NATIONAL BANKRUPTCY CONFERENCE
A Voluntary Organization Composed of Persons Interested in the Improvement of the Bankruptcy Code and Its Administration

February 15, 2013

Advisory Committee on Bankruptcy Rules
c/o Peter G. McCabe, Secretary
Committee on Rules of Practice and Procedure
Administrative Office of the United States Courts
One Columbus Circle, NE
Washington, D.C. 20544

Re: Proposed Amendments to Federal Rules of Bankruptcy Procedure

To Members of the Advisory Committee:

I write on behalf of the National Bankruptcy Conference to express its views regarding amendments to the Federal Rules of Bankruptcy Procedure that have been proposed to address procedural issues raised by the Supreme Court's decision in *Stern v. Marshall*, 131 S. Ct. 2594 (2011).[1] A description of the Conference is attached.

In general, the Conference supports the proposed amendments. The Conference's Committee on Courts and the Administrative System has prepared a Report, which the Conference has approved, describing the Conference's position and some suggested revisions to the proposed amendments. A copy is attached.

The Conference appreciates the Advisory Committee's consideration of our views. We are available to answer any questions the Committee may have.

Very truly yours,

s/ Richard Levin

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[1] The views expressed in this letter are those of the Conference, on whose behalf this letter is being written, and do not necessarily reflect either my personal views or those of my law firm, Cravath, Swaine & Moore LLP.

National Bankruptcy Conference

A non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws.

History. The National Bankruptcy Conference (NBC) was formed from a nucleus of the nation's leading bankruptcy scholars and practitioners, who gathered informally in the 1930's at the request of Congress to assist in the drafting of major Depression-era bankruptcy law amendments, ultimately resulting in the Chandler Act of 1938. The NBC was formalized in the 1940's and has been a resource to Congress on every significant piece of bankruptcy legislation since that time. Members of the NBC formed the core of the Commission on the Bankruptcy Laws of the United States, which in 1973 proposed the overhaul of our bankruptcy laws that led to enactment of the Bankruptcy Code in 1978, and were heavily involved in the work of the National Bankruptcy Review Commission (NBRC), whose 1997 report initiated the process that led to significant amendments to the Bankruptcy Code in 2005.

Current Members. Membership in the NBC is by invitation only. Among the NBC's 60 active members are leading bankruptcy scholars at major law schools, as well as current and former judges from eleven different judicial districts and practitioners from leading law firms throughout the country who have been involved in most of the major corporate reorganization cases of the last three decades. The NBC includes leading consumer bankruptcy experts and experts on commercial, employment, pension, mass tort and tax related bankruptcy issues. It also includes former members of the congressional staff who participated in drafting the Bankruptcy Code as originally passed in 1978 and former members and staff of the NBRC. The current members of the NBC and their affiliations are set forth on the second page of this fact sheet.

Policy Positions. The Conference regularly takes substantive positions on issues implicating bankruptcy law and policy. It does not, however, take positions on behalf of any organization or interest group. Instead, the NBC seeks to reach a consensus of its members - who represent a broad spectrum of political and economic perspectives - based on their knowledge and experience as practitioners, judges and scholars. The Conference's positions are considered in light of the stated goals of our bankruptcy system: debtor rehabilitation, equal treatment of similarly situated creditors, preservation of jobs, prevention of fraud and abuse, and economical insolvency administration. Conferees are always mindful of their mutual pledge to "leave their clients at the door" when they participate in the deliberations of the Conference.

Technical and Advisory Services to Congress. To facilitate the work of Congress, the NBC offers members of Congress, Congressional Committees and their staffs the services of its Conferees as non-partisan technical advisors. These services are offered without regard to any substantive positions the NBC may take on matters of bankruptcy law and policy.

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National Bankruptcy Conference
2012 Annual Meeting

Report of the Committee on Courts and the Administrative System
on Proposed *Stern* Amendments to the Bankruptcy Rules

Stern v. Marshall, 131 S. Ct. 2594 (2011), has been discussed extensively during the last two meetings of the Conference. At the 2011 Annual Meeting, a detailed analysis of the decision was presented, and at the 2012 Midyear Meeting, Conferees Gibson and Vance prepared a comprehensive Update. The Update included a discussion of various adopted and proposed local and national rules which would respond to some of the issues raised by the decision.

In August 2012, the Committee on Rules of Practice and Procedure of the Judicial Conference circulated a Preliminary Draft of Proposed Amendments to the Federal Rules of Bankruptcy Procedure proposing various changes to the Bankruptcy Rules including several rule changes that would "respond to the … recent decision in *Stern v. Marshall* …."

The Chair has asked the Committee on Courts and the Administrative System to report on the Proposed Rules. After a draft of this Report was circulated, the Sixth Circuit Court of Appeals decided *Waldman v. Stone*, 698 F.3d 910 (6th Cir. 2012), which bears on many of the issues discussed herein. The *Waldman* decision is discussed briefly below. Since the draft was originally circulated, the Ninth Circuit Court of Appeals decided *Exec. Benefits Ins. Agency v. Arkison (In re Bellingham Ins. Agency, Inc.)*, 702 F.3d 553 (9th Cir. 2012). *Bellingham* reaches a different conclusion from *Waldman* on the issue of the effect of consent to a bankruptcy judge's final adjudicatory authority. We do not believe *Bellingham* changes any of the conclusions or recommendations in this Report.

A. The Proposed Rules.

1. Background.

Congress enacted 28 U.S.C. § 157 in response to *Northern Pipeline Const. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982). In doing so, it divided bankruptcy proceedings into two categories—core and noncore. The procedural rules were somewhat different in the two categories; most importantly, the bankruptcy judge's adjudicatory authority was more limited in noncore proceedings. In noncore proceedings, absent consent of the parties, the bankruptcy judge was required to submit proposed findings of fact and conclusions of law to the district court, and the district court could enter a final order or judgment after a de novo review of party objections. 28 U.S.C. § 157(c)(1).

28 U.S.C. § 157(b) contained a nonexclusive list of "core" proceedings but, and significantly, these terms had no historical connotation in bankruptcy cases (the older terms, plenary and summary jurisdiction, bore little relationship to the present allocation

of adjudicative power) and courts were, in a sense, flying blind. Moreover, the question whether particular proceedings were core or noncore proved especially difficult in complex proceedings, and also in proceedings involving a possible right to jury trial. Nevertheless, courts generally developed workable rules for distinguishing core and noncore proceedings although the actual decisions, especially for more complex proceedings, were not uniform.

Stern then came on the scene and held for certain proceedings defined as "core"—i.e., a debtor's common law counterclaim to a creditor's claim (at least when determination of the claim would not resolve the counterclaim)—the bankruptcy court lacked adjudicatory authority. So, after *Stern* there were three different categories of proceedings--(1) core proceedings in which the bankruptcy court had final adjudicatory authority, (2) core proceedings in which the bankruptcy court lacked final adjudicatory authority and (3) noncore proceedings, even though 28 U.S.C. § 157 and various Bankruptcy Rules were based on the premise that there were only two categories of proceedings. And significantly, there were no procedural rules for this new category of core proceeding in which the bankruptcy court lacked final adjudicatory authority since the core rules were no longer applicable and the noncore rules were not, at least by their terms, applicable to proceedings that were defined as core in the statute. Or, as the logicians would say, there was an "undistributed middle."

Pre-*Stern,* 28 U.S.C. § 157(c)(2) was clear that even if a matter was noncore, the parties could consent to the final adjudicatory authority of the bankruptcy court. After *Stern,* although section 157(c)(2) is not applicable by its terms, most courts and commentators assumed that parties could consent to the bankruptcy court's final adjudicative authority in core proceedings in which the bankruptcy court lacked final adjudicatory authority under Article III. The Proposed Rules specifically do not resolve the issue of whether consent is permissible or effective in such proceedings but, instead, provide a procedural mechanism for the bankruptcy court to determine whether consent has been given and then leave the question of whether consent affects the adjudicatory authority of the bankruptcy court for judicial determination.

2. <u>The Proposed Rules.</u>

The Proposed Rules build on this background and contain three significant components:

First, the Proposed Rules no longer tie the Rules themselves to the core/noncore distinction and generally delete references to such a distinction. Thus, Proposed Rules 7008, 7012, 9027 and 9033 remove the terms core and non-core "to avoid possible confusion in light of *Stern.*" In fact, the significance of the distinction, if any, is unclear after *Stern* and the Proposed Rules.

Second, under the Proposed Rules, parties in all bankruptcy proceedings (including removed proceedings) must state in their pleadings whether they do or do not consent to entry of final orders or judgment by the bankruptcy judge. *See* Proposed Rules 7008, 7012(6). As noted, the Proposed Rules do not determine the effect of consent on the adjudicatory authority of the bankruptcy court. *See* Report to Standing Committee, at 28.

Third, Proposed Rule 7016 governing pre-trial procedures, gives the bankruptcy court broad power to decide "on its own motion or a party's timely motion" whether (1) to hear and determine the proceeding, (2) to hear the proceeding and issue proposed findings and conclusions, or (3) to take some other action. The Committee's Note to Rule 7012 explains that, after the answer, the bankruptcy judge's subsequent determination of the appropriate course of proceedings, including whether to enter final orders and judgments or to issue proposed findings of fact and conclusions of law, is a pretrial matter now provided for in amended Rule 7016."

3. *Waldman v. Stone*.

In this case, Stone founded and owned a business. Through a series of steps, Waldman gained control of the business, as well as certain debts of Stone and nonbusiness properties of Stone, and sought to collect on such debts. Stone ultimately filed a bankruptcy case and sought (a) disallowance of Waldman's claims, and (b) an affirmative judgment against Waldman for breach of contract and fraud including punitive damages. The bankruptcy court found that Waldman had perpetrated "one of the most egregious frauds the court had ever encountered," disallowed Waldman's claims, and granted Stone compensatory and punitive damages of almost $3.2 million dollars. The District Court affirmed.

On appeal, Waldman raised various jurisdiction/*Stern* issues. The Court of Appeals for the Sixth Circuit found that the bankruptcy court had core jurisdiction to decide disallowance. But, as to the affirmative judgment for compensatory and punitive damages, the Court of Appeals found that, although Waldman had consented to the adjudicatory authority of the bankruptcy court, the issue was basic to the allocation of judicial power and, therefore, that consent was inoperative. Ultimately, the Court of Appeals held that the bankruptcy court lacked adjudicative authority over the affirmative damage claims, that the bankruptcy court's judgment could not be treated as findings of fact and conclusions of law and reviewed on the basis, and that the case would be remanded to the bankruptcy court to recast its opinion as proposed findings of fact and conclusions of law which would be subject to review by the district court.

The opinion deals with several *Stern* issues which are discussed below. Specifically, the Court holds that consent is not effective to validate the bankruptcy court's exercise of adjudicative power when an Article III court is required. The Court of Appeal's reasoning thereby challenges the widely prevailing assumptions about consent discussed above and, without directly addressing the issues, undermines the constitutionality of 28 U.S.C. § 157(c)(2) and the statute governing Magistrate powers. Moreover, the decision suggests that an opinion rendered as a final judgment or order cannot be treated by the district court as proposed findings of fact and conclusions of law. In this regard, the Court called attention to the application of Bankruptcy Rule 9033 to situations in which the bankruptcy court issues proposed findings of fact and conclusions of law. Finally, the Court of Appeals suggests that the principle that *Stern* does not apply if the judgment or order that is within the bankruptcy court's final adjudicatory powers (i.e., a claim objection or discharge issue) would resolve a separate claim that otherwise is beyond the bankruptcy court's final adjudicatory authority, should be construed very narrowly and is applicable only when the issues are exactly the

same. *Compare In re Shawn-Dietz*, 2012 WL 1497795 (9th Cir. B.A.P. 2012) (final judgment on dischargeability; *Stern* not applicable to final judgment on discharged debt). And the Court does not address the possible application of collateral estoppel to some rulings on Stone's affirmative claims. Members of the Committee note that, in their experience, there has been very little consideration of res judicata/collateral estoppel issues in the *Stern* context.

B. Commentary.

The Proposed Rules would provide only a limited fix of *Stern* issues, perhaps because there is a serious question whether a more comprehensive fix could be accomplished through the rulemaking process. Essentially, the Proposed Rules avoid the core/noncore distinction for Rules purposes, require the parties to state whether they consent to a final judgment or orders, and provide for the bankruptcy court to figure out what to do. There are some potential questions/issues regarding the proposal, set forth in no particular order:

1. Proposed Rule 7016 permits the bankruptcy court to decide *Stern* issues "on its own motion." Given the importance and difficulty of such issues, it might be preferable to require that such power be exercised only after notice and a hearing. But note that 28 U.S.C. § 157(b)(3) does give the bankruptcy court the power to decide whether a matter is a core proceedings without a hearing, although our impression is that this power is not widely exercised. There is also a timing issue, because Proposed Rule 7016 contemplates that resolution of the *Stern* issues will come during the pre-trial phase of the case. However, it is the consensus of the Committee that *Stern* probably applies to motions to dismiss and possibly other preliminary rulings as well, and it is not clear whether parties will have an opportunity to raise such issues during the consideration of such matters. *See Kirschner v. Agoglia*, 476 B.R. 75 (S.D.N.Y. 2012) (motion to dismiss within *Stern).*

2. (a) Several adopted or pending local rules have provisions to permit the district court to consider a bankruptcy court's purported final judgment or order in a proceeding where the bankruptcy court lacks adjudicative authority, as proposed findings of fact and conclusions of law. Thus, the Southern District of New York Reference Order provides that "the district court may treat any order of the bankruptcy court as proposed findings of fact and conclusions of law if it concludes that an Article III court order is required." The Proposed Rules have no such provisions, but some courts have been treating what purport to be final bankruptcy court judgments and orders as proposed findings of fact and conclusions of law absent such authority, and a recent opinion of Judge Rakoff suggests that the district court may have such authority even without a local rule. *See Kirschner v. Agoglia*, supra. *Compare In re Merillville Surgery Center, LLC*, 474 B.R. 618, 625 (Bankr. N.D. Ind. 2012) (if asked, court won't perform magistrate function). And it is noteworthy that some bankruptcy judges have been writing their rulings in a form to be used either as final judgments and orders or proposed findings of fact and conclusions of law depending on whether the district court decides that the bankruptcy court did or did not have full adjudicative authority. The *Waldman* decision suggests that these local rules as well as judicial rulings and practices are contrary to *Stern.*

(b) The present rules have very different procedures for bankruptcy court final judgments and orders, and bankruptcy court rulings on proposed findings of fact and conclusions of law. Specifically, FRBP 7054 and FRCP 54(a) deal with final judgments and orders, whereas FRBP 9033 deals with proposed findings of fact and conclusions of law. And, importantly, FRBP 9033 requires the proposed findings of fact and conclusions of law to be submitted to the parties, who have the opportunity to object. Thus, if the district court does treat the bankruptcy court's "final" judgment or order as proposed findings and conclusions pursuant to either local rules or otherwise, there is a question whether the loser has been deprived of its procedural rights under FRBP 9033 because it did not know that the ruling was not in fact a final judgment or order. Finally, the Committee believes it may be desirable to establish more uniform procedures for both bankruptcy court final judgments and orders, on the one hand, and proposed findings of fact and conclusions of law, on the other hand, especially in light of the fact that the bankruptcy court itself may be uncertain as to the question of the outer limits of its adjudicatory authority.

3. The Proposed Rules are unclear whether some form of partial consent is permitted—e.g., if there are multiple counts, to render a final judgment on some specified counts but not others. Also, it is not clear how the Proposed Rules apply to a contested proceeding, since the amended rules in question are not included in the list of automatically adopted rules in Rule 9014. At its 2012 Annual Meeting, the Conference expressed the view that partial consent to adjudication of some but not all counts should be permitted. Also, the Committee believes that it is likely that *Stern* issues will arise in some contested matters.

4. If there is a pending motion to withdraw the reference, which frequently happens in *Stern* situations, the present practice is for bankruptcy courts to continue handling the proceeding while the withdrawal motion is pending, although a stay could be issued under Rule 5011(c). However, some district courts in denying motions to withdraw the reference have rendered rulings which would seem to preempt the bankruptcy court's authority over the matters covered by Proposed Rule 7016(b). For example, district courts sometimes indicate that they are going to withdraw the reference before trial thus leaving some uncertainty about the bankruptcy court's adjudicative authority over dispositive motions. Other district courts have standing practices to either deny motions to withdraw the reference at least on a preliminary basis or to defer a ruling to pretrial proceedings. These practices are likely to cause some uncertainty with regard to motions to dismiss which, as noted above, are probably within *Stern.* Given the substantial number of post-*Stern* adversary proceedings that are subject to withdrawal motions, the Committee believes it may be desirable to have greater uniformity or, at least, some form of more generalized guidelines for dealing with situations where there are pending withdrawal motions.

5. The Proposed Rules do not deal with the legal issue whether consent is sufficient to permit the bankruptcy court to render final judgments and orders and waives any objection to the court's adjudicatory authority, although prior to *Waldman v. Stone*, the widespread assumption was that consent was effective. But there is a separate issue whether, if a party declines to consent, that party can also be deemed to have implicitly consented and waived the right to object to a final judgments or orders of

the bankruptcy court by actions taken in the proceeding or even the bankruptcy case itself after the pleadings have been completed (e.g., in connection with the plan process). The Committee does not believe further rulemaking is required at this time (or whether, in light of Waldman, this issue can be addressed by rule).

6. One issue which has been sharply debated in the case law is whether avoidance actions asserted as a defense to a claim are subject to *Stern* and, if not, whether at the very least, affirmative avoidance claims by the Trustee are subject to *Stern. See, e.g., Exec. Benefits Ins. Agency v. Arkison (Bellingham Ins. Agency, Inc.)*, 2012 WL 6013836 (9th Cir. 2012) (subject to Stern, but party consented). Given the sharp divergence on these issues and the significant number of cases in which they arise, there might be some merit in attempting to resolve at least these issues. However, there clearly is a question whether this can be done by rulemaking.

7. In those Circuits that have a BAP, what happens if a party elects not to consent to a final judgment or order in a *Stern* type case, loses, and then appeals to the BAP? Does the failure to object to the BAP hearing the appeal retroactively waive the original election? And, if the bankruptcy court has already rendered proposed findings and conclusions, is the case remanded to the bankruptcy court or does the BAP consider the case in the same manner as would a district court? In such a situation, can the BAP hear additional evidence as can the district court? Although the Committee is not aware of any reported case after *Stern*, the general consensus has been that a party's consent to having the BAP hear an appeal constitutes consent to its adjudicative authority (*see, e.g.*, 28 U.S.C. § 158(c)(1)) but, here again, *Waldman* casts some doubt on this assumption, particularly in appeals involving matters that are beyond a non-Article III court's adjudicatory authority.

C. Conclusion and Recommendations.

Overall, the Proposed Rules seem to be a reasonable approach to a difficult problem, and it is not surprising that they do not solve all issues. The Conference should recommend approval, but may wish to address some of the technical questions raised herein. The Committee also believes that the Conference is likely to address the issues raised by the *Waldman* case further in connection with its consideration of 28 U.S.C. § 157.

Following the November meeting, the Committee addressed various issues raised in paragraphs B(1) and B(3) above, and there was a consensus of the Committee with respect to the following:

1. Proposed Rule 7016 should be revised to require the Court actually to hold a hearing on *Stern* issues or, at least for the Court to make a formal decision not to hold a hearing rather than simply deciding the *Stern* issues on its own.

2. The Proposed Rules should be amended so that there is a mechanism for the parties to raise *Stern* issues including consent if the *Stern* issue should be raised by a party who has not yet filed an answer or other pleading before the issue arises. The Committee did not have a formal recommendation on what that mechanism might be but believes the issue would have to be raised and the question of consent addressed in the

papers filed by a defendant (or other party who had not yet filed a pleading) in any pre-answer motion or other motion presenting *Stern* issues. Under the Proposed Rules, the plaintiff would address such matters in its initial pleading.

3. If the *Stern* issue is not raised by the mechanism suggested in paragraph 2 above, the Committee believes it would present an issue of implied consent, but the Committee does not believe this issue should be addressed by the rule, at least at this time.

4. Proposed Rules 7008 and 7012(b) should be revised to permit a party to consent to the Bankruptcy Court's final adjudicative authority over specified issues or claims without consenting to such authority over all issues or claims in the proceeding.

Committee on Courts and
the Administrative System

November 2, 2012, updated January 23, 2013
and February 8, 2013