SUPREME COURT JUDICIALECTLY BRIDGES THE “STATUTORY GAP” IN POST-
STERN BANKRUPTCY DECISION

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The Headline:

The United States Supreme Court has ruled in a fraudulent transfer case that although bankruptcy courts lack the constitutional authority to enter final judgments in certain cases (per Stern v. Marshall), they can nevertheless issue proposed findings, subject to de novo review by the district court, even in cases identified by statute as “core” proceedings. This is in effect a judicial bridging of the so-called “statutory gap” between subsections of 28 U.S.C. § 157, which provides a non-exclusive list of so-called “core proceedings,” also providing for distinct disposition of core and non-core proceedings.¹

The decision effectively extended the Court’s Stern v Marshall decision to a fraudulent transfer case (Stern, a purportedly “narrow” decision, had held that a bankruptcy court could not enter final judgment on an estate’s counterclaim, despite being listed in the Section 157 as a core proceeding). Thus, fraudulent transfers and perhaps other core proceedings join the ranks of “Stern claims” – cases that are core by statute, but non-core according to the Supreme Court.

The Court did not, however, address whether bankruptcy courts could enter final orders in such cases with the parties’ consent, and it did not specify which “core proceedings” have effectively been rendered non-core as so-called Stern claims.

The Case:

In Executive Benefits Insurance Agency v. Arkison, Trustee, ___ U.S. ____, 2014 WL 2560461 (2014), the Supreme Court affirmed a Ninth Circuit ruling in favor of a Chapter 7 trustee in a fraudulent transfer proceeding. Bellingham Insurance Agency, Inc. (“BIA”) filed a voluntary Chapter 7. BIA’s trustee sued Executive Benefits Insurance Agency (“EBIA”) alleging fraudulent conveyance of assets from BIA to EBIA. The trustee obtained a summary judgment in the bankruptcy court, which EBIA appealed to the district court. The district court affirmed that decision after a de novo review, entering judgment for the trustee.

While on appeal to the Ninth Circuit, the Supreme Court’s decision in Stern v. Marshall² issued. EBIA moved to dismiss the appeal for lack of jurisdiction. The Ninth Circuit rejected that motion and affirmed the district court. This appeal to the Supreme Court followed.

¹ Section 157 classifies certain actions as “core proceedings,” on which bankruptcy courts can enter final orders (e.g., claim allowance, termination of the automatic stay, preferences, fraudulent conveyances, discharge ability, etc.) Non-core proceedings are referenced generally as matters related to a bankruptcy case, on which bankruptcy courts may hear and issue proposed findings of fact and conclusions of law, subject to de novo review by a district court.

Stern’s Backdrop:

In Stern, the Supreme Court held that a bankruptcy judge lacked the constitutional authority to enter final judgment on a counterclaim asserted by a bankruptcy trustee, even though estate counterclaims were among the enumerated “core” proceedings under Section 157, which by statute, could be the subject of final orders by a bankruptcy judge. The Stern court reasoned that the estate’s counterclaim was in effect a private cause of action (as opposed to a public right) that could only be resolved with finality by an Article III judge (appointed for life).

So in effect, the Stern Court held that bankruptcy courts lacked the constitutional authority to enter a final judgment in a matter that Congress had specifically expressed was a core proceeding. The Stern opinion was purportedly “narrow;” however, courts and commentators were rightly concerned that its ruling had potentially far reaching implications.

Stern created uncertainty for many reasons, two of which were: (i) whether other proceedings listed in 157 as core proceedings were affected by Stern, notwithstanding Stern’s purported “narrow” ruling; and (ii) whether bankruptcy courts could issue final judgments with the parties’ consent, or failing that, issue proposed findings of fact and conclusions of law in core proceedings, a procedure authorized for non-core proceedings, but not for core proceedings.

This latter conundrum came to be known as the “statutory gap.” Section 157 expressly contemplates bankruptcy judges issuing proposed findings and conclusions in non-core proceedings; however, such an option was not specifically allowed for core proceedings (presumably, this was not necessary because under Section 157, bankruptcy judges could enter final orders in core proceedings, at least before Stern). Thus, the dilemma was whether parties and courts could work around the potential Stern issues lurking in core proceedings by simply issuing proposed findings and conclusions (rather the final orders as specified by 157), even though Section 157 did not specifically allow that practice.

The Supreme Court Bridges the Statutory Gap:

In Executive Benefits, the Supreme Court summarized its ruling as follows:

In Stern, we held that Article III prohibits Congress from vesting a bankruptcy court with the authority to finally adjudicate certain claims. 564 U.S., at ——. But we did not address how courts should proceed when they encounter one of these “Stern claims”—a claim designated for final adjudication in the bankruptcy court as a statutory matter, but prohibited from proceeding in that way as a constitutional matter.

As we explain in greater detail below, when a bankruptcy court is presented with such a claim, the proper course is to issue proposed findings of fact and conclusions of law. The district court will then review the claim de novo and enter judgment. This approach accords with the bankruptcy statute and does not implicate the constitutional defect identified by Stern.

The unanimous opinion in Executive Benefits traces the historical development from the Northern Pipeline\(^3\) case through Granfinanciera\(^4\) and Stern v. Marshall. It noted however that although “Stern made clear some claims labeled by Congress as “core” may not be adjudicated by a bankruptcy court in


the manner designated by Section 157(b). Stern did not, however, address how the bankruptcy court should proceed under those circumstances.\(^5\)

The Court then judicially bridged the statutory gap, relying upon Section 157's severability provision, which, as quoted in the opinion, states as follows:

If any provision of this Act or the application thereof to any person or circumstance is held invalid, the remainder of this Act, or the application of that provision to persons or circumstances other than those as to which it is held invalid, is not affected thereby.

With this severability provision in hand, and with the assumption that the fraudulent transfer claims could not be treated under the core proceedings-final orders provision, the Court concluded that the fraudulent transfer proceeding was effectively "not a core proceeding." Thus, if it was not a core proceeding, it was in effect "non-core" and could be treated under Section 157(c)(1), or so the Court reasoned. This would in turn allow a bankruptcy court to hear a proceeding and submit proposed findings of fact and conclusions of law to the district court for de novo review and entry of final judgment.

**Procedural Disposition in Executive Benefits:**

Rather than remanding the case, the Court affirmed the Ninth Circuit. Because the underlying matter was resolved by summary judgment, the district court conducted a de novo review. Although this was as a result of an appeal, rather than this submission of proposed findings and conclusions, the Court was apparently convinced that this provided the parties with the same net effect – a de novo review by a district court.

**What the Court Did Not Do:**

The Court did not expressly find that fraudulent transfer claims are so-called Stern cases ("...we assume without deciding, that the fraudulent conveyance claims in this case are Stern claims."). That issue was effectively not litigated, so the reader is left to wonder whether the outcome would have been any different had that been put in issue.

The Court gave little guidance as to which of the other enumerated core proceedings have been judicially rendered "non-core." While the private claim / public right dichotomy has been addressed in the Granfinanaria – Stern – Executive Benefits cases, no bright line has been drawn as to which of the other core proceedings have been affected by this ruling. For now, however, we must assume that fraudulent transfers (and perhaps other avoidance actions) are now "Stern claims," in effect statutorily core, but judicially non-core.

Finally, the Court did not appear to address the larger issue of whether bankruptcy courts can enter final judgment on these so-called Stern claims with the consent of all parties. While crafting a somewhat pragmatic ruling, the Court stopped short of resolving this issue (arguably as federal courts are courts of limited jurisdiction, one is left with the conclusion that the answer to this issue, at least for now, is no).

\(^5\) Actually, the Stern court said its opinion was "narrow" and applied only to counterclaims. Very little was "made clear" by Stern.
Author’s View:

Courts and practitioners will need to absorb this case, much like *Stern*, as the Supreme Court has effectively re-written a statute, judicially, and its full effect is less than clear. Arguably, only Congress can literally close a “statutory gap,” but that did not stop the Court from declaring a core proceeding non-core. Even if the Court’s reasoning is a bit of a stretch, it is nevertheless a unanimous decision from the Supreme Court, and it will likely guide bankruptcy practice going forward, despite the unresolved issues.

At a minimum, it does appear to address, at least in part, one issue left unresolved by *Stern*. The statutory gap has apparently been bridged, although it will be left to the lower courts to determine the extent to which Section 157 has been abrogated, and which “core proceedings” are no longer “core proceedings.”

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