

The Significance of *Wellness International v. Sharif*

Law360, New York (July 14, 2014, 10:22 AM ET) -- The United States Supreme Court, on July 1, 2014, granted a petition for certiorari in an important Seventh Circuit case limiting the power of bankruptcy courts to decide property disputes. *Wellness International Network Ltd. et al. v. Sharif*, 727 F.3d 751 (7th Cir. 2013). The Seventh Circuit had held last year that the bankruptcy court lacked the constitutional authority to determine whether purported trust assets were property of the debtor's estate. In its view, this was a "state law claim between private parties that is wholly independent of federal bankruptcy law and is not resolved in the claims-allowance process." 727 F.3d at 776.

The Supreme Court had just held on June 9, 2014, that certain nominally "core" proceedings (e.g., fraudulent transfer suits) could be litigated in the bankruptcy court, but only if that court's proposed fact findings and legal conclusions were subject to the district court's de novo review. *Executive Benefits Insurance Agency v. Arkison (In re Bellingham Insurance Agency)*, (U.S. Sup. Court June 9, 2014) ("Bellingham"). This ruling followed the court's decision in *Stern v. Marshall*, 131 S. Ct. 2594, 2620 (2011) (5-4), holding that bankruptcy courts "lack ... constitutional authority to enter final judgment on a state law ... claim [by the estate] that is not resolved in ... [the] process of ruling on ... [the] creditor's claim."

Relevance

The litigants challenging the constitutional authority of the bankruptcy court in *Bellingham* and *Stern* were third parties who had been sued by the bankruptcy estate. In *Wellness*, however, the debtor who voluntarily chose to file his bankruptcy petition after a stinging defeat in the federal court system had belatedly challenged the bankruptcy court's constitutional authority after losing a fight over his discharge and his ownership of trust assets in that court. The Supreme Court will now have to resolve a conflict between the Seventh Circuit and other courts of appeals over the bankruptcy court's ability to decide routine property ownership issues.

Practically, a lender who has successfully pursued a debtor in the court system and is then confronted with its debtor's bankruptcy does not want to spend valuable resources and more time litigating over whether the bankruptcy court can determine what assets are included within the debtor's bankruptcy estate.

Until *Wellness*, other appellate courts have regularly held that bankruptcy courts had the power to determine whether property in the debtor's possession belongs to the estate under Bankruptcy Code § 541 as federal law claims despite the presence of state law issues. *In re Johnson*, 960 F.2d 396 (4th Cir. 1992) (held, bankruptcy courts continue to have authority to enter final orders and actions against debtor to determine whether property in debtor's possession belongs to bankruptcy estate); *In re Croft*,

737 F.3d 372, 374 (5th Cir. 2013) (held, actions under Code § 541 are federal claims although issues of state law present).

The Seventh Circuit's narrow focus on state law issues in *Wellness* would shift much of the usual bankruptcy court litigation to the district courts, creating unnecessary delay and expense to creditors.

Facts

The debtor sued Wellness in a Texas federal district court but lost because of his failure to respect Wellness' discovery requests, causing the court to deem the material facts admitted against him. The Fifth Circuit affirmed the judgment against the debtor and remanded the case to the district court for an award of attorneys' fees to Wellness. When Wellness started to enforce its money judgment, the debtor filed a Chapter 7 petition in the bankruptcy court for the Northern District of Illinois.

Wellness sued the debtor in the bankruptcy court seeking a denial of his bankruptcy discharge and also a declaratory judgment that assets purportedly held by the debtor in trust were property of his bankruptcy estate. According to Wellness, the debtor had prepared a pre-bankruptcy financial statement showing more assets than he had listed on his bankruptcy schedules, including the property purportedly held in trust.

The debtor again failed to respond to Wellness' discovery requests and to bankruptcy court discovery orders. Wellness then sought a default judgment against the debtor. The bankruptcy court eventually denied the debtor's discharge, entering a default judgment, and separately found that the assets purportedly held by the debtor in a so-called trust were actually property of the debtor's estate. The district court affirmed. During the entire course of this litigation, the debtor belatedly challenged the bankruptcy court's jurisdiction. 727 F.3d at 756-60.

The Seventh Circuit

The Seventh Circuit affirmed the denial of the debtor's discharge but reversed the lower courts on the property claim. It reasoned that Wellness had asserted a state law alter ego claim "wholly independent of federal bankruptcy law." *Id.*, at 776. Relying on the Supreme Court's 2011 *Stern* holding, the court explained that the alter ego claim in *Wellness* was "indistinguishable from the tortious interference counterclaim in *Stern*." *Id.*, at 774.

Nor could the debtor waive his constitutional objection because it "implicated separation-of-powers principles" and was not waivable. *Id.*, at 755, 761-773. Noting that the waiver issue was a "thorny question," the Seventh Circuit conceded that the circuits were split on the issue. *Id.*, at 761.

Significance of the Case

The dispute in *Wellness* should meet the requirements of *Stern* that an "action stem ... from the bankruptcy itself." 131 S. Ct. at 2618. Wellness sued the debtor under Code § 541 to determine whether property in the debtor's possession was an asset of the estate, an issue that was most relevant in the context of a bankruptcy case.

Bankruptcy courts have routinely decided these issues with appellate court approval, reasoning that actions under Code § 541 are federal law claims despite state law issues. *See, e.g., Mueller v. Nugent*, 184 U.S. 1, 13-14 (1902); *In re Johnson*, 960 F. 2d at 400-02; *In re Croft*, 737 F. 3d at 374; *Tyler v. D.H.*

Capital Management Inc., 736 F. 3d 455, 461 (6th Cir. 2013); *In re Dittmar*, 618 F. 3d 1199, 1204 (10th Cir. 2010); *In re The Ground Round Inc.*, 482 F. 3d 15, 17 (1st Cir. 2007). The Seventh Circuit, however, found that Wellness' action under Code § 541 was a state law claim that did not "stem ... from the bankruptcy," a finding at odds with other circuits.

The Supreme Court granted certiorari in *Wellness* to consider not only the property-of-the-estate issue, but also the issue of litigant consent. Wellness argued alternatively in its petition that the debtor had impliedly consented on the basis of its conduct. The Supreme Court avoided the consent issue in *Bellingham*, however, and can do so again in *Wellness*.

Property issues are at the heart of bankruptcy administration because bankruptcy cases are essentially in rem. See, e.g., *Tennessee Student Assistance Corp. v. Hood*, 541 U.S. 440, 448 (2004) ("A bankruptcy court's in rem jurisdiction permits it to 'determin[e] all claims that anyone, whether named in the action or not, has to the property or thing in question. The proceeding is 'one against the world.'"), quoting 16 J. Moore et al., *Moore's Federal Practice* § 108.70[1], at 108-106 (3d ed. 2004); *Van Huffel v. Harkelrode*, 284 U.S. 225, 228-229 (1931) (held, bankruptcy court had power to sell debtor's property "free and clear" of state's tax lien); *Local Loan Co. v. Hunt*, 292 U.S. 234, 241 (1934) ("... generally, proceedings in bankruptcy are in the nature of proceedings in rem").

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