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A Brand-New Ball Game?
What *Stern v. Marshall* Means for Lenders

BY DAVID N. CRAPO & HOWARD BROD BROWNSTEIN

What's all this about *Stern v. Marshall?* Commentators and courts have scrambled to take the Supreme Court at its word, and attempt to limit the impact of the *Stern* decision. Whether these decisions will stand up under future Supreme Court review, if and when it occurs, is not so clear. Early decisions seem favorable, but it is likely that litigants emboldened by *Stern* — including those adverse to secured creditors — may probe the limits of bankruptcy court authority.

DAVID N. CRAPO, ESQ.
Counsel, Financial Restructuring & Creditors' Rights Department, Gibbons P.C.

HOWARD BROD BROWNSTEIN, CTP
President, The Brownstein Corporation

One of the main advantages to the Chapter 11 bankruptcy process historically has been its ability to dispose of virtually all issues affecting the debtor and its business affairs, whether they arise under state or federal law. A federal bankruptcy judge, whether sitting in Wilmington, Los Angeles, Chicago or any other jurisdiction, is quite capable of applying the law of any state that it finds to be appropriate. State law is, in fact, the applicable legal framework for most routine creditor claim matters, such as determining the amount that each creditor is due, and whether the debtor has any defenses, offsets or counterclaims. So, unless the creditor's claim arises under federal law, a bankruptcy court will typically apply state law, such as the law of the state where the underlying transaction occurred.

On June 23, 2011, the Supreme Court issued its opinion in *Stern v. Marshall*,[1] addressing a bankruptcy court's exercise of "core jurisdiction"[2] and, in particular, its authority to enter a final judgment over a claim arising under state law, asserted by a Chapter 11 debtor-in-possession, as a counterclaim to a creditor's proof of claim. The court held that, although federal law gave the bankruptcy court the statutory authority to exercise core jurisdiction over the debtor's state law counterclaim for tortious interference asserted against the creditor's proof of claim for defamation, the bankruptcy court lacked the constitutional authority to do so, because the resolution of the counterclaim was not required for a resolution of the proof of claim.

As the recent *Teleservices* decision has stated, "*Stern* can be summarized as a dispute over a considerable inheritance and a stepmother's effort to employ the bankruptcy court to recover what that court finally determined was a multi-million-dollar tort claim against the deceased husband's son. At issue was the bankruptcy judge's ability to enter a final judgment on account of that claim. Had the estate simply sued the stepson, it is unlikely that the case would have reached the [Supreme] Court [as the lack of bankruptcy court power to enter a final judgment in such a non-bankruptcy tort claim was well settled]... However, the estate's claim had been brought as a counterclaim to the stepson's own tort claim against the bankruptcy estate and [the governing statutory authority under which bankruptcy judges are able to issue final judgments in contested matters] identified such counterclaims as being [within the bankruptcy court's so-called] 'core' [jurisdiction, and the Supreme Court so found]. However, the [Supreme] Court ... dropped a bombshell by declaring that the judgment [which the bankruptcy court had clear statutory authority to enter] was nonetheless invalid because it violated the Constitution."[3]

Stern v. Marshall may embolden lienholders — particularly junior lienholders — to challenge the authority of bankruptcy courts to issue final orders authorizing sales free and clear of liens, claims and encumbrances. The basis for such an objection would be that such a sale potentially deprives the holders of such liens, claims and encumbrances of a property interest, and only an Article III court has the constitutional authority to enter such an order.

1 131 S. Ct. 2594 (2011).
2 The term "core jurisdiction" is used here for ease of reference. Technically, the issue raised by the Supreme Court's decision in *Stern v. Marshall* is not a jurisdiction issue, but is an issue of the authority of the bankruptcy court to enter a "final" judgment in matters that are grounded in state law, due to the limited powers of such courts. A detailed discussion of bankruptcy jurisdiction is beyond the scope of this article.

3 *In re Teleservices Group, Inc.*, 2011 Bankr. LEXIS 3128 (Aug. 17, 2011).

This is potentially a game-changing decision for bankruptcy, including for lenders engaged in the restructuring process, although subsequent decisions appear to try to "get the genie back in the bottle." Even in cases where a borrower is not seeking bankruptcy protection, bankruptcy is always a reference point, with the borrower, lender and creditors all continuously measuring the distance to bankruptcy, and considering whether their interests would be better served in a bankruptcy proceeding. That reference point has included, until the *Stern* case, the assumption that all matters involved in the borrower's situation could be resolved, if necessary, in a bankruptcy. However, subject to how courts will interpret the decision in *Stern*, as well as future Supreme Court decisions, *Stern* may have stripped the bankruptcy process of this capability, possibly rendering it less efficient and effective.

Why did the Supreme Court do this? If it wasn't broke, why fix it? Basically, the court in the *Stern* case was reflecting that, although bankruptcy is a power of the federal government enumerated in Article I, §8 of the Constitution, "bankruptcy courts" are not specifically provided for. The system of federal courts — the federal district court, the circuit courts of appeals and the Supreme Court — is created under Article III. Congress, in creating bankruptcy courts in 1979, acted pursuant to Article I, which did not provide bankruptcy judges with the privileges and protections that are accorded other "Article III" federal judges (i.e., lifetime tenure or with protection against having their compensation diminished).

In this day and age, we can safely assume that, even without such privileges and protections, bankruptcy judges can administer the law fairly and impartially, and have in fact done so since 1979. However, the Supreme Court is the interpreter of the intentions of the Constitution's framers, who lived in a different political era when a judge without lifetime tenure and protection against salary reduction might have been susceptible to improper influence. "*Stern*... [stands for the proposition] that the separation of powers [under the Constitution] requires a judiciary that is independent of the legislative and executive branches."[4] Therefore, in *Stern*, the court is requiring that any tribunal capable of depriving a party of its property has to be an Article III judge with the concomitant privileges and protections.

The Supreme Court in the *Stern* decision is basically saying that a bankruptcy court does have the authority to adjudicate creditors' claims that arise under state law (e.g., for moneys loaned, goods delivered or services provided). However, if the debtor has a counterclaim that arises under state law, the bankruptcy court may lack the constitutional authority to adjudicate it. This means that final resolution of that claim, taking into account any such counterclaims, is delayed while a separate proceeding takes place in federal district court.

The *Stern* case involved a creditor that had a claim against the debtor for defamation of character, with the debtor having a counterclaim against the creditor for tortious interference with contractual relations. The Supreme Court rejected the contention that the debtor's state law counterclaim for tortious interference raised issues of "public right" that properly can be decided by tribunals other than Article III courts. According to the *Stern* court, the application of the public rights doctrine is limited to claims depending on the will of Congress such as: 1.) claims arising under a particularized federal legislative scheme; 2.) claims created by federal law; or 3.) particularized claims for which Congress has devised an expert and inexpensive method of resolution.

A state common law claim grounded in tort, like tortious interference, is not a claim arising under a federal statute or legislative scheme, nor does it require a specialized tribunal for resolution. It is simply a claim whose purpose is merely to augment the bankruptcy estate that has little, if any, relationship to the claims resolution and distribution process. "*Stern* reaffirms that only an Article III judge can enter a judgment associated with the estate's recovery of contract and tort claims designed to augment the estate."[5]

The court in *Stern v. Marshall* also rejected the contention that the creditor had consented to the adjudication of the debtor's counterclaim by the bankruptcy court, by filing a proof of claim against the debtor in the bankruptcy court. In doing so, the Supreme Court appears to have limited the scope of a waiver arising out of the filing of a proof of claim in a bankruptcy.

Secured creditors and their legal counsel should keep an eye on how courts interpret the Supreme Court's decision in *Stern v. Marshall,* as this will likely influence the relative attractiveness of bankruptcy reorganization for addressing a borrower's problems…

The Supreme Court stated at the end of its opinion, that its ruling in *Stern v. Marshall* is a limited, or "narrow" one. The court concluded that, by enacting Bankruptcy Code §157(b)(2)(C), Congress, "in one isolated respect," had violated the constitutional limitations on the jurisdiction of non-Article III courts like bankruptcy courts. So there might be some comfort drawn from the notion that perhaps this decision only applies to fact situations like those found in *Stern*. Nevertheless, the Supreme Court's analysis leaves open many questions concerning the scope of the bankruptcy courts' core jurisdiction. Other courts have already begun to address some of those questions, with varying results. What follows is a discussion of some of those results that are of particular interest to secured creditors.

The Application of *Stern v. Marshall* to Secured Creditors

Commentators and courts have scrambled to take the Supreme Court at its word, and attempt to limit the impact of the *Stern* decision. Whether these decisions will stand up under future Supreme Court review, if and when it occurs, is not so clear. Early decisions seem favorable, but it is likely that litigants emboldened by *Stern* — including those adverse to secured creditors — may probe the limits of bankruptcy court authority.

The reasoning of the bankruptcy court decision in *Teleservices* provides a thoughtful analysis, and hopefully suggests that, notwithstanding the limitations enunciated in *Stern v. Marshall* on bankruptcy courts' core jurisdiction and, therefore, their authority to issue final judgments, bankruptcy courts should continue to be able to issue most of the kinds of final orders affecting the rights and interests of secured creditors that they have issued in the past. After all, the Constitution does expressly grant Congress the exclusive authority to enact uniform bankruptcy laws.

As the court in *Teleservices* pointed out, moreover, the Bankruptcy Code "contemplates a trustee (or debtor-in-possession) administering the bankruptcy estate with much less judicial oversight than had previously been the custom. Thus, much of what happens in a bankruptcy case does not require the intervention of a judge, let alone an Article III judge. The requirements of "notice and a hearing" in various sections of the Bankruptcy Code are merely administrative requirements properly left to Congress, to ensure that various actions of the trustee (or the debtor-in-possession) are fair to all interested parties, consistent with the fiduciary duties of the trustee or debtor-in-possession, and comply with the requirements of the Bankruptcy Code.

4 *Id.*

5 *Id.*

Under the reasoning in *Teleservices*, even in the wake of *Stern v. Marshall*, none of the bankruptcy functions listed below require consideration by or the order of a district court. Congress can and has properly authorized the bankruptcy court to issue any necessary orders.

Sales, Leases and Use of the Debtor's Assets

Pursuant to Bankruptcy Code §363, the trustee or debtor-in-possession may use, sell or lease "property of the estate" (as defined in Bankruptcy Code §541), although such sale, use or lease of property outside the ordinary course of business will require bankruptcy court approval, as will the use of cash collateral by the debtor-in-possession or trustee over the objection of a creditor.

There should be no impact from *Stern* upon the bankruptcy courts' continued authority to issue orders approving sales of "property of the estate," including the authority to approve sales free and clear of liens, claims and encumbrances, with valid liens to attach to the proceeds of such sales. This is because the filing of a bankruptcy petition creates the "bankruptcy estate" within the exclusive jurisdiction of the bankruptcy court, and such estate is comprised of "property of the estate" (wherever located). The power to sell property free and clear of liens, claims and encumbrances is also a power that state courts in a foreclosure action currently enjoy. Indeed, in many states, foreclosure sales proceed without any prior judicial approval, and in all states, Article 9 of the Uniform Commercial Code permits secured creditors to foreclose upon their interest in the personal property of the debtor at public or private sales without first resorting to a court for authorization.

Nevertheless, *Stern v. Marshall* may embolden lienholders — particularly junior lienholders — to challenge the authority of bankruptcy courts to issue final orders authorizing sales free and clear of liens, claims and encumbrances. The basis for such an objection would be that such a sale potentially deprives the holders of such liens, claims and encumbrances of a property interest, and only an Article III court has the constitutional authority to enter such an order.

Moreover, the authorization of the sale of the interest of a person or entity other than the debtor in property of the estate may now require an order of the federal district court, because such orders provide for the involuntary taking of property of a non-debtor. However, such sales are more an issue in the bankruptcy cases of individuals, and are rarely an issue in business bankruptcies.

Rejection, Assumption and Assumption and Assignment of Debtor's Contracts

Bankruptcy courts should still be authorized to issue orders authorizing the rejection, the assumption, or the assumption and assignment of contracts under Bankruptcy Code §365. As any survey of Chapter 11 filings over the past five years will show, the bankruptcy courts' continued authority to issue such orders will facilitate the sales of debtors' businesses and assets that have become the means by which many debtors now "reorganize."

Post-Petition Credit

Stern v. Marshall suggests no reason why bankruptcy courts cannot issue orders authorizing trustees or debtors-in-possession to obtain credit. Consistent with its powers under the Bankruptcy Clause of the Constitution, Congress may, as it has done in the Bankruptcy Code, establish the relative priority of claims against the bankruptcy estate. Hence, there would appear to be no Constitutional prohibition against a bankruptcy court issuing an order providing a post-petition lender with a super-priority claim above all other administrative priority claims, pursuant to Bankruptcy Code §364(c)(1), as security for a post-petition extension of credit.

Similarly, a debtor that has either voluntarily filed a bankruptcy petition or, in response to an involuntary bankruptcy petition, consented to the entry of an order for relief, has voluntarily subjected its property to administration in a bankruptcy case. Consequently, a bankruptcy court may still enter an order providing a post-petition lender with liens on the debtor's unencumbered property or junior liens on the debtor's encumbered property, pursuant to Bankruptcy Code §364(c)(2) and (3), because granting such liens would not constitute an involuntary taking of the assets of either the debtor (which has presumably consented to the financing anyway) or a senior secured creditor. A bankruptcy court's approval of a priming lien pursuant to Bankruptcy Code §364(d) should similarly not violate the Constitutional prohibition against taking property without due process, as long as the lien positions of the primed liens are, in fact, adequately protected as required by the Bankruptcy Code.

Claims Allowance

Stern v. Marshall does not remove the claims resolution process from the authority of the bankruptcy court. Although Bankruptcy Code §502(b)(1) directs the bankruptcy court to consider "any agreement or applicable law" in determining whether to allow a claim against the debtor's estate, the application of law to fact does not necessarily require an Article III judge. Indeed, claims allowance is nothing more than a step in the bankruptcy process whereby Congress has allowed a debtor to surrender assets to the bankruptcy estate for administration in exchange for certain protections, including the automatic stay and the discharge. Much of the Bankruptcy Code's claim distribution scheme does not even require the intervention of the court at all. Congress has properly chosen the bankruptcy court to complete the process of claims allowance, which it can do as long as it does not deprive a claimant of property, a power that, according to *Stern*, is reserved to the district courts whose judges enjoy lifetime tenure and protection from salary reduction.

While *Stern v. Marshall* "suggests" that the bankruptcy court would have lacked jurisdiction over the debtor's state law counterclaim against the creditor's proof of claim even were it filed as an affirmative defense or set-off, the court in *Teleservices* disagrees with that "suggestion" in that regard. In an analysis that is, in fact, consistent with the analysis in *Stern v. Marshall*, the court in *Teleservices* found that, just because a counterclaim asserted in response to a proof of claim arises under state law, this does not affect the bankruptcy court's authority to hear and decide the claim. In such a case, the bankruptcy court would merely be deciding the claimant's share in the bankruptcy estate's distribution to the creditor *vis-à-vis* other creditors, just as it would do if the state law counterclaim were treated merely as a set-off or affirmative defense. Whereas, if the issue were whether to award affirmative monetary relief against the creditor, the bankruptcy court would lack the authority, under *Stern*.

The Strong-Arm Powers of the Trustee or Debtor-in-Possession

Bankruptcy Code §544(a) authorizes the trustee or debtor-in-possession to avoid, among other things, any lien or security interest that has not been perfected as of the petition date. If a court attempting to apply the decision in *Stern* determines that such actions are deemed to be part of the bankruptcy court's power to determine a secured creditor's share in a distribution from the bankruptcy estate, bankruptcy courts should be able to continue to hear and decide those issues. However, if a future court reads the *Stern* decision to mean that such actions are involuntary takings of a property interest, then the authority of bankruptcy courts to support a trustee's use of Strong-Arm Powers would be in doubt.

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Preference Actions

In *Stern v. Marshall*, the Supreme Court seems to accept the authority of bankruptcy courts to hear and decide preference actions, at least to the extent that they are part of the claims resolution process. Bankruptcy courts' continued authority to hear and decide such actions is particularly relevant to secured creditors in two contexts: 1.) where the secured creditor is undersecured; and 2.) where the secured creditor perfected its lien or security interest during the 90-day preference period immediately preceding the petition date. At least one court in a case decided since *Stern v. Marshall* has acknowledged the bankruptcy court's authority to exercise core jurisdiction over preference actions, which might or might not be promising, depending upon on which side a party typically finds itself in preference litigation.[6]

Equitable Subordination

Actions for the equitable subordination of claims pursuant to Bankruptcy Code §510(b) necessarily go to the determination of the affected creditor's distribution from the estate or under a plan of reorganization. Accordingly, it is not surprising that at least one court, in the wake of *Stern v. Marshall*, has held that bankruptcy courts may exercise core jurisdiction over such actions.[7]

Settlements

The bankruptcy courts may still enter orders approving settlements among parties reaching a consensual agreement. The requirement of Bankruptcy Rule 9019 for notice and a hearing to approve settlements, according to the *Teleservices* decision cited above, suggests that this merely provides for court oversight to ensure that the settlement is fair and consistent with the fiduciary obligations of the debtor-in-possession or trustee.[8]

Automatic Stay Litigation

Notwithstanding *Stern v. Marshall*, creditors, including secured creditors, should still have to seek relief from the automatic stay from the bankruptcy court to continue pre-petition litigation or self-help remedies.[9] Although the automatic stay deprives such a creditor of access to the courts, it does not deprive creditors of a property interest already had. Thus, the Fifth Amendment prohibition against a "taking" without due process is not implicated. It follows also that bankruptcy courts should still retain core jurisdiction over actions against creditors for violations of the automatic stay.[10]

Debtors' Discharge

Because the discharge injunction, like the automatic stay, only deprives a creditor of access to the courts, and not a property interest, bankruptcy judges should still be able to enter final judgments on complaints to determine the dischargeability of a debt of an individual debtor, pursuant to Bankruptcy Code §523(a).[11] In other words, neither *Stern v. Marshall* nor the Constitution should prohibit a bankruptcy court from determining that a creditor's claim is, in fact, dischargeable.

Unauthorized Post-Petition Transfers of Debtor's Assets

Bankruptcy courts should continue to have authority to hear and enter final judgments in actions under Bankruptcy Code §549, to avoid unauthorized post-petition transfers of a debtor's assets, since these constitute core proceedings concerning property of the bankruptcy estate, the proper uses of which are limited by the Bankruptcy Code.[12]

Plan Confirmation Process

It is also likely that bankruptcy courts will retain core jurisdiction over plan confirmation issues.[13] There can be contested issues, however, that may be central to the debtor's ability to confirm a plan that creative creditor's lawyers could assert do not fall within the bankruptcy court's "core" jurisdiction, in light of the *Stern* decision.

Secured creditors and their legal counsel should keep an eye on how courts interpret the Supreme Court's decision in *Stern v. Marshall*, as this will likely influence the relative attractiveness of bankruptcy reorganization for addressing a borrower's problems in comparison to consensual restructuring and state law alternatives such as assignment for the benefit of creditors, receivership and trust mortgage. abfj

6 *In re Blixseth*, 2011 Bankr.LEXIS 2953 * 35 (Bankr. D. Mont, Aug. 1, 2011).
7 *Id.*
8 *Teleservices*, 2011 Bankr. LEXIS 3128 *44, n. 52.See also In re Okwonna-Felix, 2011 Bankr. LEXIS 3028 * 13 (Bankr. S.D. Tex., Aug. 3, 2011).
9 *Teleservices*, 2011 Bankr. LEXIS 3128 *49; Salander O'Reilly Galleries, 2011 Bankr.LEXIS 2688.
10 *Teleservices*, 2011 Bankr. LEXIS 3128 **47-49; In re Turner, 2011 WL 2708907 *8 (Bankr. S.D. Tex., July 11, 2011).
11 *Teleservices*, 2011 Bankr. LEXIS 3128 **47-48; In re Muhs, 2011 WL 3421546 **2, 6-7 (Bankr.S.D. Tex., Aug. 2, 2011); In re Martinez, 2011 WL 2925481 *1 (Bankr. N.D. Ohio, July 18, 2011).
12 *In re Innovative Communication Corp.*, 2011 Bankr. LEXIS 3040 * 12-14 (Bankr. D.V.I. Aug. 5, 2011).
13 *In re Safety Harbor Resort and Spa,* 2011 WL 3849369 **1, 10, 12 (Bankr. M.D. Fla. Aug. 30, 2011).

DAVID A. CRAPO, ESQ., is counsel in the Financial Restructuring & Creditors' Rights department of Gibbons P.C., a regional law firm headquartered in New Jersey, with offices in New York, Wilmington and Philadelphia.

HOWARD BROD BROWNSTEIN, CTP, is president of The Brownstein Corporation, a turnaround and crisis management firm in Philadelphia.

This article is intended to be an academic discussion of an important recent decision concerning a rapidly changing and developing area of bankruptcy law, and nothing contained herein should be read as an opinion of Gibbons P.C. or any of its attorneys.