Wellness International Ltd. v. Sharif: *Stern* and State Law Claims and The Constitutional Validity of Consent

Report of the National Bankruptcy Conference*

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On the last day of the 2013 Term, the Supreme Court granted a writ of certiorari to review the Seventh Circuit's decision in *Wellness International Network Ltd. v. Sharif,* 727 F.3d 751 (7th Cir. 2013), *cert. granted*, 134 S. Ct. 2901 (July 1, 2014) (No. 13-935). The Court limited its grant to the following issues:

1. Whether the presence of a subsidiary state property law issue in an 11 U.S.C. § 541 action brought against a debtor to determine whether property in the debtor's possession is property of the bankruptcy estate means that such action does not "stem[] from the bankruptcy itself" and therefore that a bankruptcy court does not have the constitutional authority to enter a final order deciding that action.

2. Whether Article III permits the exercise of the judicial power of the United States by the bankruptcy courts on the basis of litigant consent, and, if so, whether implied consent based on a litigant's conduct is sufficient to satisfy Article III.

The Court did not plunge hastily into its decision to review the case. *Wellness* was on the list of cases to be considered at the justices' conference on five occasions before the grant of certiorari was announced.[1] The Court's decision to consider the consent issue was especially noteworthy because it was announced just a few weeks after the Court avoided reaching the same issue in *Executive Benefits Insurance Agency v. Arkison*, 134 S. Ct. 2165 (June 9, 2014).[2]

The National Bankruptcy Conference has undertaken a review of the issues before the Supreme Court in *Wellness*—a project that builds on its earlier reports on the Scope and Implications of *Stern v. Marshall*[3] and *Executive Benefits Insurance Agency v. Arkison*: Does Party Consent Render Bankruptcy Court Adjudication Constitutionally Valid?[4] After a discussion of the lower courts' decisions in *Wellness*, the report consists of two papers. The first, written by Jonathan Landers and Brady Williamson, discusses the impact of *Stern* on the operation of the bankruptcy system due to uncertainty about the scope of core claims that fall outside the bankruptcy judge's adjudicatory authority. Relevant to the first issue identified by the Court, the authors' analysis calls for a clearer and narrower definition of *Stern* claims that permits bankruptcy judges to hear

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[*] The National Bankruptcy Conference is a voluntary organization composed of persons interested in the improvement of the bankruptcy laws of the United States and their administration. For more information, see http://www.nationalbankruptcyconference.org/mission.cfm.

[1] The Supreme Court docket indicates that *Wellness* was listed for the conferences held on the following dates: April 18, June 12, 19, 26, and 30, 2014.

[2] The Court explained in *Arkison* that its disposition of the case on other grounds eliminated the need "to address whether [petitioner] EBIA in fact consented to the Bankruptcy Court's adjudication of a *Stern* claim and whether Article III permits a bankruptcy court, with the consent of the parties, to enter final judgment on a *Stern* claim." Justice Thomas wrote, "We reserve that question for another day." 134 S. Ct. at 2170 n.4.

[3] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1979503.

[4] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2365333.

and decide many key issues that arise in bankruptcy but turn in part on state law. The second paper, written by Elizabeth Gibson, revisits the issue addressed in last year's report—the constitutional effect of party consent to bankruptcy court adjudication—and suggests how the Supreme Court's precedents should guide the Court's analysis of the consent issue in *Wellness*. Melissa Jacoby provided substantive and editorial assistance to both reports.

The Case Below

Lengthy litigation in the Texas courts between Sharif and Wellness International Network ("WIN") resulted in the entry of a judgment of over $655,000 against Sharif as a sanction for his discovery abuses. Thereafter Sharif filed a chapter 7 petition in the Northern District of Illinois. WIN subsequently brought an adversary proceeding in the bankruptcy court against Sharif, seeking denial of the discharge on four grounds and a declaratory judgment that a trust for which Sharif was the trustee was his alter ego and thus its assets were property of the bankruptcy estate.[5] 727 F.3d at 757.

As in the Texas litigation, Sharif failed to respond to discovery requests in the proceeding and violated the bankruptcy court's discovery order. As a sanction for the debtor's failure to comply, the bankruptcy court entered a default judgment in favor of WIN on all five counts of its complaint and awarded attorney's fees and costs. *Id.* at 758. On appeal, the district court affirmed after rejecting Sharif's *Stern* objection—raised for the first time after briefs were filed in that court—as untimely. *Id.* at 760.

On further appeal, the Seventh Circuit held that the bankruptcy court had authority to enter a final judgment on the objection-to-discharge counts because they were core matters that arose under federal law and were "central to the restructuring of the debtor-creditor relationship." *Id.* at 773. Without deciding whether the alter ego claim was a core or noncore matter under 28 U.S.C. § 157, the Seventh Circuit held that Sharif had waived the statutory argument that the claim was noncore by not arguing that issue in either the bankruptcy or district court. *Id.* at 762. But, the Seventh Circuit decided, under *Stern* and its own decision in *In re* Ortiz, 665 F.3d 906 (7th Cir. 2011), the bankruptcy court lacked constitutional authority to enter a final judgment on the alter ego claim because "it [was] between private parties[,] . . . stem[med] from state law rather than a federal regulatory scheme[,] . . . [did] not involve a particularized area of law[,] . . . and . . . [was] intended only to augment the bankruptcy estate." *Id.* at 774.

Before reaching the constitutional issue, the Seventh Circuit considered at some length whether Sharif had waived the issue through his litigation conduct and his failure to raise the issue earlier in the litigation. The court noted that the Supreme Court in Commodity Futures Trading Commission v. Schor, 478 U.S. 833 (1986), had stated that the protections of Article III, § 1

[5] The Seventh Circuit referred to this claim as an "alter-ego claim." *See, e.g.*, 727 F.3d at 762. In the Supreme Court, petitioners refer to it as a "§ 541 claim." *See, e.g.*, Brief for Petitioners at 19, Wellness Int'l Network, Ltd, v. Sharif, No. 13-935 (U.S. Sept. 9, 2014). It is unlikely that the result in the Supreme Court will be determined by nomenclature, but the term the Court uses may signal the outcome it reaches.

operate to safeguard both litigants' rights and the separation of powers and that only the former protections were waivable. Accordingly, said the court of appeals, it was faced with the "practical problem . . . of separating out the waivable personal safeguard from the nonwaivable structural safeguard." *Id.* at 769. The court relied on *Stern* to conclude that WIN's alter ego claim was distinguishable from the administrative proceeding in *Schor*:

> [U]nlike *Schor*, where party consent was permissible because the statutory scheme at issue did not implicate structural concerns, the Supreme Court has already held that the statutory scheme granting bankruptcy judges authority to enter final judgment in core proceedings *does* implicate structural concerns where the core proceeding at issue is the "stuff of the traditional actions at common law tried by the courts at Westminster in 1789."

Id. at 771 (quoting *Stern*, 131 S. Ct. at 2609) (internal quotation marks deleted). This analysis led the Seventh Circuit to hold that "under current law a litigant may not waive an Article III, § 1 objection to a bankruptcy court's entry of final judgment in a core proceeding." *Id.* at 773.

The court of appeals distinguished consent in the case before it from the consent provisions of both § 157(c)(2) for bankruptcy judges in noncore proceedings and § 636(c)(1) for magistrate judges in civil proceedings. Absent consent, those statutes authorize non-Article III judges only to submit proposed findings of fact and conclusions of law. In contrast, the court said, "Congress has vested bankruptcy judges with authority to enter final orders and judgments in core proceedings subject only to review by the district court under traditional appellate standards." *Id.* at 772. Because of the more limited conferral of authority under §§ 157(c)(2) and 636(c)(1), the Seventh Circuit said, without deciding the issue, that those statutes may "allow[] room for notions of consent and waiver," unlike § 157(b)(2). *Id.*[6]

The Seventh Circuit remanded the case to the district court for a determination of whether the alter ego claim was in fact core or noncore under § 157. If it was a core matter, the court said that there was no statutory authority for the bankruptcy court to submit proposed findings of fact and conclusions of law to the district court or even to preside over discovery. Therefore, the district court would have to withdraw the reference and set a new schedule for discovery. If, on the other hand, the district court determined that the claim was a noncore matter, it could treat the bankruptcy court's order "purporting to enter a final judgment" as proposed findings of fact and conclusions of law, which the district court could review de novo. *Id.* at 776-777.

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[6] The Supreme Court's subsequent decision in *Arkison* rejected any distinction between core proceedings that require Article III adjudication and noncore proceedings. 134 S. Ct. at 2174 ("[B]ecause these *Stern* claims fit comfortably within the category of claims governed by § 157(c)(1), the Bankruptcy Court would have been permitted to follow the procedures required by that provision, *i.e.,* to submit proposed findings of fact and conclusions of law to the District Court to be reviewed *de novo*.").

Stern and State Law Claims

Jonathan M. Landers and Brady C. Williamson

The U.S. Supreme Court granted a writ of certiorari in Wellness International Network v. Sharif, 134 S. Ct. 2901 (July 1, 2014) (No. 13-935), on two issues, including the following that raises the broad question of the role of state law:

> Whether the presence of a subsidiary state property law issue in an 11 U.S.C. § 541 action brought against a debtor to determine whether property in the debtor's possession is property of the bankruptcy estate means that such action does not "stem[] from the bankruptcy itself" and therefore that a bankruptcy court does not have the constitutional authority to enter a final order deciding that action.

Since the Supreme Court decided *Northern Pipeline*,[1] it has been clear that affirmative claims by a debtor against a third party for torts and breaches of contract are outside of the adjudicatory authority of the bankruptcy courts. Building on the plurality opinion in *Northern Pipeline*, Congress enacted a list of matters that are "core proceedings" in 28 U.S.C. § 157(b), which a bankruptcy court would have the authority to hear and decide, whether they are structured as adversary proceedings, contested matters, or motions seeking relief in the bankruptcy court. The list includes categories such as financing orders, avoidance actions, lien priority disputes, orders approving the use or lease of property and cash collateral, sale orders, and confirmation orders. Section 157(b) also contains a catch-all for "other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or equity security holder relationship." *Id.* § 157(b)(O). Significantly, under this statutory language, virtually everything that happens in a bankruptcy case other than third party actions falls within one or more of the "core" categories.[2] It is in this context that the impact of the Supreme Court's decision in *Stern v. Marshall*, 131 S. Ct. 2594 (2011), should be considered.

I. Mixed Messages on the Scope of the Constitutional Problem in *Stern*

Characterizing its decision as narrow and rejecting Justice Breyer's prediction of more sweeping effects,[3] the *Stern* Court majority said the ruling did not "meaningfully change[] the division of labor in the current statute" and "does not change all that much." 131 Sup. Ct. at 2620. A footnote in the Supreme Court's unanimous decision in *Arkison* reinforces the *Stern* majority's interpretation, repeating that "the removal of claims from core bankruptcy jurisdiction does not

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[1] Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982).

[2] The alter ego claim in *Wellness*, which asserted an illusory trust, arguably falls under § 157(b)(2)(E), "orders to turn over property of the estate."

[3] *Stern*, 131 Sup. Ct. at 2630 (Breyer, J. dissenting) (decision will lead to a "constitutionally required game of judicial ping-pong between courts … [leading] to inefficiency, increased cost, delay and needless additional suffering among those faced with bankruptcy").

'meaningfully chang[e] the division of labor in the current statute.'" 134 Sup. Ct. at 2173 n. 8. Yet, it is not surprising that lower courts have struggled to find the boundaries of *Stern*'s reasoning, with some courts holding that *Stern* precludes bankruptcy court adjudication of a much broader set of matters, using concepts that are neither self-defining nor familiar in bankruptcy jurisprudence.

Stern provided the following guidance:

- Bankruptcy courts could continue to enter judgments in actions that "stem[] from the bankruptcy itself or would necessarily be resolved in the claims allowance process." *Stern*, 131 S. Ct. at 2618. The second prong, "necessarily resolved in the claims allowance process," has a particularly limited reach.
- Bankruptcy courts "lack[] the constitutional authority to enter a final judgment on a [debtor's] state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim." *Id.* at 2620.
- The claim in *Stern* was "in no way derived from or dependent upon bankruptcy law" and would "exist[]without regard to any bankruptcy proceeding." *Id.* at 2618. It was a "state law action independent of the federal bankruptcy law and not necessarily resolvable by a ruling on the creditor's proof of claim in bankruptcy." *Id.* at 2611. It did not "flow from a federal statutory scheme" but instead was a "state common law [claim] between two private parties" that "does not 'depend[] on the will of congress.'" *Id.* at 2611, 2614.
- The claim in *Stern* was brought "to augment the bankruptcy estate" rather than to adjust "'creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res.'" *Id.* at 2614.

Wellness and other lower court decisions have analyzed the boundaries of *Stern* claims in terms of (1) whether the claim arose under bankruptcy law or state law; (2) whether the claim could involve private parties outside of bankruptcy; (3) whether the claim was brought to augment the bankrupt estate; and (4) whether the claim stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process. Since *Stern*, courts have construed many matters that Congress had deemed core under § 157(b) to be beyond the adjudicatory authority of bankruptcy judges, thus becoming so-called *Stern* claims. Examples include counterclaims unless necessarily decided in ruling on the creditor's proof of claim, fraudulent conveyances (and presumably preferential transfers), and property of the estate when determined by state law issues.

The challenge for lower courts is compounded by the pervasive role of state law in the bankruptcy system. The Supreme Court has repeatedly held that most claims issues in bankruptcy are to be resolved according to state law. State law also provides the rule of decision for many other central bankruptcy matters. Examples include the validity of claims, the assumption or rejection of contracts and leases, dischargeability of debt, and property of the

estate. Bankruptcy law more expressly incorporates state law to various degrees under §§ 510(a) (equitable subordination), 544(b) (voidable transfers), 547 (preferences), and 548 (fraudulent transfers). The bottom line is that it is possible for a party to plausibly argue that a great many claims arising in business/reorganization and consumer cases, apart from straight claims allowance and discharge questions, are *Stern* claims. A test based on whether a matter arises under state law, possibly involves private parties, and augments the estate is potentially of broad and uncertain applicability. There should be no mystery why courts struggle to apply *Stern* to both familiar and new situations and why some courts construe *Stern* to be "broad in scope" and "sweeping." *Frazin v. Haynes & Boone, L.L.P. (In re Frazin)*, 732 F.3d 313, 318-19, 323-24 (5th Cir. 2013).

Moreover, both *Stern* and the Seventh Circuit's decision in *Wellness* speak of "claims" to mean a request for legal or equitable relief by one party against another, rather than "issues within claims" or "components of a claim." Yet post-*Stern* decisions from lower courts have applied the concept to what might be termed "*Stern* issues"—i.e., components of a claim over which the bankruptcy courts did not have adjudicatory authority. The Fifth Circuit's decision in *Frazin*, which involved the Texas Deceptive Trade Practices Act ("DTPA"), is one such example.[4]

II. Squaring Wellness with Modern Civil Practice

The *Wellness* case is replete with references to the lack of bankruptcy court authority over state law and common law claims and disputes that could arise outside of a bankruptcy case, as contrasted with bankruptcy law matters and claims allowance. The Seventh Circuit's holding in *Wellness* and a broad reading of *Stern* are sharply at variance with modern developments in civil practice. For more than seventy-five years, federal civil procedure has moved toward consolidating proceedings involving multiple issues and parties into a single action, on the theory that this is the most efficient way to handle such matters in the first instance, with the district court retaining discretionary authority to sever claims or hold separate trials. In general, the Court's approach has been to apply transactional and relatedness concepts to federal jurisdiction and authority over what is essentially a single matter.[5]

Examples of the modern transactional approach include rules governing compulsory counterclaims, indispensable parties, joinder of claims and parties, and third party claims, as well as the expansion of the doctrines of res judicata and collateral estoppel. The Supreme Court itself has enabled procedural consolidation of related matters by expanding doctrines of ancillary and pendent jurisdiction (now legislatively authorized as supplemental jurisdiction) to deal with the possibility that a court would otherwise have subject matter jurisdiction over some, but not all, claims that arise out of a common set of facts. It is somewhat ironic that the

[4] In *Frazin* the Fifth Circuit held that the bankruptcy court lacked authority to enter a final judgment on the debtor's Deceptive Trade Practices Act counterclaim that arose as part of a fee application dispute.

[5] *See generally* 13D Charles Alan Wright, Arthur R. Miller, & Richard D. Freer, Federal Practice and Procedure – Jurisdiction and Related Matters § 3567 (3d ed. 2014).

federal courts have followed a practical and functional approach in the joinder context to questions involving federal versus state courts, while they have taken a more formalist and doctrinaire approach in bankruptcy cases to questions involving district courts and the bankruptcy judges over which the district courts have supervisory control.

A transactional approach could, by extension, be useful in the bankruptcy context. *Wellness* itself offers an example of how such principles might be applied. The debtor had submitted a loan application in which he claimed ownership of assets valued at $5.4 million. Later in bankruptcy the debtor asserted that these assets were owned by the Soad Wattar Trust of which he was trustee. A creditor, WIN, brought an adversary proceeding asserting five claims: four asserting nondischargeability of debts on various grounds, including that the debtor "concealed property that he owns by holding such property in the name of the Soad Wattar Living Trust" and a failure to explain the disappearance of the $5.4 million, and further seeking a declaratory judgment that the Soad Wattar Trust was the debtor's alter ego. WIN sought discovery of documents regarding formation and funding of the Trust. Ultimately, the debtor failed to produce the information requested, and the bankruptcy court entered a default judgment on all counts on multiple grounds, including specific violations of the discovery orders relating to the Trust.

The Seventh Circuit held that the rulings on nondischargeability were within the bankruptcy court's adjudicatory authority because they arose from federal law, and the granting or denial of discharge was "central to the restructuring of the debtor-creditor relationship." But, although recognizing that there might have been "some overlap" between the objections to discharge and the alter ego claim, the court of appeals concluded that the alter ego claim was a state law claim existing "without regard to any bankruptcy proceeding." Notwithstanding the overlap, the court held that the bankruptcy court did not "need[] to resolve the alter-ego claim."[6] In other words, the court looked at the issue of adjudicatory authority on a piecemeal basis and concluded that the bankruptcy court lacked adjudicatory authority to resolve one claim even though it provided the underpinning for the claims that the bankruptcy court did have authority to adjudicate.

Had the Seventh Circuit applied transactional principles, it might have determined that questions of the formation, validity, and effect of the Trust were central to all issues in the case. The bankruptcy court and district court clearly thought so; there are references to issues relating to the Trust throughout the findings of the bankruptcy court. In fact, notwithstanding the Seventh Circuit's opinion, it is arguable that at least some of these findings would be collaterally estopped in any alter ego litigation. As such, consistent with the ancillary and pendent jurisdiction cases, a court could have found one constitutional case that did not require a separation of issues and assignment of some issues to the district court for final adjudication. Needless to say, this approach may be factually based, but courts seem to have found it relatively easy to apply in most situations. In the event of uncertainty, the district court has the

[6] Wellness, 727 F.3d at 756-57, 758-59, 773, 775.

power to withdraw the reference over the whole matter or even a part of the matter.[7] Such an approach would avoid many of the problems previously discussed.[8]

Since *Stern*, what is essentially a unitary matter is being broken up into components with different decision-making procedures. The bankruptcy court has adjudicatory authority over some but not others. This is exactly what happened in *Wellness, Waldman,*[9] and *Frazin,* and in *Stern* itself. Recent bankruptcy and district court decisions continue to reflect this fragmentation.[10]

III. Consequences of Uncertainty Regarding the Scope of the Bankruptcy Court's Adjudicatory Authority

In its 2013 Report on *Arkison*, the National Bankruptcy Conference identified a number of practical consequences of *Stern* on the operation of the bankruptcy system. These effects are attributable to the combination of uncertainty regarding *Stern*'s scope and the consent issues raised in Professor Gibson's paper. Since that Report, these consequences have become even more pronounced.

First, as already noted, the uncertainty of what constitutes a *Stern* claim has continued to multiply the number of necessary proceedings and generate additional costs, particularly in large chapter 11 cases. This dynamic incentivizes litigants to delay a decision on the merits

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[7] 28 U.S.C. § 157(d).

[8] Perhaps an even better analogy, with ancient roots, involves the allocation of jurisdiction when there were separate systems of law and equity. At that time, each court of law or equity guarded its jurisdiction carefully and, as in *Stern*, the issue was adjudicatory power—i.e., each court had judicial power only over matters within its own jurisdiction. Notwithstanding this principle, courts of equity applied a so called "clean up rule" by which, if the court of equity decided the basic equitable issues in the case, it could "clean up" the remaining legal issues without requiring those to be brought in a court of law. Such an approach should have particular resonance here since bankruptcy courts were descended from courts of equity and issues concerning the Trust were central to dischargeability and thus might be "cleaned up" by the bankruptcy court. This is consistent with the approach taken in *Wellness* by the bankruptcy and district courts.

[9] Waldman v. Stone, 698 F.3d 910 (6th Cir. 2012).

[10] *See, e.g.*, In re Northeast Ind. Dev. Corp., 513 B.R. 825 (Bankr. S.D.N.Y. 2014) (bankruptcy court could hear and decide debtor's objection to post-petition default interest, but had to issue proposed findings of fact and conclusions of law on debtor's claims against a lender for breach of oral workout agreement, fraud, and unjust enrichment, and claim against receiver for mismanagement); In re Porter, 511 B.R. 785, 811 (Bankr. E.D. La. 2014) (complex consumer case involving some core claims, some *Stern* claims, and some unclear; court stays decision "in light of still developing jurisprudence" and because "the challenge to this Court's constitutional authority calls into question the nature of the judgment"); In re Louisiana Riverboat Gaming Partnership, 504 B.R. 439 (Bankr. W.D. La. 2014) (core and *Stern* claims; motion to withdraw reference; court stayed discovery and questioned whether bankruptcy court could preside over discovery on *Stern* claim); In re New York Skyline, 512 B.R. 159 (S.D.N.Y. 2014) (numerous issues, some *Stern* claims; case involved consent, but implicit consent difficult to find because bankruptcy court thought the matter core; ultimately, reversed for reconsideration by bankruptcy court and possible future review by district court).

through (1) motions to limit the power and authority of the bankruptcy court at the outset of a proceeding; (2) raising questions about the scope of the bankruptcy court's adjudicatory authority; (3) insisting on disaggregating a proceeding by issue so that the bankruptcy court must sit in different capacities (making a final decision in some matters, while issuing only proposed findings in others) or that the district court must decide part of the proceeding; (4) attempting to remove the case or proceeding from the bankruptcy court through motions to withdraw the reference, dismiss, remand to a state court, compel arbitration, or abstain; (5) seeking to limit the role of the bankruptcy court mid-proceeding by seeking future withdrawal of the reference or limiting the court's ability to decide dispositive motions; and (6) challenging the bankruptcy court's adjudicatory authority for the first time on appeal. On the latter point, in most of the cases reaching the courts of appeals, the *Stern* claim issue either was not raised in the bankruptcy court, or was raised only after substantial litigation had already taken place. The Supreme Court in *Stern* noted that the "consequences of a litigant 'sandbagging' the court . . . can be . . . particularly severe."131 S. Ct. at 2609. Even if the delayed raising of *Stern* is inadvertent, the impact on prior proceedings, the cost to all parties, and justice delayed are significant. In short, the Supreme Court decisions in *Stern* and *Arkison* have changed the tactics and strategies in bankruptcy—by most accounts, attributable not to design but to imprecision or inadvertence.

A decision this Term in *Wellness* will either resolve some or all of the uncertainty or compound it.[11] In any event, the cost to the system should be a greater part of the dialogue within the profession, the bench, and the academy than it has been. Constitutional determinations, including the status of non-Article III judges, do not generally turn on practical consequences. Yet the Supreme Court's consideration of such consequences is not without precedent. In *Peretz v. United States* the Court took note of "the importance of magistrates to an efficient federal court system" and quoted approvingly the Third Circuit's observation that "'the role of the magistrate in today's federal judicial system is nothing less than indispensable.'" 501 U.S. at 928-929 (quoting Government of the Virgin Islands v. Williams, 892 F. 2d 305, 308 (3d Cir. 1989)). Zealously representing their clients in bankruptcy cases, counsel may choose to request a withdrawal of the reference in the first instance, or litigate the propriety of the findings of fact and conclusions of law, or "appeal" the work of the bankruptcy court or bankruptcy appellate panel. The resulting financial and efficiency costs will be borne by the litigants, of course, but also in a broader sense by the system itself. Whether in a consumer case or a complex Chapter 11, the result probably will not comport with Rule 1 of the Federal Rules of Civil Procedure or anyone's notion of due process.

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[11] Courts are already facing these issues. The Sixth Circuit recently decided that, after *Stern* and *Arkison*, the bankruptcy court could still render an affirmative judgment on dischargeable claims. However, this seems at variance with *Wellness*, where the court held that the bankruptcy court did have adjudicatory authority over dischargeability issues but not over a closely related veil-piercing claim. In re Hart, 564 F.3d Appx. 773 (6th Cir. 2014). The Ninth Circuit reached the same result as the Sixth Circuit in In re Ray Cai, 571 Fed. Appx. 580 (9th Cir. 2014).

Second, with the possible exception of clearly core matters, such as determination of claims and allowability, there is a real risk that bankruptcy courts will exercise authority cautiously and defensively. They may be more likely to render proposed findings and conclusions rather than enter bench rulings and final judgments in a wide range of proceedings, even those they routinely decided in the past, such as straightforward avoidable transfer issues and property exemptions.[12] Recently, two well respected bankruptcy judges articulated this concern. Chief Judge Cecelia Morris of the Southern District of New York noted that the workload of the bankruptcy courts had increased tremendously because courts were doing "more findings of fact and conclusions of law" and, since the rulings required review and possibly input by counsel before being sent to the district court, "everything gets slowed down." Similarly, Judge Barbara Houser of the Northern District of Texas explained that it would be more difficult to make bench rulings, "the only mechanism that lets our dockets move efficiently" because district courts will want "something in writing" rather than a hearing transcript.[13] As these judges suggest, *Stern* leads to built-in delay of time-sensitive matters, greater expense, and a risk of results not in keeping with the rehabilitative policies of the Bankruptcy Code. Similarly, when a matter arises that involves some issues on which a bankruptcy judge has clear adjudicatory authority and others that raise *Stern* concerns, bankruptcy judges might proceed as if they lacked adjudicatory authority on the entire matter, with proposed findings of fact and conclusions of law on all issues. The district court would then have to sort out which is which and possibly make wholly unnecessary de novo determinations.

Third, the uncertainties described above are likely to undercut the efficient administration of bankruptcy cases of all kinds. In personal bankruptcy cases that normally consume relatively limited court resources, resolving counterclaims would be delayed and would have to be resolved by the district court, along with a variety of avoidance actions. In such cases, since creditors are often told not to file claims because no distribution is anticipated, the result could be a decision by the case trustee to forego pursuing the recovery of assets that would otherwise be available for creditors, undermining one of the core functions of the bankruptcy system. Separate actions might be required to determine the nondischargeability of a debt and to obtain

[12] These issues are discussed in some detail in Keith Sharfman & G. Ray Warner, Bankruptcy Court Jurisdiction After Executive Benefits Insurance Agency v. Arkison, 22 ABI L. Rev. 539, 557-60 (2014), a roundtable discussion among Judge Eugene Wedoff, Dean Erwin Chemerinsky, Richard Levin, Esq. and John Rao, Esq. (hereafter "Roundtable"). Judge Wedoff noted that there is a "great difference between issuing a final judgment on a Stern-affected matter, and issuing proposed findings and conclusions." *Id.* at 557.

[13] BNA Bankruptcy Law Reporter (June 19, 2014), pp. 827-28 (reporting on ABI discussion on June 16, 2014).

judgment. Confirmation of chapter 13 repayment plans could be put on hold while claims and disputes are sent to the district court.[14]

The same is true for chapter 11 business cases. Questions of the bankruptcy judge's adjudicatory authority could apply to a wide variety of issues, including (1) financing order provisions concerning the validity of debts and liens; (2) application of the subordination provisions of § 510(a), which, by definition, requires the application of nonbankruptcy law and deals with creditor v. creditor issues; (3) orders approving sales of assets (especially if including some form of injunctive relief against third parties, eliminating successor liability, or ordering the sale "free and clear" of claims and interests); (4) plan confirmation orders approving settlements, granting third-party injunctions or channeling orders, and providing for post-confirmation jurisdiction; (5) avoidance actions; (6) orders determining the respective rights of creditors and third parties in property of the estate; and (7) actions granting injunctions under § 105. In some reported cases, chapter 11 plan confirmation has been delayed while critical issues are resolved by the district court.[15] The administration of business reorganization cases is likely to be hampered until the Supreme Court clarifies the scope of *Stern* claims.

Fourth, the post-*Stern* environment has generated procedural questions not answered by existing laws and rules. For example, Federal Rule of Bankruptcy Procedure 9033 applies to the review of a bankruptcy judge's proposed findings of fact and conclusions of law in non-core proceedings, and, as the *Arkison* decision made clear, offers a path for dealing with *Stern* claims. What happens if the bankruptcy court mistakenly believes a claim is not a *Stern* claim and fails to follow the Rule 9033 procedures?[16] As another example, what happens if the bankruptcy court renders a decision on a *Stern* claim and the losing party fails to seek district court review? This scenario could lead to litigation on issues such as whether any such order is void or voidable, non-appealable, and subject to collateral attack, and whether the lawyer representing the losing party is subject to a malpractice claim. Is a party recovering a money judgment in a *Stern* claim matter entitled to interest for the period between the bankruptcy court's issuance of

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[14] The plethora of federal and state statutes and administrative rules dealing with modifications of home mortgages provide examples of potential *Stern* claims in chapter 13.

[15] *In re* Longview Power, 515 B.R. 107 (Bankr. D. Del. 2014) (in determination of insurance policy coverage for plan feasibility purposes, question of whether policy is property of the estate is core, while question of coverage is noncore). By contrast, in another recent plan confirmation bench decision, the bankruptcy court made critical rulings on (1) subordination of debt, (2) the right of creditors to a make-whole premium, (3) the interest rate for non-consenting classes of secured claims, and (4) the availability of releases. *In re* MPM Silicones, LLC, 2014 WL 4436335, No. 14-22503-rdd (Bankr. S.D.N.Y. Sept. 9, 2014). Thereafter, the releases were modified to exclude certain pending litigation between various creditors, so long as the court maintained jurisdiction over the litigation. The bankruptcy court overruled *Stern* claim objections on the ground that these issues involved fundamental issues of adjusting the debtor-creditor relationship, and did not involve augmentation of the bankruptcy estate. Yet, one could find language in *Stern* and the Seventh Circuit's *Wellness* decision to suggest that subordination and the make-whole premium are outside of the bankruptcy court's adjudicatory authority.

[16] Roundtable, *supra* note 12, at 557-59.

proposed findings of fact and conclusions of law and a final judgment of the district court? When a bankruptcy proceeding involves *Stern* claims and bankruptcy issues that are transactionally related, there is complexity in terms of rulings and opinions.[17] There is uncertainty whether the bankruptcy court can grant a final judgment on dispositive motions. Dealing with such matters becomes even more complicated if some of the issues involve a right to jury trial; according to well-established precedent, the jury trial issues must be tried first.[18] If the Supreme Court's decision in *Wellness* does not clarify and narrow the scope of matters falling outside the bankruptcy judge's adjudicatory authority, it may be necessary to revise provisions of the Judicial Code and various rules of procedure.

Fifth, broad interpretations of *Stern* cast doubt on the continued use of bankruptcy appellate panels in the districts and circuits that use them. Bankruptcy appellate panels are composed of bankruptcy judges, not Article III judges. Thus, when a bankruptcy appellate panel affirms a bankruptcy court's decision, it has generated no ruling by an Article III court. Indeed, the Seventh Circuit has suggested that the court of appeals would have no jurisdiction to hear an appeal from such an order because it was not entered by an Article III judge. In re Ortiz, 665 F.3d 906, 915 (7th Cir. 2011).[19]

Sixth, depending on how the Supreme Court decides *Wellness*, broad interpretations of *Stern* claims coupled with uncertainty could dramatically increase the workload for district courts. When bankruptcy courts believe that claims might be *Stern* claims, they are likely to opt for producing proposed findings of fact and conclusions of law. The district courts will have to address these matters, whether in depth or cursorily, even if those courts ultimately conclude the matters did not involve *Stern* claims. Parties also may seek so-called "comfort orders" in cases of uncertainty (which occurred after the *Northern Pipeline* decision). Indeed, a comfort order may be essential to go forward with plan confirmation or sale of assets, given that it is unclear whether an order of a bankruptcy court lacking adjudicatory authority produces the requisite level of finality ordinarily associated with such orders to satisfy the parties. The National Bankruptcy Conference would be remiss if it did not note the potential systemic impact on district courts of a Supreme Court decision in *Wellness* that leaves uncertainty in place or, worse, finds the role of bankruptcy judges—as well as magistrate judges—even more cabined.[20]

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[17] This was also true pre-*Stern* when core and non-core matters were tried together, but there was much less uncertainty over which was which.

[18] *In re* Renewable Energy Dev. Corp., 500 B.R. 77, 90 (D. Utah 2013) (citing Miles v. Indiana 387 F.3d 591, 599 (7th Cir. 2004)).

[19] These issues are also discussed in Roundtable, *supra* note 12, at 560-63.

[20] Since Congress created the magistrate position in 1968, it has incrementally increased magistrate judges' real and potential responsibilities, primarily though not exclusively based on consent. Sworn to Serve: Reflections on Changes in the Duties of U.S. Magistrate Judges, Federal Lawyer, May/June 2014. Magistrate judges resolve almost 13,000 cases on average each year under the consent provisions of § 636(c)(1).

Some basic statistics about the federal judiciary demonstrate the potential impact on the district courts. Between 2008 and 2012, there was an average of 335 active bankruptcy judges presiding over approximately 1.5 million cases annually, mostly chapter 7 and chapter 13 cases in roughly a three-to-one ratio. Although some of these cases produced little adjudicatory work for bankruptcy judges, others contained hundreds of adversary proceedings and contested matters. The average number of pending district court cases, at any time in that period, was about 360,000 for 950 active and senior judges, or 380 for each judge. If bankruptcy cases were distributed evenly to district judges, each district judge's case load would quadruple—from just over 380 to just over 2,000. A comparative point: about 2,800 bankruptcy matters are appealed each year on average from the bankruptcy courts to the district courts, including motions for the withdrawal of the reference.

A final point—beyond evidentiary support or contradiction—is that the diminishing independence and authority of bankruptcy judges may well affect the quality of the bankruptcy bench. To the extent bankruptcy judges are even more subject to reversal or modification by the district courts, and to the extent they lose authority to fully supervise bankruptcy cases, the perception of the importance of the position may suffer. It surely will not increase.

IV. Conclusion and Recommendation on Narrowing the Scope of *Stern* Claims

The Seventh Circuit's decision in *Wellness* should be reversed. The Supreme Court should reiterate that its ruling in *Stern* was sharply limited, and it should provide more guidance for courts to identify a small subset of claims that Congress considered core but go beyond the bankruptcy court's adjudicatory authority. Most importantly, the Court should make it clear that, just as § 157 provides, the fact a dispute is governed or affected in whole or part by state law is not determinative. *See* 28 U.S.C. § 157(b)(3). The existing tests for *Stern* claims are too indefinite and, as shown by the discussion above, courts and litigants are uncertain as to their application.[21] A single dispute is sometimes broken into components that must be processed differently. The confusion and uncertainty about the scope of *Stern* claims undercut the efficient and just handling of bankruptcy cases. The situation invites strategic behavior, often late in the process, as many of the appellate decisions have revealed. Although courts have issued numerous reported decisions citing *Stern,* these decisions likely reflect only a small percentage of the situations in which *Stern* has produced disputes and confusion. In sum, clarifying the scope of the bankruptcy court's adjudicatory authority as to matters involving state law is pressing and necessary for the just administration of the bankruptcy system.

The National Bankruptcy Conference recommends that, in deciding *Wellness*, the Supreme Court reaffirm what it clearly stated in *Stern*—that the decision was limited in scope— and was not the sweeping decision that some courts have taken it to be. Under this approach, the Court

[21] Many of these issues would be resolved if the Court determined consent cures any constitutional defect, as discussed in Professor Gibson's paper, but much would depend on the breadth of the consent and the resolution of issues such as compelled consent and deemed consent by inaction.

would clarify the part of *Stern* which refers to claims that (1) "stem from the bankruptcy itself" as opposed to (2) those that are "in no way derived from or dependent upon bankruptcy law" and are "state law action[s] independent of the federal bankruptcy law." The former category, which bankruptcy courts have authority to adjudicate, would include the resolution of claims within the longstanding in rem power and authority of the bankruptcy court, as reflected in Central Community College v. Katz,[22] and the power to decide questions relating to property of the estate in the actual or constructive possession of the debtor, even if the dispute is governed in whole or part by state law. The latter category, which bankruptcy courts cannot finally adjudicate (at least without party consent), would be limited to state law claims by the estate against a third party to augment the estate, as in *Northern Pipeline*; similar claims that are asserted as counterclaims but are not necessary to be resolved in the claims allowance process, as in *Stern*; and perhaps avoidance actions if the defendant has not filed a proof of claim.[23]

If this approach is adopted, *Stern* really would not have "change[d] all that much." Bankruptcy judges would have adjudicatory authority over matters that arise in the administration of bankruptcy cases and over the implementation of bankruptcy-specific procedures. For example, a bankruptcy judge could enter final orders in proceedings involving claims issues, dischargeability and related matters, and property of the estate. Bankruptcy judges would also be able to adjudicate matters that are fundamental to the reorganization process and the liquidation of assets, such as debtor-in possession financing, sales of property, and plan confirmation, because those matters fall within the bankruptcy court's in rem authority. With respect to the issue in *Wellness*, an examination of the lower courts' opinions indicates that the question of the debtor's ownership of the trust was basic to the issues of discharge, sanctions, and determination of property of the estate. The bankruptcy judge therefore had power to enter a declaratory judgment that the assets of an alter ego were property of the bankrupt estate.[24]

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[22] 546 U.S. 356 (2006).

[23] The significance of filing a proof of claim is that, because of section 502(d), the creditor's claim cannot be allowed until the avoidance claim is determined. Thus the avoidance claim becomes an essential part of the claims allowance process. Although sometimes the significance is explained in terms of consent, the Supreme Court has held that such "consent" was never actual but was essentially compelled because the creditor had no other way to recover on its claim. Katchen v. Landy, 382 U.S. 323 (1966); Langenkamp v. Culp, 498 U.S. 42 (1990). This is essentially the approach the Supreme Court followed in discussing these cases in *Stern*. *See* 131 Sup. Ct. at 2616-18. The Supreme Court has already adopted such an analysis in holding that there is a right to jury trial on avoidance actions by defendants not filing a proof of claim. *See* Granfinanciera, S.A. v. Nordberg, 492 U.S. 33 (1989).

[24] *See In re* Gladstone, 513 B.R. 149, 159 (Bankr. S.D. Fla. 2014) (holding that "[t]he [declaratory judgment] relief requested requires the Court to determine what is and is not property of the estate, a decision central to the mission of the bankruptcy court."). In addition to *Gladstone*, there are at least five other reported decisions discussing the application of *Stern* to veil piercing/alter ego claims, and these courts have reached inconsistent results or decided to postpone deciding the issue. Messer v. Bentley Manhattan Inc. (*In re* Madison Bentley Associates, LLC), 474 B.R. 430 (S.D.N.Y 2012); Weiss v. Lockwood, 499 B.R. 392 (D. Mass. 2013); Rodriguez v. Four Dominion Drive LLC (*In re* Boyd), No. 11-51797, 2012 WL 5199141 (Bankr. W.D. Tex. Oct. 22, 2012); TTOD Liquidation, Inc. v. Lim (*In re* DOTT Acquisition, LLC), No. 10-

72255, 2014 WL 554532 (Bankr. E.D. Mich. Feb. 13, 2014); TTOD Liquidation, Inc. v. Lim (*In re* DOTT Acquisition, LLC), No. 12-12133, 2012 WL 3257882 (Bankr. E.D. Mich. July 25, 2012); M2M Multihull, LLC v. West (*In re* West), No. 10-14653, 2012 WL 204221 (Bankr. R. I., Jan. 20, 2012).

The Constitutional Validity of Consent

S. Elizabeth Gibson

If the Supreme Court in *Wellness* decides that WIN's alter ego/§ 541 claim against Sharif is one for which the bankruptcy court had constitutional authority to enter a final judgment, there will, once again, be no need for the Court to reach the issue of consent. That issue will likely be reserved for yet still another day. If, however, the Court concludes that the proceeding is one for which final adjudication by an Article III court is required in the absence of party consent to bankruptcy court adjudication, the issue of consent will loom large. As Messrs. Landers and Williamson discuss, a decision that declines to rein in the scope of *Stern* or provide manageable principles for its application will have a detrimental impact on the efficient administration of bankruptcy cases. Those adverse results could be minimized, however, if the Court were to hold that parties can effectively waive the right to Article III adjudication.

I. Bankruptcy and Magistrate Act Decisions

The Supreme Court in past cases has appeared to assume without questioning, yet without directly deciding, that parties who have a constitutional right to an Article III determination of a bankruptcy proceeding may, by consenting to a determination by a bankruptcy judge, eliminate any constitutional infirmity—in other words, that the right to an Article III adjudication in a bankruptcy proceeding is waivable.

There is a long history of applying notions of consent and waiver to determine whether various proceedings can be heard and decided in the bankruptcy court. Long before the 1978 Bankruptcy Code, the Supreme Court held that the right to an Article III judge in non-summary proceedings in the bankruptcy court could be waived by litigants. MacDonald v. Plymouth County Trust Co., 286 U.S. 263, 267 (1932). And § 2a(7) of the Bankruptcy Act of 1898, as amended in 1952, provided that the failure to object to the summary jurisdiction of a bankruptcy court was "deemed" to constitute consent to the court's jurisdiction. Law of July 27, 1952, Pub. L. No. 456, 66 Stat. 420-21.

The Court has similarly suggested its approval of consent under the bankruptcy adjudicative scheme introduced by the 1978 Act and revised in 1984. Beginning with *Northern Pipeline*, the Court—or in some cases individual justices—have attached significance to the fact that an objecting party failed to consent to the bankruptcy judge's entry of a final judgment. These statements implied that, had the parties consented, the outcome would have been different:

- "None of the [Court's] cases has gone so far as to sanction the type of adjudication to which Marathon will be subjected *against its will* under the provisions of the 1978 Act." *Northern Pipeline*, 458 U.S. at 91 (Rehnquist, J., concurring in the judgment) (emphasis added).

- "[T]he Court's holding is limited to the proposition stated by Justice Rehnquist in his concurrence in the judgment—that a 'traditional' state common-law action, not made subject to a federal rule of decision, and related only peripherally to an adjudication of bankruptcy under federal law, must, *absent the consent of the litigants*, be heard by an 'Art. III court' if it is to be heard by any court or agency of the United States." *Id.* at 92 (Burger, C.J., dissenting) (emphasis added).
- "[C]ases such as these would have to be heard by Art. III judges or by state courts—*unless the defendant consents to suit before the bankruptcy judge*—just as they were before the 1978 Act was adopted." *Id.* at 95 (White, J., dissenting) (emphasis added).
- "The Court's holding in [*Northern Pipeline*] establishes only that Congress may not vest in a non-Article III court the power to adjudicate, render final judgment, and issue binding orders in a traditional contract action arising under state law, *without consent of the litigants*, and subject only to ordinary appellate review." *Thomas v. Union Carbide Agric. Prods. Co.*, 473 U.S. 568, 584 (1985) (emphasis added).
- "Indeed, the relevance of concepts of waiver to Article III challenges is demonstrated by our decision in *Northern Pipeline,* in which the absence of consent to an initial adjudication before a non-Article III tribunal was relied on as a significant factor in determining that Article III forbade such adjudication." *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833, 849 (1986).

Most recently, the Court in *Stern* referred to the consent provision of § 157(c)(2) with apparent approval. 131 S. Ct. at 2607. The Court rejected the argument that § 157(b)(5) deprived the bankruptcy court of jurisdiction to try a personal injury tort claim. Finding the provision for a district court trial to be non-jurisdictional, the Court concluded that the claimant, Pierce, had consented to the bankruptcy court's resolution of his defamation claim and had thereby waived any objection under that provision. In reaching this conclusion, the Court referred to § 157(c)(2), under which it said "parties may consent to the entry of final judgment by [a] bankruptcy judge in [a] noncore case." It stated that "Pierce does not explain why [§ 157(b)(5)'s] statutory limitation may not be similarly waived." In citing § 157(c)(2), the Court did not indicate that it harbored any doubts about the constitutional validity of the waiver it provides for. The dissent in *Stern* made it even clearer: "Even when private rights are at issue, non-Article III adjudication may be appropriate when both parties consent." *Id.* at 2628 (Breyer, J., dissenting).

Several of the Supreme Court's decisions concerning the Federal Magistrates Act have relied on the parties' consent as the basis for upholding actions taken by non-Article III magistrate judges. In *Peretz v. United States*, 501 U.S. 923 (1991), the Court rejected a constitutional challenge to a magistrate's conduct of voir dire in a felony case. It held that "[t]here is no constitutional infirmity in the delegation of felony trial jury selection to a magistrate when the litigants consent." *Id.* at 936. Indeed, the defendant's consent was the only fact that distinguished *Peretz* from the Court's earlier decision in *Gomez v. United States*, 490 U.S. 858 (1989), in which it held that magistrates lack statutory authority to conduct voir dire in a felony

trial. The *Peretz* Court explained that its earlier interpretation had been largely influenced by its desire to avoid an interpretation that would raise a serious constitutional issue. That consideration was absent in *Peretz*, according to the Court, because "the defendant's consent significantly changes the constitutional analysis." *Id.* at 932. *See also* Gonzalez v. United States, 553 U.S. 242 (2008) (holding that defense counsel's consent permitted a magistrate judge to preside over voir dire in a felony trial); *Roell v. Withrow*, 538 U.S. 580 (2003) (upholding a magistrate judge's entry of judgment in a civil case based on the parties' written and implied consent to have the magistrate judge preside over the case).

II. *Commodity Futures Trading Commission v. Schor*

The Supreme Court directly addressed the constitutional effect of consent to non-Article III adjudication in *Commodity Futures Trading Commission v. Schor*, 478 U.S. 833 (1986). That decision, which involved adjudication of a common law counterclaim by an administrative agency, provides a framework for assessing the effect of consent to non-Article III adjudication. In *Schor* the Supreme Court explained that the purpose of Article III, § 1 is twofold: first, it serves the institutional interest of separation of powers by creating an independent judiciary; second, it preserves the individual liberty of litigants to go before judges who are insulated from the pressures exerted by other branches of government. *Id.* at 848. These safeguards are achieved by mandating lifetime appointments and salary protections for Article III judges.

Schor held that, similar to other individual constitutional rights, the protection for litigants in Article III adjudication may be waived. *Id.* at 848-49. In contrast, it concluded that "[t]o the extent that th[e] structural principle is implicated in a given case, the parties cannot by consent cure the constitutional difficulty." *Id.* at 850-51.

The Court's formulation seems to require a court to engage in a constitutional analysis even if the parties consent to adjudication by a non-Article III judge. Although *Schor* says that Article III, § 1 "serves to protect primarily personal, rather than structural, interests," *id.* at 848, the Court's dual-function analysis requires examination of the extent to which a particular legislative scheme implicates the structural principle of separation of powers. *Schor* provides the analysis required to make that determination.

The Court set out the three factors listed below as ones to be weighed in "determining the extent to which a given congressional decision to authorize the adjudication of Article III business in a non-Article III tribunal impermissibly threatens the institutional integrity of the Judicial Branch." *Id.* at 851. None of these factors is determinative; instead, the Court instructed that the analysis must focus on "the practical effect that the congressional action will have on the constitutionally assigned role of the federal judiciary." *Id.*

- **The extent to which the essential attributes of judicial power are reserved to Article III courts.** In applying this factor in *Schor*, the Court looked at the extent to which the statutory scheme deviated from the traditional agency model. This examination

included the scope of the authority given the agency, the means of enforcement of the agency's order, and the standard of judicial review. *Id.* at 851-53.

- **The origins and importance of the right to be adjudicated.** Here the Court considered whether the claim at issue was a public or private right and whether it was governed by state or federal law. Although *Schor* involved a private right under state law, the Court found the nature of the claim not to be dispositive for Article III purposes. Instead, the Court took into account the fact that "the decision to invoke this forum is left entirely to the parties and the power of the federal judiciary to take jurisdiction of these matters is unaffected." *Id.* at 855.
- **The concerns that drove Congress to depart from the requirements of Article III.** In applying this factor, the Court found significant that Congress's "primary focus was on making effective a specific and limited federal regulatory scheme" and that the conferral of authority on the agency to hear a common law counterclaim was limited to what was necessary to achieve that goal. As a result, the Court concluded that any intrusion on the federal judiciary was *de minimis*. *Id.* at 856.

While *Schor* did not set forth a mechanical test that is easily applied by plugging factors into a settled formula, it did signal the need to consider the issue pragmatically. The Court stated that "due regard must be given in each case to the unique aspects of the congressional plan at issue and its practical consequences in light of the larger concerns that underlie Article III." *Id.* at 857. Ultimately, the Court concluded that the legislative scheme at issue raised "no questions about the aggrandizement of congressional power at the expense of a coordinate branch" and "no genuine threat" to the separation of powers. *Id.* at 856-57. The parties' consent, therefore, to adjudication by the administrative agency was effective to eliminate any constitutional concern under Article III.

III. Application of *Schor* to § 157(c)(2)

A. No distinction between Stern *claims and noncore proceedings*.

The Seventh Circuit attempted to narrow the impact of its decision in *Wellness* by distinguishing between the adjudication of *Stern* claims—those statutorily designated as core but which Article III prohibits bankruptcy courts from finally adjudicating—and noncore proceedings. It held that party consent is ineffective to allow bankruptcy court adjudication only with respect to the former. 727 F.3d at 772. The Supreme Court's decision in *Arkison*, however, makes that distinction no longer viable. Based on the severability provision of the 1984 Act, the Court held that a *Stern* claim should be treated as a noncore proceeding under § 157(c) so long as it satisfies the criteria of subsection (c)(1), which it invariably will.[1] Thus *Stern* claims and noncore claims

[1] In *Arkison* the Court examined whether a fraudulent conveyance claim, which it assumed to be a *Stern* claim, is "not . . . core" but is "otherwise related to a case under title 11"—the requirements of § 157(c)(1). Despite the statutory inclusion of fraudulent conveyance proceedings in the list of core proceedings, the Court concluded that such claims satisfy the first requirement of subsection (c)(1) because "Article III

are one and the same, and a decision about whether a bankruptcy court can finally adjudicate a *Stern* claim with the consent of the parties is a decision about whether the consent provision of § 157(c)(2) is constitutionally valid.

B. Is there any need to apply the Schor *factors?*

There is a split in the circuits as to whether litigants' consent to bankruptcy court adjudication (or waiver of any objection) validates the entry of a final judgment by a bankruptcy judge in a proceeding that otherwise requires adjudication by an Article III court. The Ninth Circuit held in *Arkison* that the appellant consented to a determination by the bankruptcy judge and thereby waived any constitutional objection. Executive Benefits Ins. Agency, Inc. v. Arkinson (*In re* Bellingham Ins. Agency, Inc.), 702 F.3d 553, 567-70 (9th Cir. 2012). Three other courts of appeals have held that party consent does not eliminate an Article III objection to bankruptcy court adjudication or prevent a party from raising the issue for the first time on appeal. In addition to the Seventh Circuit's decision in *Wellness*, there are decisions by the Fifth and Sixth Circuits: *BP RE, L.P. v. RML Waxahachie Dodge, L.L.C. (In re BP RE, L.P.)*, 2013 WL 5975030 (5th Cir. Nov. 11, 2013); *Frazin*, 732 F.3d at 320 n.3; *Waldman v. Stone*, 698 F.3d 910, 917-918 (6th Cir. 2012), *cert. denied*, 133 S.Ct. 1604 (2013).

In reaching their respective conclusions in these cases, the courts of appeals cited *Schor*, but they largely based their decisions on summary conclusions about whether the case before them implicated the structural concerns of separation of powers. In upholding consent, the Ninth Circuit concluded in a footnote that "the allocation of authority between bankruptcy courts and district courts does not implicate structural interests, because bankruptcy judges are 'officer[s] of the district court' and are appointed by the Courts of Appeals." *Arkison*, 702 F.3d at 567 n.9.

The Fifth and Sixth Circuits came to the opposite conclusion almost as quickly. The Fifth Circuit in *Frazin* concluded that the Supreme Court in *Stern* had already decided that the entry of a final judgment by a bankruptcy court on certain state law counterclaims does implicate separation of powers. 732 F.3d at 320 n.3. In its subsequent *BP RE* decision, the Fifth Circuit applied the same reasoning to a noncore proceeding in which the parties had consented to bankruptcy adjudication. It concluded that, while the parties' consent gave the bankruptcy court statutory authority to enter a judgment in a noncore proceeding under § 157(c)(2), under *Stern* the bankruptcy court lacked constitutional authority to do so. The Sixth Circuit in *Waldman* concluded that allowing judicial power to be shifted from Article III judges to judges who lack constitutional protections causes "the Judicial Branch [to be] weaker and less independent than it is supposed to be" and, because of this structural concern, adjudication by an Article III court is not subject to waiver by a party. 698 F.3d at 918.

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does not permit these claims to be treated as 'core.'" 134 S. Ct. at 2174. As for the second requirement, the Court said that "fraudulent conveyance claims are self-evidently 'related to a case under title 11.'" *Id.* The Court's application of the "related to" requirement shows that it interpreted the term to be inclusive of all of the jurisdictional categories under 28 U.S.C. § 1334, rather than as being distinct from "arising under" and "arising in" forms of bankruptcy jurisdiction.

The Seventh Circuit's decision in *Wellness* contained an extended examination of *Schor*, as well as of the Ninth and Sixth Circuits' decisions, but its analysis of the extent to which structural concerns were implicated was based on its view that *Stern* had already decided the matter:

> [U]nlike *Schor*, where party consent was permissible because the statutory scheme at issue did not implicate structural concerns, the Supreme Court has already held that the statutory scheme granting bankruptcy judges authority to enter final judgment in core proceedings *does* implicate structural concerns where the core proceeding at issue is the "stuff of the traditional actions at common law tried by the courts at Westminster in 1789."

727 F.3d at 771 (quoting *Stern*, 131 S. Ct. at 2609) (internal quotation marks deleted).

The Fifth and Seventh Circuits' reliance on *Stern* in this context was misplaced. The courts failed to appreciate the significance of the fact that *Stern* decided the Article III issue in a case in which the objecting party had *not* consented to have the bankruptcy court decide the counterclaim that was asserted against him. *See Stern*, 131 S. Ct. at 2607. That difference between *Stern* and a case in which the parties consent to bankruptcy court jurisdiction is all important. As the Supreme Court said in *Peretz*, "[T]he defendant's consent significantly changes the constitutional analysis." 501 U.S. at 932. Were that not so, consent would always be irrelevant. If without consent the bankruptcy court's final adjudication would be consistent with Article III, no consent would be needed. And if the need for Article III adjudication in the absence of consent meant that the right to an Article III court could not be waived, consent would never suffice. The Court's recognition in *Schor* and *Peretz* of the constitutional validity of consent renders that analysis untenable.

The Sixth and Ninth Circuits provided reasons independent of *Stern* for why the final adjudication by the bankruptcy court did or did not implicate structural concerns, but their analyses did not go far enough. For the Ninth Circuit consent was validated by the fact that the authority of Article III courts was delegated to judicial officers within the federal judiciary. For the Sixth Circuit any delegation of authority by Article III courts to non-Article III judges implicated structural concerns and prevented waiver. Both courts, however, fell short by failing to consider the full context of the bankruptcy adjudicatory scheme as required by *Schor*. Only by considering all of the *Schor* factors can a court determine whether party consent eliminates the constitutional concern about a bankruptcy court's final adjudication of a noncore issue or *Stern* claim.

C. Application of the Schor *factors.*

To apply *Schor* to determine whether party consent under § 157(c)(2) eliminates constitutional questions about adjudication by bankruptcy judges, the entire statutory scheme of 28 U.S.C. §§ 151-158 has to be considered. Congress enacted these provisions in 1984 in response to *Northern Pipeline*, in which the Supreme Court—without a majority rationale—struck down the statutory scheme for the exercise of bankruptcy jurisdiction enacted by Congress in the

Bankruptcy Reform Act of 1978. As expressed in the plurality opinion written by Justice Brennan, by assigning to bankruptcy judges the jurisdiction granted in what was then 28 U.S.C. § 1471, Congress violated Article III because the bankruptcy courts as then constituted were neither legislative courts nor adjuncts of the district court. Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50, 76, 87 (1982). In concluding that the contract action before the Court did not constitute a "public right" that a legislative court might adjudicate, Justice Brennan stated:

> [T]he restructuring of debtor-creditor relations, which is at the core of the federal bankruptcy power, must be distinguished from the adjudication of state-created private rights, such as the right to recover contract damages that is at issue in this case. The former may well be a "public right," but the latter obviously is not.

Id. at 71.[2]

Congress responded to *Northern Pipeline* by largely keeping intact the scope of bankruptcy subject-matter jurisdiction, but by limiting the authority of bankruptcy judges to exercise that jurisdiction. It enacted 28 U.S.C. § 151, which declares that bankruptcy judges in each district "constitute a unit of the district court" and that they are judicial officers of the district court. The statute authorizes bankruptcy judges to "exercise the authority conferred under this chapter . . . , except as otherwise provided by law or by rule or order of the district court." Section 152 provides for the appointment of bankruptcy judges for fourteen-year terms by the court of appeals for the circuit in which the district is located.

In an effort to comply with the principles announced in *Northern Pipeline*, Congress enacted § 157, which governs the authority of bankruptcy judges. This statute's structure reflects the reasoning of Justice Brennan's plurality opinion. Subsection (a) authorizes district courts to refer "any or all" bankruptcy cases and proceedings to the bankruptcy judges for the district. What the bankruptcy judge is permitted to do after referral depends on the nature of the proceeding involved.

Drawing from Justice Brennan's language about matters at the "core of the federal bankruptcy power," subsection (b) authorizes bankruptcy judges to "hear and determine all cases under title 11 and all core proceedings." 28 U.S.C. § 157(b)(1). Bankruptcy judges may enter

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[2] Concurring in the judgment in an opinion joined by Justice O'Connor, Justice Rehnquist objected to the breadth of the plurality opinion. He wrote, however, that he did agree that "[n]one of the cases has gone so far as to sanction the type of adjudication to which Marathon will be subjected *against its will* under the provisions of the 1978 Act." 458 U.S. at 91 (Rehnquist, J., concurring) (emphasis added). He also agreed that, given the scope of appellate review of bankruptcy court decisions, bankruptcy courts were not adjuncts of the district courts under the bankruptcy court system established in 1978. Because the grant of authority to bankruptcy judges to hear the type of claim at issue in the case before the Court was not readily severable from the remaining grant of authority under 28 U.S.C. § 1471, Justices Rehnquist and O'Connor concurred in the judgment that the grant of jurisdiction to bankruptcy courts in section 1471 was unconstitutional. *Id.* at 91-92.

appropriate orders and judgments, subject to appeal under ordinary standards of review. Although the statute does not define "core proceedings,"[3] it equates them with proceedings arising under title 11 or arising in a case under title 11, and it provides a nonexclusive list of core proceedings. It is apparent that Congress deemed core proceedings to be public rights that bankruptcy courts could adjudicate as legislative courts.

Subsection (c) governs bankruptcy proceedings that are not core proceedings. This category includes claims like the one at issue in *Northern Pipeline*. Because noncore proceedings do not involve public rights, Congress limited the role of bankruptcy judges to serving as adjuncts of the district court—*unless* the parties consent to the entry of judgment by the bankruptcy judge. In the absence of consent, bankruptcy judges may only hear the proceeding and submit proposed findings of fact and conclusions of law to the district court for de novo review.

When the entirety of this legislative scheme for bankruptcy adjudication is taken into account, the analysis prescribed by *Schor* leads to the conclusion that party consent eliminates constitutional objections to the entry of a judgment by a bankruptcy judge. The first factor *Schor* considered was the extent to which the essential attributes of judicial power are reserved to Article III courts. In responding to *Northern Pipeline*, Congress left the judicial power in the ultimate control of the Article III courts:

- Courts of appeals appoint bankruptcy judges as judicial officers of the district court. 28 U.S.C. § 152(a)(2).
- District courts choose whether to refer bankruptcy cases and proceedings to the bankruptcy court, and they can withdraw that reference in particular cases or proceedings for cause, regardless of the preferences of the parties. *Id*. § 157(a), (d).
- District courts by order or rule can limit the authority conferred by statute on bankruptcy judges. Thus, the Article III courts, not Congress, have the final say about the scope of bankruptcy judges' authority. *Id*. § 151.
- Except where Congress declared a matter to involve a public right at the core of bankruptcy or where the parties otherwise consent, bankruptcy judges may only submit proposed findings of fact or conclusions of law, with a judgment or order entered by the district court following de novo review of the bankruptcy judge's recommendation. § 157(c)(1).

The second *Schor* factor is the origin and importance of the right to be adjudicated. Bankruptcy proceedings involve a broad range of issues, some arising under federal bankruptcy law or other federal law, others arising under state statutory or common law. The adjudicative scheme is therefore unlike the agency model considered in *Schor* in which the non-Article III decision maker was for the most part given authority to determine only a narrow range of issues in a specialized area. Nevertheless, the Court indicated that the nature of the claim, though relevant,

[3] Section 157(b)(2) does give a list of illustrative examples of core proceedings.

is not dispositive in determining the effect of consent to non-Article III adjudication. Moreover, as in *Schor*, "the decision to invoke this forum [the bankruptcy court] is left entirely to the parties [who choose to consent], and the power of the [Article III] federal judiciary to take jurisdiction of these matters is unaffected [since they refer the proceedings to the bankruptcy court and can withdraw the reference]." 478 U.S. at 855.

The final *Schor* factor—the concerns that drove Congress to depart from the requirements of Article III—is especially significant here. In reconstructing the bankruptcy adjudicative scheme after *Northern Pipeline*, Congress sought to maintain an effective bankruptcy system with specialized courts capable of handling the bankruptcy caseload in a timely manner, while at the same time leaving sufficient power in the Article III courts to preserve judicial independence. The plurality opinion in *Northern Pipeline* had indicated that matters at the core of the bankruptcy process might well be subject to determination by non-Article III judges—a conclusion clearly shared by the dissenting justices. Congress attempted to identify proceedings of that type, while giving bankruptcy judges only the authority of an adjunct to the district court with respect to the others. Although *Stern* determined that Congress's judgment was wrong in one type of core proceeding that should have been designated as noncore, and *Arkison* assumed that to be the case with another, those decisions do not suggest that Congress was attempting to augment its authority at the expense of the judiciary or to diminish the authority of the Article III courts.

The analysis that the Court employed in *Schor* for determining the extent to which a structural principle is implicated by non-Article III adjudication therefore supports the validity of the adjudication of private rights by bankruptcy courts with the parties' consent. Parties can waive their personal rights to an Article III adjudication, and, given the continued control of Article III courts, any impact on separation of powers is minimal.

IV. Implied Consent

Wellness also raises the issue of how parties' consent to bankruptcy court adjudication of *Stern* claims (and noncore proceedings) must be given. Must it always be expressly stated, or may consent be implied from the parties' litigation conduct? The Supreme Court has provided the answer to this question in analogous contexts.

In *Schor* the Court stated that a party's consent to non-Article III adjudication could be implied:

> Even were there no evidence of an express waiver here, Schor's election to forgo his right to proceed in state or federal court on his claim and his decision to seek relief instead in a CFTC reparations proceeding constituted an effective waiver …. Schor effectively agreed to an adjudication by the CFTC of the entire controversy by seeking relief in this alternative forum.

478 U.S. at 849-850.

Likewise, in *Roell v. Withrow*, the Court held that the parties by their litigation conduct had given implied consent to adjudication by a magistrate judge. Notwithstanding a requirement of advance, written consent imposed by statute and rule,[4] the Court held that the parties "'clearly implied their consent' by their decision to appear before the Magistrate Judge, without expressing any reservation, after being notified of their right to refuse and after being told that [the magistrate judge] intended to exercise case-dispositive authority." 538 U.S. at 586. The Court reasoned that rejection of a bright-line requirement of express consent served to "check[] the risk of gamesmanship by depriving parties of the luxury of waiting for the outcome before denying the magistrate judge's authority. Judicial efficiency is served; the Article III right is substantially honored." *Id.* at 590.

The argument for recognizing implied consent in the bankruptcy context is perhaps even stronger than with respect to magistrate judges. Section 157(c)(2) of title 28 authorizes bankruptcy court adjudication of noncore proceedings "with the consent of all the parties." The statute gives no indication that the consent must be express or in writing. The Federal Rules of Bankruptcy Procedure do, however, require express consent in adversary proceedings. Rule 7008(a) requires complaints, counterclaims, cross-claims, and third-party complaints "to contain a statement that the proceeding is core or non-core and, if non-core, that the pleader does or does not consent to entry of final orders or judgment by the bankruptcy judge." And Rule 7012(b) requires a responsive pleading to admit or deny the plaintiff's allegation that the proceeding is core or noncore and, if noncore, to include a statement indicating whether consent is granted for the bankruptcy judge to enter final orders or a judgment. The rule goes on to state that "[i]n non-core proceedings final orders and judgments shall not be entered on the bankruptcy judge's order except with the express consent of the parties."

If the Court reaches the implied consent issue in *Wellness*, it should follow the reasoning of *Roell* that express consent should not be required at the cost of inviting strategic behavior by parties who litigate without objection before the bankruptcy court and raise the issue of lack of consent only after losing. But even if the Court were to enforce the Bankruptcy Rules' requirement of express, written consent, its decisions in *Schor* and *Roell* would support an amendment of the Bankruptcy Rules to allow consent to be implied by a party's failure to object to bankruptcy court adjudication.

[4] Section 636(c)(2) requires parties to "communicate[]" to the clerk of court whether they consent to have a magistrate judge adjudicate their civil proceeding, and Fed. R. Civ. P. 73(b) provides that, to "signify their consent, the parties must jointly or separately file a statement consenting to the referral." The Court in *Roell* noted, however, that § 636(c)(1)—"the font of a magistrate judge's authority"—speaks only of the "'the consent of the parties,' without qualification as to form," in contrast to other statutory provisions governing magistrate judges that require a "specific written request." *Id.* at 587.