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Wellness International: litigants may consent to adjudication by bankruptcy courts

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Introduction

On May 26 2015 the Supreme Court issued its opinion in *Wellness International Network, Ltd v Sharif*,(1) holding that parties may consent to bankruptcy courts entering final judgment on so-called '*Stern* claims' – claims that have been designated as "core" in Section 157 of the US Judicial Code, but for which the parties are constitutionally entitled to adjudication by an Article III court. The court held also that the parties' consent need not be express, but must be knowing and voluntary. The *Wellness* decision resolved a conflict among the circuits on one of the many questions raised by the Supreme Court's landmark 2011 ruling in *Stern v Marshall.* The decision is significant: a decision that litigants could not consent to adjudication in a bankruptcy court would have required already overburdened district courts to take over a large portion of the bankruptcy docket, and would have called into question the use of magistrate judges by district courts in other cases by consent of the parties.(2) As the court noted, without the assistance of bankruptcy and magistrate judges, whose numbers exceed that of circuit court and district court judges combined, "the work of the federal court system would grind nearly to a halt".(3)

Bankruptcy judges and Article III

Article III of the Constitution provides that the "judicial power" of the United States can be exercised only by judges who are independent from the executive and legislative branches of the government, as guaranteed by life tenure and protections against reductions in salary. Unlike the judges of the district courts, the circuit courts and the Supreme Court, bankruptcy judges are not Article III judges, but are appointed by the circuit courts of appeals for 14-year terms.(4) In its 1982 decision in *Northern Pipeline*, the Supreme Court held that the 1978 Bankruptcy Reform Act, which granted bankruptcy judges the power to decide "all civil proceedings arising under Title 11 [the Bankruptcy title of the United States Code] or arising in or related to cases under Title 11",(5) violated Article III by authorising bankruptcy judges to decide claims for which litigants are constitutionally entitled to an Article III adjudication, such as a state-law contract claim against an entity that was not otherwise party to the bankruptcy proceedings.(6) The court in *Northern Pipeline* also held that matters involving "public rights" could be assigned to non-Article III courts (often called 'legislative courts'), but did not provide clear guidance on the scope of the public rights exception.

Congress responded to the *Northern Pipeline* decision with the Bankruptcy Amendments and Federal Judgeship Act of 1984. The act gives district courts original jurisdiction over bankruptcy cases,(7) but the district court may delegate – or refer – such cases to bankruptcy judges.(8) The Bankruptcy Code provides that bankruptcy judges may enter final judgments, subject to appeal, in matters classified as "core proceedings" concerning the restructuring of the debtor's estate – such as matters concerning the administration of the estate and the allowance of claims against the estate.(9) Bankruptcy courts may also hear and determine "non-core" proceedings related to the bankruptcy case, and may enter final judgment on such matters, if all the parties to the proceeding consent.(10) Without such consent, bankruptcy courts may submit only proposed findings of facts and conclusions of law, which the district court reviews *de novo*.(11)

In its landmark decision in *Stern v Marshall*(12) the Supreme Court held that certain core proceedings were matters within the judicial power that Congress could not constitutionally assign to bankruptcy courts for adjudication – in that case the debtor's counterclaim for tortious interference with a gift. The court noted that in *Northern Pipeline* it had "recognized that there was a category of cases involving 'public rights' that Congress could constitutionally assign to 'legislative' courts for resolution",(13) the scope of which was not clearly established. While the court did not delineate the scope of the public rights exception, it did note that the counterclaim at issue there clearly did not fall within any of the

various formulations of that doctrine that had been set out by the court in previous decisions.(14) The court also left open the question of whether a bankruptcy court could hear *Stern* claims and propose findings of fact and conclusions of law to the district court for *de novo* review, even though there is no express statutory authority to do so. In its 2014 *Bellingham* decision, the court held that bankruptcy courts may issue proposed findings and conclusions when faced with such claims.(15)

Another issue left unresolved in *Stern* was the related question of whether litigants may consent to a bankruptcy judge issuing a final judgment on a bankruptcy-related matter that does not fall within the scope of the public rights exception. The court in *Stern* hinted that there would have been no constitutional impediment to the bankruptcy court entering judgment on the counterclaim at issue in that case if the parties had consented: among the reasons the court listed for finding that the counterclaim did not fall within the public rights exception was that the claimant had not truly consented to the resolution of the claim in the bankruptcy proceeding. The court cited its earlier decision in *Commodity Futures Trading Commission v Schor*,(16) in which the court had held that parties can waive their personal rights to have their claims heard by an independent Article III judge. But the *Schor* court emphasised that Article III not only protects personal rights, but also bars "congressional attempts 'to transfer jurisdiction [to non-Article III tribunals]' thereby preventing 'the encroachment or aggrandizement of one branch at the expense of the other'."(17) Thus, the court held:

> "*to the extent that this structural principle is implicated in a given case, the parties cannot by consent cure the constitutional difficulty for the same reason that the parties by consent cannot confer on federal courts subject matter jurisdiction beyond the limitations imposed by Article III.*"(18)

The question was therefore whether allowing bankruptcy courts to decide *Stern* claims by consent would impermissibly threaten the institutional integrity of the judicial branch.(19) The circuit courts of appeals split on the issue. In *Wellness International* the Seventh Circuit had ruled that parties could not waive the Article III requirement that *Stern* claims be heard by an independent federal judiciary and could not consent to the bankruptcy court adjudicating such matters.(20) The Fifth and Sixth Circuits were in accord.(21) The Ninth Circuit in *Bellingham* had held that the parties could consent to adjudication by the bankruptcy court,(22) but the Supreme Court did not address the issue in its decision in that case. A year later, the court turned its attention to the issue in *Wellness International.*

Wellness International

Wellness International manufactures health and nutrition products that were distributed by Richard Sharif. Sharif sued Wellness, alleging that it was running an illegal pyramid scheme. However, Sharif repeatedly ignored Wellness's discovery requests and Wellness was eventually granted a default judgment, as well as penalties of more than $650,000 for attorneys' fees. Sharif filed for bankruptcy under Chapter 7 and Wellness filed an adversary proceeding in the bankruptcy case, objecting to the discharge of the debt because, among other reasons, Sharif had concealed property by claiming it was owned by a trust. Wellness also sought a declaratory judgment that the trust was Sharif's alter ego and its assets should be treated as part of the estate. Sharif filed an answer admitting that the adversary proceeding was a core matter under Section 157(b) of the Judicial Code (ie, one in which the bankruptcy court could enter final judgment) and requesting judgment in his favour. Sharif again failed to comply with discovery obligations, and the bankruptcy court entered a default judgment for Wellness.

Sharif appealed to the district court and, six weeks before he filed his opening brief, the Supreme Court decided *Stern*, holding that under Article III, bankruptcy courts could not be given authority to enter final judgment on claims that seek only to augment the bankruptcy estate and that would exist independently of the bankruptcy proceeding. Sharif did not cite *Stern* in his opening brief, but after the briefing was closed, he sought leave to file a supplemental brief, citing a Seventh Circuit court opinion interpreting *Stern* and arguing that the bankruptcy court's opinion must be treated as a report and recommendation, subject to *de novo* review. The district court held that Sharif had waived the issue by not raising it in a timely fashion.

The Seventh Circuit held that the alter-ego claim was almost indistinguishable from the state-law counterclaim for tortious interference that had been at issue in *Stern* and that the bankruptcy court did not have constitutional authority to enter a final judgment on that claim.(23) The Seventh Circuit also held that while ordinarily Sharif's objection would not have been preserved as it was untimely, a litigant may not waive a *Stern* objection, because it concerned the allocation of authority between the bankruptcy courts and the district courts and implicated structural interests in protecting the separation of powers.(24)

The Supreme Court granted *certiorari* to address 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. The court also granted *certiorari* on the question of whether the common law alter-ego claim at issue in *Wellness* is one that Congress may assign to bankruptcy courts for adjudication.(25) The court reversed the judgment of the Seventh Circuit, holding that litigants may validly consent to adjudication by bankruptcy courts.(26) The court also found that the Constitution does not require that such consent be express – it could be implied based on a party's actions. Nonetheless, the court held that consent must be "knowing and voluntary".(27)

Chief Justice Roberts, in dissent, would have resolved the case on the grounds that Article III posed no barrier to the bankruptcy court adjudicating the alter-ego claim, as determining what properly is

within the estate is "central to the restructuring of the debtor-creditor relationship" and traditionally within the authority of the bankruptcy court.(28) According to Roberts, the alter-ego claim differed from a fraudulent conveyance claim against a non-creditor (which the court has suggested must be heard by an Article III court),(29) in that the alter ego claim does not seek assets in the hands of a third party, but targets only property already within the debtor's actual or constructive possession.(30) However, the majority did not address whether the alter-ego claim was a *Stern* claim because it concluded that the bankruptcy court could enter judgment on the claim with the parties' consent.(31) Thus, once again, the court declined the opportunity to provide much-needed further guidance on the scope of the public rights exception and the concomitant constitutional limits on the matters that Congress may assign to bankruptcy courts for adjudication.

Justice Sotomayor, speaking for a six-member majority of the court, began by noting the long history of permitting parties to consent to adjudication of disputes by non-Article III tribunals.(32) In *Schor*, the court noted, no structural concern was implicated by allowing the Commodity Futures Trading Commission to adjudicate legal claims with the parties' consent because "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".(33) Just as Congress may encourage parties to settle disputes out of court or through arbitration without "impermissible incursions on the separation of powers, Congress may make available a quasi-judicial mechanism through which willing parties may, at their option, elect to resolve their differences".(34)

Similarly, the court noted, the court had previously held that no structural concerns were implicated by allowing magistrate judges to supervise jury selection in criminal cases, with the consent of the defendant.(35) This is because magistrates are appointed and subject to removal by Article III judges, the decision to assign the matter to the magistrate is made by the district court, subject to veto by the parties, and the decision whether to empanel the jury chosen by the magistrate remains with the district court. The court held that because the district court maintains control and jurisdiction, the court held that there is no danger that Congress is attempting "to transfer jurisdiction [to non-Article III tribunals] for the purpose of emasculating constitutional courts".(36) The lesson is plain, the court held:

> "*allowing Article I adjudicators [ie 'legislative courts' created by Congress] 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.*"(37)

The court then turned to the question of whether allowing bankruptcy courts to decide *Stern* claims by consent would "impermissibly threate[n] the institutional integrity of the Judicial Branch".(38) Citing *Schor,* the court noted that the issue must be decided not in a formalistic manner, but "with an eye to the practical effect" on the "constitutionally assigned role of the federal judiciary", weighing up:

> "*the extent to which the essential attributes of judicial power are reserved to Article III courts, and, conversely, the extent to which the non-Article III forum exercises the range of jurisdiction and powers normally vested only in Article III courts, the origins and importance of the right to be adjudicated, and the concerns that drove Congress to depart from the requirements of Article III.*"(39)

It would not "usurp the constitutional prerogatives of Article III courts", the court held, to allow litigants to consent to adjudication of *Stern* claims in bankruptcy courts.(40) The court cited five reasons for that conclusion:

- Like magistrate judges, bankruptcy judges are appointed and subject to removal by Article III judges;(41)
- Bankruptcy courts hear matters only on reference by the district courts, which may withdraw the reference *sua sponte* or at the request of a party;(42)
- Any concerns regarding separation of powers are diminished because it is up to the parties to invoke the non-Article III forum, and the power of the federal judiciary remains in place;(43)
- The bankruptcy courts' authority is limited to "a narrow class of common law claims as an incident to the [bankruptcy courts'] primary, and unchallenged, adjudicative function";(44) and
- There is no indication that Congress was attempting to aggrandise itself or humble the judiciary; rather, Congress left the entire process subject to the total control and jurisdiction of the federal judiciary.(45)

Provided that bankruptcy judges are "subject to control by the Article III courts", the court held, "their work poses no threat to the separation of powers".(46)

The court distinguished both *Stern* and *Northern Pipeline* on the grounds that in both cases, the litigant had not truly consented to the resolution of the claim against it in the bankruptcy court.(47) Dismissing as hyperbole the dissent's "ominous predictions"(48) that the decision would endanger the separation of powers and lead to "steady erosion of Article III authority" by Congress,(49) the court concluded that:

> "*[a]djudication based on litigant consent has been a consistent feature of the federal court system since its inception. Reaffirming that unremarkable fact, we are confident, poses no great threat to anyone's birthrights, constitutional or otherwise.*"(50)

When can consent be implied?

As noted above, the court found that consent to adjudication by a bankruptcy judge may be implied by a party's actions, but that it must be knowing and voluntary. The court also held that statutes or rules may require express consent where the Constitution does not,(51) and noted that Bankruptcy Rules 7008 and 7012 require that the parties state expressly whether the proceeding is core or non-core, and, if it is non-core, whether they consent to entry of final orders of judgment. These rules will help to minimise questions of implied consent, but will not eliminate them all together, as illustrated by the *Wellness* case itself. There the matter was one designated as core by the Judicial Code, and the parties were unaware that the matter might be one as to which they were entitled to adjudication by an Article III court until *Stern* was decided, while *Wellness* was on appeal. The issue arose of whether Sharif's consent could be implied from his failure to have objected to the bankruptcy court's authority until after the briefing was over. The Supreme Court remanded the case to the Seventh Circuit to determine for the "deeply factbound analysis" of whether the record evidenced consent.(52)

Whether consent could be implied was addressed by the Delaware bankruptcy court just a week after the *Wellness* decision in *Nortel Networks*.(53) There, SNMP Research International, Inc had filed an adversary proceeding in the bankruptcy court against debtor Nortel and a third party, Avaya. The complaint alleged that the claims against the debtor were core and the claims against Avaya were non-core, demanded a jury trial and stated that SNMP intended to move to withdraw the reference. However, SNMP did not make the motion to withdraw until almost 17 months later. Avaya and the debtors argued that SNMP had consented to adjudication by the bankruptcy court by filing a claim against Avaya in the bankruptcy court, not objecting to the bankruptcy court deciding a motion to dismiss that had been filed by another non-debtor party and waiting 17 months to move to withdraw the reference. The bankruptcy court rejected these arguments, noting that the Supreme Court's instruction in *Wellness* that consent must be "knowing and voluntary" reinforces the necessity for careful deliberation in finding consent.(54) The court cited SNMP's statement of intent to withdraw the reference and its demand for a jury trial, which was, the court held, such a fundamental right that waiver is disfavoured.(55) Thus, the court found that consent could not be implied and it did not have authority to hear the claims against Avaya.

Comment

In ruling that parties may consent to adjudication by a bankruptcy court, the Supreme Court has made good on its statement that its decision in *Stern* would not "meaningfully change the division of labor" (56) between bankruptcy and district courts. The decision leaves in place the longstanding practice of permitting parties to consent to a bankruptcy court adjudicating claims that otherwise would have to be determined by a district court. Had the decision gone the other way, the district courts would have been required to shoulder a much larger load of bankruptcy cases. Perhaps it should be no surprise that the author of the opinion was Sotomayor, the only justice who previously had served as a district court judge.

While the *Wellness* decision answers an important question left unresolved in *Stern,* the issue of when consent may be implied remains to be developed by the lower courts. And an even more fundamental question is still left unaddressed: what is the precise scope of matters that Congress may constitutionally assign to bankruptcy courts for adjudication? That question will inevitably arise as parties withhold consent to adjudication of issues by the bankruptcy courts, and as the bankruptcy courts address whether the matters are properly characterised as non-core, so that the bankruptcy courts can enter final judgment regardless of consent.

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Endnotes

(1) __ S Ct __ (2015); 2015 WL 2456619, at *1 (May 26 2015).

(2) See 28 USC § 636(c).

(3) *Wellness Int'l*, 2015 WL 2456619, at *3.

(4) See 28 USC § 152(a)(1).

(5) *N Pipeline Constr Co v Marathon Pipe Line Co*, 458 US 50, 54 (1982) (plurality opinion) (internal citation and quotations omitted).

(6) *Wellness Int'l*, 2015 WL 2456619, at *15.

(7) See 28 USC § 1334.

(8) See 28 USC § 157(a).

(9) See 28 USC §§ 157(b), 158.

(10) See 28 USC § 157(c)(2).

(11) See 28 USC § 157(c)(1).

(12) 131 S Ct 2594 (2011).

(13) *Id* at 2610.

(14) *Id* at 2614.

(15) For further details please see "Supreme Court on powers of bankruptcy courts after Stern".

(16) *Stern*,131 S Ct at 2614, citing *Commodity Futures Trading Comm'n v Schor*, 478 US 833, 844 (1986).

(17) *Schor*, 478 US at 850.

(18) *Id* at 850-51.

(19) *Wellness Int'l*, 2015 WL 2456619, at *21, quoting *Schor,* 478 US at 851.

(20) See *Wellness Int'l Network, Ltd v Sharif*, 727 F3d 751, 771 (7th Cir 2013), cert granted in part, 134 S Ct 2901 (2014).

(21) See *In re Frazin*, 732 F3d 313 (5th Cir 2013), cert denied sub nom *Frazin v Haynes & Boone, LLP*, 134 S Ct 1770 (2014); *Waldman v Stone*, 698 F3d 910 (6th Cir 2012), cert denied 133 S Ct 1604 (2013).

(22) See *Wellness Int'l*,727 F3d at 771.

(23) *Id* at 774.

(24) *Id* at 771.

(25) 134 S Ct 2901 (July 1 2014).

(26) *Wellness Int'l,* 2015 WL 2456619, at *10.

(27) *Id* at *12.

(28) *Id* at *16 (Roberts, CJ, dissenting).

(29) *Id* at *18 (Roberts, CJ, dissenting) citing *Granfinanciera, SA v Nordberg*, 492 US 33, 56 (1989); *Executive Benefits Ins Agency v Arkison (In re Bellingham)*, 134 S Ct 2165 (2014).

(30) *Id.*

(31) *Id* at *6, n 7.

(32) See *Wellness Int'l*, 2015 WL 2456619, at *8.

(33) *Id* at *8, quoting *Schor*, 478 US at 855.

(34) *Id.*

(35) *Id.* at *8, citing *Peretz v United States*, 501 US 923 (1991).

(36) *Id* (internal citations omitted).

(37) *Id* at *8.

(38) *Id* at *9, quoting *Schor*, 478 US at 851.

(39) *Id* at *9, quoting *Schor*, 478 US at 851.

(40) *Id* at *9.

(41) *Id* citing *Peretz*, 501 US at 937; 28 USC §§152(a)(1), (e).

(42) *Id* citing *Peretz*, 501 US at 937; 28 USC §§157(a), (d).

(43) *Id* quoting *Schor*, 478 US at 855.

(44) *Id* quoting *Schor*, 478 US at 854.

(45) *Id* at *10.

(46) *Id.*

(47) *Id* at *11.

(48) *Id.*

(49) *Id* at *25 (Roberts, CJ dissenting).

(50) *Id* at *12.

(51) *Id.*

(52) *Id* at *13.

(53) *In re Nortel Networks, Inc*, 2015 WL 3506697 (Bankr D Del June 2 2015).

(54) *Id* at *3.

(55) *Id.*

(56) *Stern,* 131 S Ct at 2620.