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U.S. Supreme Court Preserves Bankruptcy Court Power to Hear Disputes

Michael L. Cook, Lawrence V. Gelber, and David M. Hillman*

The U.S. Supreme Court recently rejected a debtor's constitutional argument that the bankruptcy court lacked the power to decide whether purported trust assets were part of his estate and thus available to creditors. The authors of this article explain the decision and its implications.

Bankruptcy courts may hear state law disputes "when the parties knowingly and voluntarily consent," held the U.S. Supreme Court on May 26, 2015.[1] That consent, moreover, need not be express, reasoned the Court.[2] Reversing the U.S. Court of Appeals for the Seventh Circuit, the Court rejected the debtor's belated constitutional argument that the bankruptcy court lacked the power to decide whether purported trust assets were part of his estate and thus available to creditors. Even the chief justice and two other justices who dissented from the breadth and reasoning of the majority opinion "would reverse" the Seventh Circuit's holding because the creditor's claim to the purported assets "falls within the . . . exception that permits a non-Article III adjudicator [i.e., bankruptcy judge] in certain bankruptcy proceedings."[3]

RELEVANCE

The decision reassures bankruptcy judges and practitioners that the system will survive. As the Court noted, "without the distinguished service of [magistrates and bankruptcy judges], the work of the federal court system would grind nearly to a halt."[4] According to the chief justice's dissent, "[i]dentifying property that constitutes the estate has long been a central feature of bankruptcy adjudication."[5] Cutting through the detailed arguments in the

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1 *Wellness Int'l Network Ltd. v. Sharif*, 2015 U.S. LEXIS 3405 (May 26, 2015).

2 *Id.* at *27 ("Nothing in the Constitution requires that consent to adjudication by a bankruptcy court be express.").

3 *Id.* at *42.

4 *Id.* at *7.

5 *Id.* at *38.

majority and dissenting opinions, the Court could easily have held unanimously that the bankruptcy court had jurisdiction to decide the property dispute in *Wellness* without ever reaching the consent issue. In any event, lenders and other parties now know that bankruptcy courts can continue to hear not only such other basic bankruptcy matters as financing, claims allowance, reorganization plans and discharge, but also state law disputes when the parties consent. As to the latter "non-core" disputes, though, when the parties do not consent, bankruptcy courts will continue to make "proposed findings of fact and conclusions of law" to the district court for consideration or, alternatively, a party may ask the district court to withdraw the dispute from the bankruptcy court.

FACTS

The debtor sued Wellness International Network Ltd. ("Wellness"), one of his largest creditors, in a Texas federal district court but lost because of his failure to respond to Wellness' discovery requests, causing the court to deem the material facts admitted against him. When Wellness started to enforce its final money judgment, the debtor filed a Chapter 7 petition in the bankruptcy court for the Northern District of Illinois.

Wellness then sued the debtor in the bankruptcy court seeking a denial of his bankruptcy discharge and 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 $5 million more of 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. The bankruptcy court eventually denied the debtor's discharge, entering a default judgment against him, and separately found that the assets purportedly held by the debtor in a so-called trust were actually property of his estate. The district court affirmed, despite the debtor's belated challenge to the bankruptcy court's jurisdiction after briefing had concluded.

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."[6] Relying on the Supreme Court's 2011 holding in *Stern v. Marshall*,[7] the

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[6] *Wellness Int'l Network, Ltd. v. Sharif*, 727 F.3d 751, 775 (7th Cir. 2013).

[7] 131 S. Ct. 2594, 2620 (2011) *(held*, bankruptcy courts "lack . . . constitutional authority

Seventh Circuit explained that the alter-ego claim in *Wellness* was "indistinguishable from the tortious-interference counterclaim in *Stern*." Moreover, it reasoned, the debtor could not waive his constitutional objection because it "implicated separation-of-powers principles" and was not waivable.[8] Noting that the waiver issue, however, was a "thorny question," the Seventh Circuit conceded that the circuits were split on the issue.[9] In its view, Wellness' alter-ego action was a state law claim that did not "stem[ ] from the bankruptcy."[10]

ANALYSIS

The Supreme Court broadly described the issue before it: "Whether Article III [of the Constitution] allows bankruptcy judges to adjudicate [state law] claims with the parties' consent."[11] Holding that the Constitution "is not violated when the parties knowingly and voluntarily consent to adjudication by a bankruptcy judge," the Court first explained the statutory and case law history of bankruptcy jurisdiction. It noted the debtor's admission that Wellness' suit "was a 'core proceeding' under 28 U.S.C. § 157(b)—i.e., a proceeding in which the Bankruptcy Court could enter final judgment subject to appeal."[12] Moreover, the debtor "requested judgment in his favor on all counts of Wellness' complaint and urged the Bankruptcy Court to find that the . . . Trust is not property of the [bankruptcy] estate." But the Court expressed "no view" on whether Wellness' claim was of the same type litigated in *Stern—i.e.*, whether it was "core" or "non-core." Instead, because of the debtor's apparent consent to bankruptcy court jurisdiction, it reasoned that the bankruptcy court "had constitutional authority to enter final judgment . . . ."[13]

The Court stressed that "[a]djudication by consent is nothing new."[14] Relying on its prior holding in *Commodity Futures Trading Comm'n v. Schor*,[15] the Court found that "entitlement to an Article III adjudicator is 'a personal

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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").

[8] 727 F.3d at 755, 774.

[9] *Id.* at 761.

[10] *Id.* at 765.

[11] *Wellness Int'l Network Ltd. v. Sharif.*, 2015 U.S. LEXIS 3405 (May 26, 2015).

[12] *Id.* at *11.

[13] *Id.* at *44.

[14] *Id.* at *14.

[15] 478 U.S. 833 (1986).

right' and thus ordinarily 'subject to waiver.'"[16] Allowing bankruptcy judges, who are appointed under Article I of the Constitution, "to decide claims submitted to them by consent does not offend the separation of powers so long as Article III courts retain supervisory authority over the process." Bankruptcy judges "are appointed and subject to removal by Article III judges."[17]

Finally, according to the Court, when responding to the Chief Justice's dissent, "Congress has supplemented the capacity of district courts through the able assistance of bankruptcy judges. So long as those judges are subject to control by the Article III courts, their work poses no threat to the separation of powers."[18] Because "litigant consent has been a consistent feature of the federal court system since its inception," the bankruptcy court's disposition of the Wellness claim "poses no great threat to anyone's birthrights, constitutional or otherwise."[19] In its pragmatic analysis, the Court applied "practical attention to substance rather than doctrinaire reliance on formal categories . . . ."[20] Justice Alito, in his partial concurrence, stressed the Court's "previous rejection of 'formalistic and unbending rules'" in *Schor*.[21]

The Court also rejected the debtor's argument that a party's consent must be express. According to the Court, "[n]othing in the Constitution requires that consent to adjudication by a bankruptcy court be express."[22] On remand, the Seventh Circuit must determine "whether [the debtor's] actions evinced the requisite knowing and voluntary consent, and also whether, as Wellness contends, [the debtor] forfeited his . . . argument" based on the Court's earlier decision in *Stern*.[23]

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[16] *Wellness Int'l Network,* 2015 U.S. LEXIS 3405, at *19, citing *Schor*, 478 U.S. at 848.

[17] *Id.* at *20–21, quoting *Peretz v. United States*, 501 U.S. 923, 937 (1991), and citing 28 U.S.C. §§ 152(a)(1), (e).

[18] *Id.* at *24.

[19] *Id.* at *26–27.

[20] *Id.* at *21, quoting *Thomas v. Union Carbide Agricultural Products Co.*, 473 U.S. 568, 587 (1985).

[21] *Id.* at *30.

[22] *Id.* at *28.

[23] *Id.* at *30.