have a hope that even if they lose in the bankruptcy courts, *Bellingham* will give them a do-over in the district courts. Prospective plaintiffs should also consider whether to file their claims in the district court in the first instance, rather than file before the bankruptcy court with the attendant risks. All attorneys that are involved in bankruptcy proceedings in any way should be aware and prepared for this important decision, which is expected as early as May of this year.

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