

## SOUTHERN DISTRICT OF NEW YORK JUDGE HOLDS THAT BANKRUPTCY COURTS CANNOT DECIDE FRAUDULENT TRANSFER ACTIONS

May 17, 2012

To Our Clients and Friends:

Nearly a year has passed since the Supreme Court held, in *Stern v. Marshall*,<sup>1</sup> that bankruptcy courts may not determine a potentially broad range of “private rights” disputes arising in bankruptcy proceedings. Lower courts have grappled with the practical implications of *Stern*, but it is not yet clear whether the decision will ultimately result in a significant curtailment of bankruptcy court power or prove narrower in application.

*Kirchner v. Agoglia*,<sup>2</sup> decided last week in the U.S. District Court for the Southern District of New York, held that *Stern*’s reasoning “unequivocally” prohibits a bankruptcy court from entering final judgment in fraudulent transfer actions – whether pursued under state law or the Bankruptcy Code. District Judge Jed Rakoff’s decision in *Kirchner* may also apply to other “private rights” actions, such as contract damages claims, unless they are resolved in the course of determining creditors’ proofs of claims (or in bankruptcy court by the parties’ consent).

*Kirchner* is an indication that *Stern*’s impact on important categories of bankruptcy disputes may yet be significant. *Kirchner*, like *Stern*, emphasizes that bankruptcy courts should continue to hear such disputes and issue a report and recommendations to the district court for final judgment. While that offers a measure of continuity, the two-court process is likely to add uncertainty and delay.

### BACKGROUND: BANKRUPTCY COURT JURISDICTION

*Kirchner* and *Stern* arise from a basic tension between the broad range of disputes that require resolution in connection with bankruptcy proceedings and the limited jurisdiction of the bankruptcy courts. Bankruptcy courts have limited jurisdiction because Congress ultimately

---

<sup>1</sup> 131 S. Ct. 2594 (June 23, 2011).

<sup>2</sup> 2012 WL 1622496 (S.D.N.Y. May 9, 2012), available at <http://www.debevoise.com/publications/kirshnervagoglia.pdf>

decided not to give bankruptcy judges the life tenure or salary protections that Article III of the Constitution guarantees those who exercise the full “judicial power of the United States.”

For decades, federal courts and Congress have struggled to honor this Constitutional limitation while giving bankruptcy courts the power necessary to facilitate and enforce comprehensive restructurings. In particular, Congress in 1984 enacted a long statutory list of “core” proceedings that a bankruptcy court could “hear and determine,” as opposed to “non-core” proceedings that (unless the parties consented) a bankruptcy court could “hear” but not “determine,” sending proposed findings and conclusions to a district court for consideration and entry of final judgment.

#### *STERN V. MARSHALL*

*Stern v. Marshall* opened a new chapter in this struggle. In *Stern*, the estate of Anna Nicole Smith, in its chapter 11 bankruptcy, counterclaimed to recover damages for tortious interference from the estate of her deceased stepson. The bankruptcy court entered judgment in her estate’s favor, but the Supreme Court determined that because the bankruptcy court was not an Article III court, it could not enter a final judgment on this tort counterclaim, even though it was a “core” proceeding, because it concerned the parties’ “private rights.”<sup>3</sup>

Although the majority in *Stern* did not provide an all-purpose definition of “private rights,” it strongly implied that “private rights” included tort, contract and property law causes of action that would traditionally have been heard in common law, equity or admiralty and that were not mere creations of federal law. However, such “private rights” could be adjudicated by bankruptcy courts when a ruling on a creditor’s proof of claim necessarily resolved the matter (or if the parties consented). The majority in *Stern* suggested that, despite the fundamental nature of their ruling, it “does not change all that much” in practice because bankruptcy courts may still propose findings of fact and conclusions of law to the district court on matters of “private rights,” leaving the final decision to the district court.

---

<sup>3</sup> The statutory concept of “core” and “non-core” proceedings was meant to maximize bankruptcy court jurisdiction within the limits placed by earlier Supreme Court decisions on the subject, including earlier discussions of what constituted “public rights” – that is, rights that did not require an Article III court for adjudication. *Stern* makes clear that the statutory “core” category is no longer congruent with the judicial “public rights” category, if indeed it ever was.

Many of the early lower court decisions applying *Stern* have attempted to contain its effect by emphasizing that it was not meant to “change all that much” or by limiting its holding to the “unique circumstances” of the compulsory tort counterclaim at issue in *Stern*. Some of these cases show a pragmatic concern that district courts not be flooded with bankruptcy-related disputes, and that bankruptcy courts not be sapped of their power to address the broad range of disputes that arise in connection with bankruptcy proceedings.<sup>4</sup>

#### KIRCHNER'S APPLICATION OF *STERN* TO FRAUDULENT TRANSFER ACTIONS

Judge Rakoff in *Kirchner* held that, leaving aside pragmatic concerns, the “simple logic” of *Stern* “unequivocally” applies to fraudulent conveyance actions – reasoning that would also extend *Stern* to breach of contract actions and a wide variety of other “private rights” disputes.

The action at issue in *Kirchner* was brought by the trustee for the Refco Litigation Trust in connection with the bankruptcy of Refco, Inc. The trustee had brought state-law fraudulent conveyance and unjust enrichment claims in bankruptcy court against alleged insiders of the debtor. The alleged insiders requested that the bankruptcy court dismiss these claims. Judge Rakoff held that even a ruling on the motion to dismiss would be a “final judgment” by the bankruptcy court, and therefore permissible only if the causes of action were not “private rights” under *Stern*, which Judge Rakoff determined that they were.

Judge Rakoff noted that, as one of its examples of “private rights,” the Supreme Court in *Stern* had cited the fraudulent transfer actions at issue in an earlier case (*Granfinanciera v. Nordberg*, 492 U.S. 33 (1989)), which were brought not under state law, but under the fraudulent transfer provision of the Bankruptcy Code. According to *Stern*, actions brought under the Bankruptcy Code’s own fraudulent transfer provision were still, in essence, “suits at common law that more nearly resemble state contract claims brought by a bankruptcy corporation to augment the bankruptcy estate than they do creditors’ hierarchically ordered claims to a pro rata share of the bankruptcy [estate].” Given this, Judge Rakoff found *Stern* to be unequivocal: If even a fraudulent transfer claim under the Bankruptcy Code was a “private right,” then a fraudulent transfer claim arising under state law must be so as well.

---

<sup>4</sup> In the Southern District of New York, for example, District Judge Naomi Buchwald recently affirmed a bankruptcy court’s approval of a settlement of several shareholder derivative suits against the debtor’s officers and directors and noted that “the full reach of *Stern* has yet to be determined” but that “the holding of *Stern* was narrow and was very much based on the unique circumstances of the case.” *In re Ambac Fin. Grp.*, 2011 WL 6844533, at \*7 (S.D.N.Y. Dec. 29, 2011).

As a result, he held that it was outside the power of the bankruptcy court to enter final judgment on that claim.

Consistent with the Southern District of New York's new Standing Order of Reference<sup>5</sup> recently entered in response to *Stern*, the court in *Kirchner* further held that bankruptcy courts should continue to hear proceedings concerning "private rights," such as fraudulent transfer actions, and issue proposed findings of fact and conclusions of law to the district courts.

#### PRACTICAL IMPLICATIONS

Few bankruptcy cases involve tortious interference counterclaims, as did *Stern*. But fraudulent conveyance actions are an important element of many bankruptcy cases. By applying *Stern* to fraudulent conveyance actions, *Kirchner* brings *Stern* into the core of bankruptcy practice. Although it is not the first ruling to do so, it is the most prominent to date. No circuit court has yet ruled on the issue, nor is it known whether the trustee in *Kirchner* will appeal.

Judge Rakoff left the trial of the fraudulent conveyance actions before the bankruptcy court and stated that "experience strongly suggests that having the benefit of the [bankruptcy court's] report and recommendation will save the district court and the parties an immense amount of time." It remains to be seen how much delay and uncertainty this additional process will add to the resolution of fraudulent conveyance and other "private rights" disputes in bankruptcy.

Parties to such actions in the Southern District of New York will need to take *Kirchner* into account as they weigh whether to settle their disputes, or bring them at all. Debtors may attempt, when possible, to frame their "public rights" actions as "necessarily" resolved in determining creditors' proofs of claims, such that the bankruptcy court may still enter final judgment, consistent with *Stern*. And it remains clear that, if all parties to the action consent, the bankruptcy court still may enter final judgment.

---

<sup>5</sup> 12 Misc. 32 (S.D.N.Y. Jan. 31, 2012), available at [http://www.nysd.uscourts.gov/rules/StandingOrder\\_OrderReference\\_12mc32.pdf](http://www.nysd.uscourts.gov/rules/StandingOrder_OrderReference_12mc32.pdf).

\* \* \*

Please feel free to contact us with any questions.

Steven R. Gross  
+1 212 909 6586  
srgross@debevoise.com

Michael E. Wiles  
+1 212 909 6653  
mewiles@debevoise.com

Richard F. Hahn  
+1 212 909 6235  
rfhahn@debevoise.com

George E. B. Maguire  
+1 212 909 6072  
gebmaguire@debevoise.com

M. Natasha Labovitz  
+1 212 909 6648  
nlabovitz@debevoise.com

My Chi To  
+1 212 909 7425  
rmcto@debevoise.com

Jasmine Ball  
+1 212 909 6845  
jball@debevoise.com

Shannon Rose Selden  
+1 212 909 6082  
srselden@debevoise.com