View Emerging That *Stern v. Marshall* Does Not Apply to Fraudulent Transfer Claims

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Since the Supreme Court decided *Stern v. Marshall* nearly a year ago, courts have diverged sharply on whether bankruptcy courts still have authority over fraudulent transfer claims.

Pre-*Stern*, most practitioners would scoff at the idea that bankruptcy courts lack authority to finally decide fraudulent transfer questions. After all, the bankruptcy courts have been deciding those questions for years. But now, many courts read *Stern* broadly and say that bankruptcy courts no longer can enter final orders on fraudulent transfer claims.

In the most recent Delaware decision to confront the issue, Judge Peter J. Walsh joined with other Delaware courts in rejecting the broad approach and adopted a much narrower reading of *Stern*. (See *Zazzali v. 1031 Exchange Group (In re DBSI Inc.)*, 2012 WL 1242305 (Bankr. D. Del. Apr. 12, 2012).) The emerging consensus among Delaware courts now appears to be that *Stern* applies only to state law counterclaims brought by a debtor against a third party.

Pre-*Stern*, Congress granted bankruptcy courts the statutory authority to decide any and all counterclaims asserted by a debtor against persons who file claims against the estate. *Stern* held this statutory grant unconstitutional to the extent that it empowered bankruptcy courts to enter final judgments on state law counterclaims that were not resolved in the process of ruling on a creditor's proof of claim. Under Article III of the U.S. Constitution, only Article III courts may exercise the judicial power of the United States and adjudicate "suits at common law." Since the counterclaim in *Stern* involved purely state common law and was not necessarily related to the claim that the creditor filed against the estate, as an Article I court, the bankruptcy court could not enter a final judgment on the claim.

The rule of *Stern* seems clear enough, but it is mucked up by an exception known as the "public rights" doctrine, which allows Congress to assign so-called "public rights" (as opposed to "private rights") to non-Article III courts for adjudication. The problem is that it's not exactly clear what qualifies as a public right. A claim created by federal law or stemming from a federal statutory scheme may qualify as a public right. So, too, may a claim relating to the restructuring of the debtor-creditor relationship, although the Supreme Court was careful to note that it never actually has decided whether the restructuring of debtor-creditor relations is, in fact, a public right.

What the Supreme Court clearly has decided before, however, is that fraudulent transfer claims "seem to us more accurately characterized as a private rather than a public right," as the court held in *Granfinanciera S.A. v. Nordberg,* 492 U.S. 33, 55 (1989). *Granfinanciera* discussed fraudulent transfer claims in a different context (the constitutional right to jury trial rather than Article III), but nevertheless plainly stated that fraudulent transfer claims are not public rights. According to the court, fraudulent transfer suits "quintessentially were suits at common law that more nearly resemble state law contract claims ... to augment the estate than they do creditors' hierarchically ordered claims to a pro rata share of the estate."

This language from *Granfinanciera* spawned the post-*Stern* split on bankruptcy courts' authority over fraudulent transfers. Like the state law counterclaim at issue in *Stern*, Congress has granted bankruptcy courts the statutory authority to enter final orders on fraudulent transfer claims. But given the Supreme Court's statements in *Granfinanciera*, is this grant also a violation of Article III?

Many courts, including several district courts in New York, say yes. These courts adopt what Delaware courts call the "broad" interpretation of *Stern* - namely, that *Stern*'s reasoning should be applied beyond its precise holding (which dealt only with counterclaims) to other types of claims. The reasoning of these courts is simple and attractive. The major premise: Bankruptcy courts may not enter final judgments on private rights. The minor premise: Under *Granfinanciera,* fraudulent transfer claims are private rights. The inevitable conclusion: Bankruptcy courts may not enter final judgments on fraudulent transfer claims.

Given this reasoning - which appears sound on its face - how do courts like *DBSI* and the other Delaware courts that adopt the "narrow" view justify their holdings? They rely on *Stern*'s frequent statements that it was a limited decision. *Stern* explicitly called itself a "narrow" decision, overruling Congress "in one isolated respect." According to the court, the decision did not "meaningfully change the division of labor" and "does not change all that much." As another Delaware court put it, *Stern* appears to be broad, but "in the end, the court took back what it had appeared to have given and made it clear that its holding was a narrow one," which the court held in *Burtch v. Huston (In re USDigital)*, 461 B.R. 276, 290 (Bankr. D. Del. 2011).

Some courts have advanced additional rationales to support the narrow approach:

- Fraudulent transfer claims arise under Sections 544 and 548 of the Bankruptcy Code and are intertwined with other sections of the code such as Section 546(e), so the claims stem from a federal statutory scheme;
- Fraudulent transfer claims cannot exist but for a debtor's insolvency, a condition that often results in bankruptcy; and
- Fraudulent transfer claims have historical ties to bankruptcy courts.

The force of these rationales is subject to debate. For example, while fraudulent transfer claims in a sense "stem" from Sections 544 and 548 of the Bankruptcy Code, the conclusion that a bankruptcy court may finally decide these claims seems to be directly at odds with *Granfinanciera*'s holding that fraudulent transfers are private rights. Indeed, *Granfinanciera* noted that the Bankruptcy Code did not fashion any "new" fraudulent transfer cause of action; rather, the code "simply reclassified a pre-existing, common-law cause of action that was not integrally related to the reformation of debtor-creditor relations." Likewise, although most fraudulent transfer claims require a showing of insolvency, not all do. See, e.g., 6 Del. C. §1304(a)(1) (actual fraudulent transfer). And the fact that fraudulent transfers have historically involved insolvency and have been decided by bankruptcy courts again seems to contradict the majority's holding in *Granfinanciera* that fraudulent transfer suits quintessentially were suits at common law. In the end, the unifying rationale among the courts adopting the narrow approach appears to be the Supreme Court's explicit statements that its decision in *Stern* was confined in scope.

Taking the Supreme Court at its word that *Stern* is a limited decision, DBSI and other courts adopting the narrow view limit *Stern*'s holding to the precise statutory subsection that was overruled by *Stern* - 28 U.S.C. §157(b)(2)(C) - and no further; *Stern*'s ruling does not extend past this one single subsection. Since fraudulent transfers are designated as core under a different subsection - Section 157(b)(2)(H) - they are not affected by *Stern*.

As can be seen from the two approaches, the question is a difficult one on which reasonable people may disagree. *Stern* and *Granfinanciera* suggest that bankruptcy courts may not enter final judgments on fraudulent transfer claims. But that interpretation could cause a major change in the way bankruptcy cases work, something *Stern* expressly said it was not doing. We are left with a paradox.

Ultimately, we can expect continued divergence on this issue until the appellate courts weigh in. But even then there is no guarantee that they will agree with each other. What can be said with confidence, however, is that after *DBSI,* the law in Delaware is becoming well settled in favor of the narrow approach.

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