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The Impact of Stern v. Marshall on Fraudulent Conveyance and Preference Actions

This article provides a summary of the *Stern v. Marshall* decision and discusses how the ruling has impacted litigation common to the construction industry.

When litigating a lawsuit before the bankruptcy court, different rules of procedure and jurisdiction are used than those applicable in other federal courts. The Supreme Court's decision in *Stern v. Marshall* in the summer of 2011 changed the landscape even more significantly by blurring the once black-and-white distinction between matters that the bankruptcy court could and could not finally decide. While bankruptcy courts still have jurisdiction to hear most bankruptcy-related cases, after *Stern v. Marshall*, bankruptcy courts may enter final judgments in a smaller number of cases, and the test by which the bankruptcy courts determine whether or not they have the requisite authority to do so has changed.

This shift has resulted in the need for different practical considerations for parties when litigating in front of a bankruptcy court, such as whether or not a creditor should file a proof of claim in a particular bankruptcy, whether or not to consent to the bankruptcy court's authority to enter a final judgment in a particular matter, and how the decision will be reviewed on appeal. This article provides a summary of the *Stern v. Marshall* decision, as well as a discussion of how the ruling in *Stern* has impacted litigation common to the construction industry.

Overview of the *Stern v. Marshall* decision

Before *Stern*, the bankruptcy court's authority to enter a final judgment was determined by reference to Section 157 of the Bankruptcy Code, which enumerates certain "core" matters over which the bankruptcy court had full authority to enter a final judgment. If a claim was considered core under Section 157, the bankruptcy court had authority to enter a final judgment even without consent of the parties, which would be reviewed on appeal by the district court under a "clearly erroneous" standard — in other words, the bankruptcy court must have clearly misapplied the law to the facts in order for the decision to be overturned.

In contrast, in non-core matters, the bankruptcy court cannot enter a final judgment without the consent of the parties. Rule 7008 of the Federal Rules of Bankruptcy procedure provides that "[i]n an adversary proceeding before a bankruptcy judge, the complaint, counterclaim, cross-claim, or third-party complaint shall 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."[1]

The decision of whether or not to consent has an important practical effect — consent to the bankruptcy court's authority to enter judgment in non-core matters changes the standard of review by the district court. If the parties consent, the district court

reviews the bankruptcy court's final judgment under the aforementioned "clearly erroneous" standard; thus, if the parties consent to judgment in a non-core matter, the district court uses the same standard of review on appeal as if the matter had been core under Section 157.[2] However, if the parties did not consent, the district court reviews *de novo* any portion of the bankruptcy court's proposed findings of fact and conclusions of law to which a party has objected.[3] In other words, in the absence of consent to the bankruptcy court's authority, the district court reviews the bankruptcy court's recommendation on the matter, conducts its own independent analysis of the law and the facts, and decides for itself what the proper result should be.

In *Stern v. Marshall*, the bankruptcy court's authority to render a final judgment was at issue with respect to two different claims: a non-core defamation claim brought by Pierce Marshall and a compulsory counterclaim brought by Vickie Marshall, which was classified as core under Section 157.[4] *Stern* was significant in that it blurred the once black-and-white distinction between matters in which the bankruptcy court could and could not enter final judgments. Whereas before *Stern* a bankruptcy court would simply look to the enumerated list of core proceedings in section 157(b) to determine whether it could enter final judgment on a matter, *Stern* now provides the bankruptcy court with a two-pronged test to determine whether or not it has the constitutional authority to enter a final judgment over certain causes of action that would have typically been considered core. "[T]he question is (1) whether the action at issue stems from the bankruptcy itself or (2) would necessarily be resolved in the claims allowance process."[5] If either prong of the test is met, then the bankruptcy court has constitutional authority to enter a final order. In addition, if all parties consent to a final judgment being rendered by the bankruptcy court, just as with non-core matters, the bankruptcy court may enter final judgment on that claim regardless of whether the *Stern* test is met.[6]

It is important to note that the *Stern* test applies only to the core matters listed in Section 157(b) because, as discussed above, bankruptcy courts have never had the authority to enter final judgments in non-core matters without the parties' consent. None of the issues regarding consent to non-core matters in *Stern* were surprising or novel — the *Stern* decision caused confusion because it stands for the proposition that bankruptcy courts have limited constitutional authority to enter final judgments in certain causes of action that the plain language of 28 U.S.C. §157 indicates are core matters.[7]

Fraudulent conveyance and preference cases

In the construction context, the effect of the *Stern* decision has been most commonly found in actions by a bankruptcy trustee to recover payments considered to be preferences or fraudulent transfers. The Bankruptcy Code provides a bankruptcy trustee with several remedies to avoid transfers of assets that occurred within a certain time period before the debtor filed for bankruptcy as preferential payments under Section 547 and/or fraudulent transfers under Sections 544 or 548. For example, payments made in the ordinary course of business from a general contractor to a subcontractor often fall into one of these categories if such payments were made within the relevant time period. Thus, actions to recover these funds for the benefit of the bankruptcy estate are common in construction industry bankruptcies.[8] Whereas before *Stern* all such actions were considered core matters in which the bankruptcy court had the unequivocal right to enter final judgments, after *Stern* the bankruptcy court's authority to enter final judgments in these types of cases has become far less clear.

For example, in *In re Erickson Retirement Communities*, the trustee of liquidating trust established under a confirmed Chapter 11 plan brought an adversary proceeding to recover payments that one of the debtors, in its capacity as general contractor on the construction project, had made to a subcontractor.[9] The trustee alleged that these transactions were preferential or fraudulent transfers that could be avoided under Sections 544, 547, and 548 of the Bankruptcy Code. In granting the subcontractor's motion for summary judgment, the *Erickson* court concluded that even after *Stern*, the bankruptcy court had the "[c]onstitutional authority to issue a final order or judgment in [the] Adversary Proceeding, as the claims asserted [arose] under bankruptcy statutes."[10]

However, in *Southeastern Materials*, the bankruptcy court took a more detailed and different approach in determining whether it had the requisite authority to enter a final order in preference and fraudulent conveyance actions brought by the trustee.[11] In this case, the trustee filed a variety of complaints against various principals, employees, and related entities of the debtor, seeking to, among other things, avoid alleged fraudulent conveyances under Sections 544 and 548 of the Bankruptcy Code, as well as avoid preferential transfers under Section 547.

The bankruptcy court explained that the holding in *Stern* is consistent with a long line of other Supreme Court cases dealing with bankruptcy jurisdiction — specifically, these cases hold that bankruptcy courts, as Article I courts, may not enter final judgments in non-bankruptcy matters that are based on the common law or state law, even if such claims are classified as core under Section 157.[12] The Court went on to describe the two-pronged test in *Stern* : "The question is whether the action at issue stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process."[13] If either prong of the test is met, then the bankruptcy court has constitutional authority to enter a final order.

Here the Court concluded that in cases where the creditor has not filed a proof of claim, without the consent of the litigants, a bankruptcy court may hear a fraudulent conveyance or preference action, but it may only submit proposed findings and conclusions to the district court, as opposed to entering a final judgment.[14] This is essentially because despite the fact that they are brought under specific provisions of the Bankruptcy Code, such claims do not stem from the bankruptcy itself and thus do not meet the first prong of the *Stern* test. However, in cases where the defendant to the action has filed a proof of claim, the bankruptcy court may enter a final judgment.[15] By filing a claim against the bankruptcy estate, the creditor triggers the process of allowance and disallowance of claims, converting the action into one that can be resolved in the claims allowance process — thus meeting the second prong of the *Stern* test. To date, only one Circuit Court has ruled on this issue. In *In re Bellingham Ins. Agency*, the Ninth Circuit followed the reasoning in *Southeastern Materials*, holding that bankruptcy courts could not enter final judgments in fraudulent conveyance actions if the creditor has not filed a proof of claim.[16]

Conclusion

Stern v. Marshall has altered the landscape for those creditors who are engaged in ongoing business with a company that has filed for bankruptcy. The uncertainty of the courts as to how to treat fraudulent transfer and preference actions in light of the *Stern* decision has caused great confusion for parties involved in such cases and altered the practical consequences of filing a proof of claim in certain cases.

If the bankruptcy court in question follows the reasoning in *Erickson*, the bankruptcy court has the authority to enter final judgments in all such cases, and the filing of a proof of claim would not affect the creditor's rights or options. However, if the particular bankruptcy court in question follows the reasoning in *Southeastern Materials*, if the creditor has not filed a proof of claim when the trustee brings a preference or fraudulent conveyance action against it, the bankruptcy court would not have authority to enter final judgment in the matter without the parties' consent. If the bankruptcy court cannot enter a final judgment, the appeals process changes because the district court would review the recommendations of the bankruptcy judge *de novo* in light of any objections of the parties. Withholding consent in these cases gives the creditor much more leeway on appeal. However, should the creditor file a proof of claim in this case, doing so could convert the action into one that would be resolved in the claims allowance process, thereby vesting the bankruptcy court with full authority to enter a final judgment in the matter; on appeal, the district court would review the bankruptcy judge's decision under the much more rigid "clearly erroneous" standard discussed above.

Thus, creditors who may potentially be subjected to fraudulent transfer or preference claims in a particular bankruptcy should thoroughly investigate how the bankruptcy district in question has addressed such cases before deciding whether to file a proof of claim, as their right to withhold consent to the bankruptcy court's authority in a certain case may be waived by doing so.

Footnotes

16 *In re Bellingham Ins. Agency*, 702 F.3d 553, 563 (9th Cir. 2012).

15 *Op. cit.* note 11 (citing *Langenkamp v. Culp*, 498 U.S. 42, 44 (1990)).

14 *Ibid*at 350-52.

13 *Op. cit*. note 11 at 348 (citing *Stern*, 131 S. Ct. at 2618).

12 *Ibid* at 347; *N. Pipeline Const. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 73 (1982).

11 *In re Southeastern Materials, Inc.*, 467 B.R. 337 (Bankr. M.D.N.C. 2012).

10 *Op. cit*. note 8 *Erickson* at 764.

9 *Ibid Erickson*.

8 *In re Erickson Retirement Communities*, 475 B.R. 762 (Bankr. N.D. Texas 2012); *In re Powers Lake Const. Co., Inc.*, 482 B.R. 803 (Bankr. E.D. Wis. 2012); *RES-GA Four LLC v. Avalon Builders of GA LLC, et al.*, 2012 WL 13544 (M.D. Ga. Jan. 4, 2012); *Kaliner v. MDC Systems Corp., LLC*, 2012 WL 5400045 (E.D. Pa. Nov. 5, 2012); *In re Smeltzer Plumbing Systems, Inc.*, 2011 WL 6176213 (Bankr. N.D. Ill. Dec. 12, 2011); *City Bank v. Compass Bank*, 2011 WL 5442092 (W.D. Texas Nov. 9, 2011).

7 *Op. cit*. note 4 at 2609.

6 *In re Pro-Pac, Inc.*, 456 B.R. 894, 902-03 (Bankr. E.D. Wis. 2011); *Mercury Cos., Inc. v. FNF Sec. Acquisition, Inc.*, — F.Supp.2d –, 2011 WL 5127613 at *3 (D. Colo. Oct. 31, 2011); *In re Sunra Coffee LLC*, 2011 WL 4963155 at *5-6 (Bankr. D. Hawaii Oct. 18, 2011).

5 *Ibid* at 2618.

4 *Stern v. Marshall*, U.S., 131 S.Ct. 2594 (2011).

3 28 U.S.C.A. §157(c)(1); Fed. R. Bankr. P. 8013; *In re Nell*, 71 B.R. 305 (D. Utah 1987).

2 28 U.S.C.A. §158; *In re Mann*, 907 F.2d 923 (9th Cir. 1990); *In re Daniels-Head & Associates*, 819 F.2d 914 (9th Cir. 1987).

1 Fed. R. Bankr. P. 7008.

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