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IN THIS ISSUE:

WELLNESS ON BANKRUPTCY COURT JURISDICTION: PRACTICALLY SPEAKING, SILENCE CAN MEAN CONSENT

By Richard K. Milin and Yitzhak Greenberg***

Four years ago, in *Stern v. Marshall*,[1] the Supreme Court created great consternation by restricting bankruptcy court jurisdiction to issue final judgments. The Court promised, however, that its decision "would not meaningfully chang[e] the division of labor" between the bankruptcy and district courts.[2] The Court took a first step toward making good on that promise in its 2014 decision in *Executive Benefits Insurance Agency v. Arkison (In re Bellingham Insurance Agency)*,[3] also known as "*Bellingham*," by holding unanimously that bankruptcy courts can issue proposed findings of fact and conclusions of law even when they lack jurisdiction to issue final judgments. Under *Arkison*, bankruptcy courts can issue judgments as they always have, and if they lack jurisdiction to issue the judgments as final, the district court can simply review the judgments *de novo*.

In June 2015, in *Wellness International Network, Ltd. v. Sharif*,[4] the Supreme Court took a further step toward preserving bankruptcy court power to adjudicate: it held that parties can consent to a bankruptcy court's issuance of final

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judgment even if the court otherwise lacked the power to do so. As in *Arkison*, the Court's reasoning in *Wellness* seems sensible, practical and even inescapable. It may seem obvious that parties can consent to bankruptcy court issuance of final judgment; after all, they can consent to resolve their dispute by arbitration or even by a mutual friend. Yet *Wellness*, unlike *Arkison*, was far from unanimous: three Justices dissented, and one concurred only in part. Further, the Supreme Court's four opinions in *Wellness* demonstrate that very significant questions about *Stern*'s rationale and implications remain undecided. These questions threaten the Court's efforts to be practical.

The *Wellness* Decision and Its Rationale

Richard Sharif contracted with Wellness International to distribute health and nutrition products.[5] He later sued Wellness, but ignored discovery requests, and ended up liable for a default judgment plus more than $650,000 in sanctions. Sharif then filed a Chapter 7 petition. Wellness alleged that he had concealed assets during discovery in his bankruptcy case and commenced an adversary proceeding to object to the discharge of his debts. Sharif admitted that Wellness's proceeding was "core" under 11 U.S.C.A. § 157, but again evaded discovery, and again a default judgment was entered against him. Undaunted, Sharif appealed to the district court.[6]

Before Sharif filed his appellate brief, the Supreme Court decided *Stern*. It was months later, however, after briefing had closed, that Sharif first raised a jurisdictional objection. He sought to file a supplemental brief arguing that the judgment against him should be considered only a "report and recommendation." The district court rejected Sharif's request as untimely.[7] The Seventh Circuit reversed, however, holding that *Stern* objections cannot be waived because they implicate "structural" separation of powers concerns under Article III of the Constitution.[8] The Seventh Circuit reasoned that *Stern* had already identified the Supreme Court's structural concerns about bankruptcy courts' adjudication of common law claims, and noted that the Sixth Circuit had previously held that *Stern* objections are not waivable because of those concerns.[9] The Seventh Circuit also ruled that Wellness's claim that a trust was Sharif's alter ego was a "*Stern* claim"—"core" under 28 U.S.C.A. § 157, but not for purposes of Article III—for which Sharif was entitled to adjudication by an Article III court.[10]

The Supreme Court reversed. In a majority opinion written by Justice Sotomayor,[11] the Court found the issues in *Wellness* easy to resolve: It held, based on "clear" precedent, that "Article III is not violated when the parties knowingly and voluntarily consent to

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adjudication by a bankruptcy judge."[12] "Adjudication by consent," the Court reasoned, "is nothing new."[13] " '[D]uring the early years of the Republic, federal courts, . . . , regularly referred adjudication of entire disputes to non-Article III referees' " when the litigants consented.[14] Further, the Court held in *Commodity Futures Trading Commission v. Schor*,[15] that rights to constitutionally mandated procedures are waivable unless they implicate a "structural principle" such as the separation of powers. The Court found no such "structural principle" in *Wellness*, because "allowing Article I adjudicators 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."[16]

The Court next held that Article III courts do retain the necessary "supervisory authority." The Court looked at this issue "practically," focusing on four key factors it had identified in *Schor*: (1) " 'the extent to which the essential attributes of judicial power are reserved to Article III courts' "; (2) the extent to which the non-Article III adjudicator " 'exercises the range of jurisdiction and powers normally vested only in Article III courts' "; (3) the " 'origins and importance of the right to be adjudicated' "; and (4) " 'the concerns that drove Congress to depart from the requirements of Article III.' "[17]

Applying these factors, the Court noted that bankruptcy judges, like magistrate judges, "are appointed and subject to removal by Article IIII judges, . . . serve as judicial officers of the United States district court . . . and collectively constitute a unit of the district court."[18] Also, "bankruptcy courts hear matters solely on a district court's reference . . . which the district court may withdraw *sua sponte* or at the request of a party."[19] As a result, "bankruptcy courts possess no free-floating authority to decide claims traditionally heard by Article III courts"; their power is limited to " 'a narrow class of common law claims as an incident to the [bankruptcy courts'] primary, and unchallenged, adjudicative function.' "[20] Moreover, "there is no indication that Congress gave bankruptcy courts the ability to decide *Stern* claims in an effort to aggrandize itself or humble the Judiciary."[21] "So long as [bankruptcy] judges are subject to control by the Article III courts," the Court concluded, "their work poses no threat to the separation of powers." Indeed, "it is no exaggeration to say that without the distinguished service of these judicial colleagues"—the bankruptcy and magistrate judges—"the work of the federal court system would grind nearly to a halt."[22]

Having presented its own practical, precedent-based analysis, the Court turned to the central point in Chief Justice Roberts' dissent. The Court made clear that it was not holding, as Justice Roberts feared, that individual consent can cure a constitutional violation. Rather, consent means that there is no violation to cure: "[W]e do not rely on Sharif's consent to 'cur[e]' a violation of Article III. His consent shows, in part, why no such violation occurred."[23] The Court even gently mocked the dissent's dark warnings and "ominous predictions" with a humorous if somewhat inelegant allusion to Robert Frost: "To hear the principal dissent tell it, the world will end not in fire, or ice, but in a bankruptcy court."[24] The Court's response was apt:

> Adjudication 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.[25]

In the final sections of its opinion, the Court addressed the question whether Sharif had, in fact, impliedly consented to bankruptcy court adjudication. The Court's discussion, in which Justice Alito did not join, was very brief, and its rationale was again both practical and heavily based on precedent. In *Roell v. Withrow*,[26] the Court stated, it had already held that litigants could consent to adjudication by a magistrate judge "by actions rather than words." Because any different rule would be "in great tension with" *Roell*, "the implied consent standard articulated in *Roell* supplies the appropriate rule for . . . bankruptcy courts."[27] Further, the Court added, this standard has "pragmatic virtues—increasing judicial efficiency and checking gamesmanship."[28]

Next, the Court provided a test for determining whether implied consent is "knowing and voluntary": "*Roell* makes clear that the key inquiry is whether 'the litigant or counsel was made aware of the need for consent and the right to refuse it, and still voluntarily appeared to try the case' before the non-Article III adjudicator."[29] Because this test asks whether a litigant "was ***made*** aware" instead of "was aware," it is not obviously reconcilable with the requirement that consent must be "knowing." However, the Court offered a partial solution—it noted that it has proposed amendments to the Federal Rules of Bankruptcy Procedure that will require parties to state expressly whether or not they consent to final decision by a bankruptcy court.[30]

Finally, the Court remanded the question whether Sharif himself knowingly and voluntarily consented, noting that it "would require a deeply factbound analysis" and "provide little guidance to litigants or the lower courts."[31] In conclusion, the Court restated its holding, this time limited to *Stern* claims and omitting express reference to knowing and voluntary consent: "The Court holds that Article III permits bankruptcy courts to decide *Stern* claims submitted to them by consent."[32]

The *Wellness* Concurrence and Dissents

Justice Alito concurred in part and concurred in the judgment. He joined in the Court's opinion "insofar as it holds that a bankruptcy judge's resolution of a *Stern* claim with the consent of the parties does not violate Article III," stating that the Court "faithfully applies" *Schor*. However, Justice Alito would not have decided whether consent may be implied. He pointed out that Bankruptcy Rule 7012(b) requires "express consent" to entry of final judgments by bankruptcy courts in non-core proceedings, and that the Court has not decided "whether a *Stern* claim should be treated as a non-core or core claim for purposes of the bankruptcy rules."[33] Further, Justice Alito stated that, according to the Seventh Circuit, Sharif "forfeited any *Stern* objection by failing to present that argument properly in the courts below" rather than waiving it by consent.[34] In his view, "*Stern* vindicates Article III, but that does not mean that *Stern* arguments are exempt from ordinary principles of appellate procedure."[35]

Chief Justice Roberts, joined by Justices Scalia and Thomas, would have resolved the case by ruling that Wellness's claim "that Sharif's bankruptcy estate contained assets he purportedly held in trust"—provided "that no third party asserted a substantial adverse claim to those assets"—is not a *Stern* claim: it "stems from the bankruptcy itself" rather than from "traditional actions at common law" and is therefore within the adjudicatory power of the bankruptcy courts.[36] Chief Justice Roberts argued that, "[a]t its most basic level, bankruptcy is 'an adjudication of interests claimed in a *res*.' "[37] Wellness merely "asked the Bankruptcy Court to declare that assets held by Sharif are part of that *res*" and "[d]efining what constitutes the estate is the necessary starting point of every bankruptcy; a court cannot divide up the estate without first knowing what's in it."[38] Accordingly, the Chief Justice stated, determining what is property " 'to which the [debtor] may be entitled, either in law or equity, in any manner whatsoever' . . . is peculiarly a bankruptcy power."[39]

The Chief Justice also relied on the fact that the 1898 Bankruptcy Act permitted "bankruptcy referees to exercise summary jurisdiction to determine whether property in the actual or constructive possession of a debtor should come within the estate, at least when no third party asserted more than a 'merely colorable' claim to the property."[40] In his view, Wellness's alter ego claim was more like decisions within referees' summary jurisdiction than like a fraudulent conveyance claim, "which this Court has implied must be adjudicated by an Article III court." The distinction, the Chief Justice explained, is that "[a] fraudulent conveyance claim seeks assets in the hands of a third party, while an alter ego claim targets only the debtor's 'second self.' "[41] Consequently, Wellness's claim "falls within the narrow historical exception that permits a non-Article III adjudicator."[42]

Chief Justice Roberts, now joined solely by Justice Scalia, went on to explain why, if Wellness's alter ego claim were a *Stern* claim, he would not hold that "private parties may consent to an Article III violation." In his view, the Court "lets down its guard" by relying on "pragmatic grounds" to permit a constitutional violation; as in the case of the line-item veto, "[a] branch's consent to a diminution of its constitutional powers . . . does not mitigate the harm or cure the wrong."[43] Moreover, "[i]f a branch of the Federal Government may not consent to a violation of the separation of powers, surely a private litigant may not do so"[44]—it is well established that litigant consent cannot create federal jurisdiction. The Chief Justice also pointed out that, in *Stern* itself, the Court concluded that allowing bankruptcy courts to adjudicate *Stern* claims would " 'impermissibly threaten the institutional integrity of the Judicial Branch' " and that district courts' control of bankruptcy courts does not remedy this threat. The Chief Justice did not, however, offer a direct response to the majority's argument that, when litigants consent, there is no constitutional violation to remedy.[45]

Justice Thomas authored his own lengthy dissent "to highlight a few questions touching on the consent issue that merit closer attention" and to "highlight the complexity of the issues the majority simply brushes past," such as "whether a violation has actually occurred."[46] His dissent offers valuable insights into his own thinking and into the key constitutional distinction between "public" and "private" rights; he suggests, for example, that consent can in effect convert private rights into public rights. Because no other Justice joined in Justice Thomas's dissent, however, and because his reasoning is both inconclusive and abstract, his dissent is likely to be of limited significance in future litigation. Ironically, by highlighting just how complicated the issues presented in *Wellness* can be, Justice Thomas's dissent can be read as an unintentional endorsement of the majority's pragmatic approach.[47]

The Implications and Limits of the *Wellness* Decision

Perhaps the greatest puzzle of *Wellness* may be why the Court found the case to be so difficult—in spite of Justice Sotomayor's claims to the contrary. In a world where arbitration is favored and litigants can consent to have their legal disputes resolved on television, why should there be any problem with agreeing to have cases resolved by a bankruptcy court? The Supreme Court's four widely differing opinions suggest three main answers.

1. Consent to constitutional violations

First, although all nine Justices embraced the principle that individual consent cannot remedy constitutional violations, they could not agree on a rationale that would allow parties to consent to bankruptcy court adjudication without allowing consent to violations of Article III. The Justices' concern to limit the effects of consent is understandable: it would theoretically be possible for Congress to undermine the Court system, without admitting any desire to "aggrandize itself," by providing litigants with powerful incentives to waive their rights to Article III courts "voluntarily." For example, Congress could underfund the Article III courts without reducing federal judges' salaries, or could require seemingly sensible procedures—such as early neutral evaluation—which would force litigants to incur significant additional costs and delays as the price of a hearing before an Article III judge. Further, Chief Justice Roberts had good reason to be alarmed by the Court majority's statement that:

> Congress could choose to rest the full share of the Judiciary's labor on the shoulders of Article III judges. But doing so would require a substantial increase in the number of district judgeships. Instead, Congress has supplemented the capacity of district courts through the able assistance of bankruptcy judges. So long as those judges are subject to control by the Article III courts, their work poses no threats to the separation of powers.[48]

To Justice Roberts, this passage must have seemed the thin edge of a very large wedge, because the Court majority seems blithely to countenance what may be the greatest congressional threat to Article III Courts' independence: using budgetary constraints as an excuse to keep the number of judges low while making Article I alternatives increasingly attractive. This threat, moreover, is not politically neutral: litigants' ability to consent to adjudication before magistrate and bankruptcy judges relieves some of the political pressure on Congress to approve court nominees proposed by a president from an opposing party, or at a minimum, allows congressmen to play for time. Thus, Congress could conceivably use the mechanism of litigant consent to assist it in manipulating or weakening the Article III courts.

Nevertheless, the Justices could not agree on a test for when consent eliminates, and when it might purport to remedy, a violation of Article III. The majority argued that Sharif's consent eliminated any constitutional violation because his right to an Article III adjudication was a "personal" right—but it did not explain what makes a right "personal" or why waiving such a right does not endanger the separation of powers.[49] Nothing seems more "personal" than the right to be free from cruel and unusual punishment, for example, yet presumably consenting to it could not make it consistent with the constitution.

Chief Justice Roberts did not even attempt to determine when consent might eliminate rather than remedy a constitutional violation, and concluded instead that parties cannot consent to bankruptcy court jurisdiction. For the Chief Justice, the controlling principle was that "[a] 'lack of federal jurisdiction cannot be waived or be overcome by an agreement of the parties.' "[50] Yet this principle seems plainly inapplicable—parties who consent to adjudication by a bankruptcy judge do not thereby create *federal jurisdiction* any more than they would if they consented to adjudication by a neighbor.

In contrast, Justice Thomas devotes much of his opinion to a historical and philosophical disquisition on the "complexity" of the question whether consent eliminates Article III violations, but his answer is both merely tentative and abstruse. He concludes that—maybe—consent converts "private" rights requiring Article III adjudication into "public" rights that do not. But this suggestion seems too broad, in that it would allow consent to negate such constitutional violations as cruel and unusual punishment.

A simpler solution suggests itself: The Court might have ruled that the right to an Article III adjudication is "personal" because it protects a *personal choice*; it allows citizens to act or refrain from acting in a particular way, like the rights to try their cases before juries, to refrain from testifying at their criminal trials, to consent to or refuse billeting of soldiers or searches of their homes, or to express their religion. Irrespective of whether a citizen chooses to exercise or to waive rights of this sort, the citizen's free choice itself exercises the right and eliminates any constitutional violation. In contrast, when rights do not protect personal choice, such as the rights to be free from cruel and unusual punishment, denials of equal protection, takings of private property or state establishments of religion, consent cannot eliminate the constitutional violation—the citizen is merely a passive victim who can consent, at most, to waive a remedy for the violation.

This distinction no doubt needs refinement, but it appears consistent with the Court's identification of waivable "personal" rights. At a minimum, if the Court had devoted more attention to determining when consent eliminates rather than excuses constitutional violations, they might have come closer to a unanimous decision in *Wellness*. They also might have focused on an issue that seems at least as important to protecting the separation of powers as the four "structural" factors the Court majority addressed: whether Congress placed undue burdens on the right to choose an Article III judge when it permitted, but took no steps to encourage, adjudication by bankruptcy judges. Because Congress imposed no undue burdens, costs or delays on Article III adjudication, *Wellness* seems unlikely to endanger the separation of powers.

2. Implied consent

The second reason why the Court found the questions in *Wellness* difficult is the Justices' ambivalence toward implied consent. If merely implied consent can deprive litigants of the right to an Article III adjudication, then requiring consent cannot reliably protect the Article III courts. Yet, as the Court majority notes, never to recognize implied consent would encourage gamesmanship by litigants who can plausibly deny having known of their rights. Also, as Judge Alito pointed out, Bankruptcy Rule 7012 requires "express consent" to bankruptcy court adjudication of non-core proceedings, and the Court has not yet decided whether *Stern* claims are "non-core" for purposes of the Rule.

Given these complexities, only five Justices were willing to endorse implied consent in *Wellness* even in principle, and they provided no guidance as to when a litigant has been "*made aware*" of his or her rights sufficiently to be deemed *actually aware* of those rights. As a result, lawyers must exercise considerable diligence to preserve rights that are merely arguable under current case law, and to argue, for reasons suggested above, that any involuntary waiver resulted from an undue burden on litigants' rights. Also, it seems both likely and beneficial that courts will increasingly rely on procedural rules requiring express consent or imposing forfeitures rather than engaging in subjective, factually intensive inquiries concerning implied consent.

3. Identification of "Stern" claims

A third reason why the Court found *Wellness* difficult is its (understandable) disagreement or uncertainty concerning exactly what constitutes a *Stern* claim. The Court majority simply assumed that the alter ego claim in *Wellness* was a *Stern* claim, but the three dissenters determined that it "likely" was not,[51] and Chief Justice Roberts' analysis on their behalf is a good example of why *Stern* seems destined to continue to create a great deal of consternation.

Even to reach his less than definitive conclusion that Wellness's alter ego claim "likely" was not a *Stern* claim, Chief Justice Roberts was required to examine Blackstone's Commentaries, the American bankruptcy statutes of 1800 and 1898 and numerous Supreme Court precedents stretching back to 1902.

Based on this history, Justice Roberts concluded that "[i]dentifying property that constitutes the estate has long been a central feature of bankruptcy adjudication," and gathering together "all the estate, real and personal, of every nature and description to which the [debtor] may be entitled, either in law or equity, in any manner whatsoever" is "peculiarly a bankruptcy power."[52] Yet the Chief Justice also indicates, without expressly stating, that this "peculiarly bankruptcy power" does not extend to situations in which a "third party assert[s] a substantial adverse claim" to the estate's assets.[53] Further, he assumes that fraudulent conveyance claims "must be adjudicated by an Article III court," though he states that the Court has only "implied" this view to date and does not express a definitive view of his own.[54]

Thus, notwithstanding the Chief Justice's assertions that determining what constitutes property of the estate is a peculiarly bankruptcy power, his logic dictates the exact opposite: pulling property into a bankruptcy estate, with the exception of the rare alter ego claim, almost always implicates substantial adverse claims of third parties. Consequently, potentially every attempt to recover preferences, fraudulent conveyances, post-petition transfers, or property in the possession of individuals or entities who have setoff claims (as banks often do) would seem to require Article III adjudication unless the party in possession of the debtor's property consents to bankruptcy court adjudication either expressly or by implication. Further, debtors such as Sharif can deprive the bankruptcy courts of jurisdiction to issue final judgment simply by being careful when they create their phony trusts—if they name their spouses, their children or anyone else as a beneficiary, the named beneficiary may well have a substantial adverse claim. Thus, Chief Justice Roberts implies that bankruptcy courts will have a relatively free hand in the future only in distributing property that is already in debtors' estates—in gathering the property of the estate, they will be severely constrained. Still, the Supreme Court majority has not yet made its views known on this difficult question.

Conclusion

Despite the Supreme Court's assurances in *Stern*, *Arkison* and *Wellness* that it will not make "meaningful" changes in the division of labor between the bankruptcy and district courts, the Court's jurisprudence—at least as the Chief Justice presents it—may prove otherwise. After *Stern*, a very large bankruptcy "megacase" may quickly prove unwieldy, as thousands of avoidance actions and other attempts to gather estate assets—actions that were left to the bankruptcy court in the days of *Enron* and *Worldcom*—become subject to *de novo* review. At a minimum, defendants are likely to be in a stronger position, because debtors cannot easily afford *de novo* review of the scores of actions that they typically are required to bring, or at least threaten, in the process of gathering estate assets. The bankruptcy process itself seems likely to be burdened as a result. It remains possible, however, that the "practical" analysis the Court employed in *Arkison* and *Wellness* will prevail, and that the Supreme Court will find a way to preserve the essence of the constitutional right to an Article III adjudication while still enabling the courts, both Article III and Article I, to do their jobs. In doing so, the Court may even rely on the eminently flexible doctrine of implied consent.

ENDNOTES:

[1]Stern v. Marshall, ____ U.S. ____, 131 S. Ct. 2594, 180 L. Ed. 2d 475 (2011).

[2]Stern v. Marshall, 131 S. Ct. at 2620.

[3]Executive Benefits Ins. Agency v. Arkison (In re Bellingham Ins. Agency), ____ U.S. ____, 134 S. Ct. 2165, 189 L. Ed. 2d 83 (2014).

[4]Wellness Int'l Network, Ltd. v. Sharif, ____

U.S. ___, 135 S. Ct. 1932 (2015).

[5]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1940.

[6]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1941.

[7]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1941.

[8]Wellness Int'l Network, Ltd. v. Sharif, 727 F.3d 751 (7th Cir. 2013).

[9]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1941-42.

[10]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1942.

[11]Justice Sotomayor was joined by Justices Kennedy, Ginsburg, Breyer and Kagan; Justice Alito joined in part, filing a separate opinion concurring in part and concurring in judgment.

[12]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1939.

[13]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1942.

[14]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1942 (citations omitted).

[15]Commodity Futures Trading Comm'n v. Schor, 478 U.S. 833, 106 S. Ct. 3245, 92 L. Ed. 2d 675 (1986).

[16]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1944.

[17]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1944 (quoting Commodity Futures Trading Comm'n v. Schor, 478 U.S. at 851).

[18]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1944-45 (citations and internal citations omitted).

[19]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1945 (internal citations omitted).

[20]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1945 (quoting Commodity Futures Trading Comm'n v. Schor, 478 U.S. at 855).

[21]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1945.

[22]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1939-40 (footnote omitted).

[23]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1945 n.10.

[24]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1937.

[25]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1947.

[26]Roell v. Withrow, 538 U.S. 580, 123 S. Ct. 1696, 155 L. Ed. 2d 775 (2003).

[27]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1948.

[28]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1948.

[29]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1948 (quoting Roell v. Withrow, 538 U.S. at 590)

[30]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1948 & n.13.

[31]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1949.

[32]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1949.

[33]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1949 (Alito, J., concurring).

[34]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1949 (Alito, J., concurring).

[35]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1949-50 (Alito, J., concurring).

[36]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1950 (Roberts, C.J., dissenting).

[37]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1955-56 (Roberts, C.J., dissenting) (quoting Katchen v. Landy, 382 U.S. 323, 329, 86 S. Ct. 467, 15 L. Ed. 2d 391 (1966)).

[38]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1952 (Roberts, C.J., dissenting).

[39]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1952 (Roberts, C.J., dissenting).

[40]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1953 (Roberts, C.J., dissenting) (quoting Mueller v. Nugent, 184 U.S. 1, 15, 22 S. Ct. 269, 46 L. Ed. 405 (1902)).

[41]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1953 (Roberts, C.J., dissenting).

[42]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1954 (Roberts, C.J., dissenting).

[43]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1950, 1955 (Roberts, C.J., dissenting).

[44]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1955 (Roberts, C.J., dissenting).

[45]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1956-59 (Roberts, C.J., dissenting).

[46]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1961 (Thomas, J., dissenting).

[47]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1961-69 (Thomas, J., dissenting).

[48]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1946.

[49]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1943-44.

[50]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1956 (Roberts, C.J., dissenting) (quoting Mitchell v. Maurer, 293 U.S. 237, 244, 55 S. Ct. 162, 79 L. Ed. 338 (1934)).

[51]Chief Justice Roberts states that "Article III *likely* poses no barrier to the Bankruptcy Court's resolution of Wellness's claim," apparently because the presence of "a 'substantial adverse' claim." Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1952-53 (Robert, C.J., dissenting) (emphasis added).

[52]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1952 (Roberts, C.J., dissenting) (citations omitted).

[53]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1953 (Roberts, C.J., dissenting) (citations omitted).

[54]Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. at 1953-54 (Roberts, C.J., dissenting) (citations omitted).

NO FRAUD WITHOUT A REPRESENTATION?

Randy Haines

Chief Bankruptcy Judge (retired)
Phoenix, Arizona

In *Husky Int'l Electronics, Inc. v. Ritz (In re Ritz)*,[1] the Fifth Circuit recently held that no "actual fraud" is made nondischargeable by § 523(a)(2) unless it is accomplished by a misrepresentation on which the creditor relies: "[W]e conclude that a representation is a necessary prerequisite for a showing of 'actual fraud' under Section 523(a)(2)(A)."[2] In so holding, the Fifth Circuit adopted a surprisingly constricted view of the kinds of fraud that the Bankruptcy Code makes nondischargeable, created a circuit split with the Seventh Circuit's holding in *McClellan v. Cantrell*,[3] ignored four centuries of bankruptcy law, and misapplied statutory interpretation and legislative history.

The creditor, Husky International Electronics, Inc., had sold electronic components on credit to Chrysalis Manufacturing Corp. until almost $164,000 was owed and past due. Daniel Ritz owned and controlled Chrysalis. During six months while Chrysalis operated but was not paying its debts as they came due, Ritz transferred over a million dollars of Chrysalis' funds to various entities that he controlled, for which Chrysalis did not receive any reasonably equivalent value.

Husky sued Ritz to hold him personally liable for the $164,000 corporate debt. Ritz filed Chapter 7. In his Chapter 7 case, Husky objected to the discharge of its debt on grounds of § 523(a)(2), (a)(4) and (a)(6). After trial, the bankruptcy court concluded that Ritz had orchestrated the transfers of Chrysalis' funds without reasonably equivalent value, that Husky had suffered at least $164,000 in damages because of those transfers, and that Ritz was not a credible witness due to his contradictory and evasive testimony. Yet the court held that Ritz's personal liability could be discharged under § 523(a)(2) because he never made a misrepresentation to Husky on which Husky had relied. On appeal, the district court concluded that although there was sufficient circumstantial evidence to find that Ritz had acted with actual intent to hinder, delay or defraud Husky, there was no actual fraud under § 523(a)(2) in the absence of a misrepresentation. The Fifth Circuit affirmed.

The Fifth Circuit held there can be no nondischargeable "actual fraud" under § 523(a)(2) in the absence of a misrepresentation and creditor reliance. In doing so it primarily relied on the Supreme Court's rationale in *Field v. Mans*,[4] and rejected *in toto* Judge Posner's subsequent analysis of *Field* in *McClellan*.[5]

Field, of course, dealt *only* with the level of reliance required when the fraud alleged for § 523(a)(2) purposes consists of a misrepresentation: "In this case we consider the level of a creditor's reliance on a fraulent misrepresentation necessary to [make a debt nondischargeable]. While the Court of Appeals followed a rule requiring reasonable reliance on the statement, we hold the standard to be the less demanding one of justifiable reliance[.]"[6] From this narrow consideration of the requisite level of reliance on an alleged misrepresentation, it is quite a stretch to conclude that the same opinion also held that the ***only*** kinds of frauds cognizable under § 523(a)(2) are misrepresentations. Nonrepresentational fraudulent conduct was never at issue in *Field*. It is hard to conceive how the decision in *Field* could be read to express any view on that other subject; it would have been dictum at best if it did.

The Fifth Circuit opinion in *Ritz* never suggests that *Field* actually addressed nonrepresentional frauds. The closest *Ritz* came to such an analysis was to suggest that *Field* had relied on the Restatement of Torts (Second) dealing with "fraudulent misrepresentation," noting that it required actual and justifiable reliance: "Although not directly addressing the issue, the Court throughout its opinion in *Field* appeared to assume that a false representation is necessary to establish 'actual fraud.' . . . [Both the Restatement (Second) of Torts and Prosser's Law of Torts] indicate that a representation is a necessary prerequisite [of an 'actual fraud']."[7]

Ritz effectively holds that there can be no "actual fraud" without a misrepresentation. This is a dramatic narrowing of at least a four hundred year old common law concept of fraud. According to Lord Coke, the Star Chamber concluded in *Twyne's Case* that there is "actual fraud" inherent in a conveyance of assets with intent to hinder, delay or defraud creditors even when there has been no representation or misrepresentation: "And it was resolved by Sir Thomas Egerton, Lord Keeper of the Great Seal, and by the Chief Justice Popham and Anderson, and the whole Court of Star Chamber, that **this gift was fraudulent**, within the statute of 13 Eliz."[8] But the Fifth Circuit was explicit that it was rejecting this historic concept of fraud: "Husky has pointed to no authority, and we are not aware of any, suggesting that the common law meaning of 'actual fraud' . . . [in 1978] encompassed fraudulent transfers of the type at issue here."[9]

Hypertechnically, perhaps, it could be argued that *Twyne's Case* did not establish any common law meaning of actual fraud because it was merely an interpretation of the Statute of Elizabeth, a statutory interpretation, not common law. But the Supreme Court has repeatedly held that the "Statute of Elizabeth was declaratory of the common law",[10] and more recently that fraudulent transfer actions are common law actions.[11]

It is particularly surprising that the Fifth Circuit panel could make this error of historical common law despite actually considering, and rejecting, Judge Posner's superb analysis in the *McClellan* opinion. *McClellan* dealt with almost exactly the same fact pattern: a creditor who was not paid for selling machinery to Mr. Cantrell sought to enjoin his further transfer of the machinery, but before the injunction was issued he transferred the machinery to his sister for no consideration, and she sold it for $160,000.[12] When she filed bankruptcy, the issue was whether the creditor's claim against her was dischargeable. The bankruptcy court dismissed the nondischargeability complaint because the Supreme Court "recently scoffed at the idea that a debt could be nondischargeable under the fraud exception of § 523(a)(2)(A) without a showing of material misrepresentation and reliance on the statement."[13] The Seventh Circuit reversed because "nothing in the Supreme Court's opinion [in *Field*] suggests that misrepresentation is the only type of fraud that can give rise to a debt that is not dischargeable under § 523(a)(3)(A). No other type of fraud was alleged in [*Field*] or discussed in the opinion."[14]

The *McClellan* opinion went on to note that "by distinguishing between 'a false representation' and 'actual fraud,' the statute [§ 523(a)(2)(A)] makes clear that actual fraud is broader than misrepresentation. . . . No learned inquiry into the history of fraud is necessary to establish that it is not limited to misrepresentations and misleading omissions."[15] Of course if that "learned inquiry" were undertaken it would start with *Twyne's Case,* establishing that a transfer of assets with intent to hinder, delay or defraud creditors is a type of fraud recognized by the common law. Indeed, it is the essence of the "bust out" scheme that led to England's establishment of both the death penalty for fraudulent debtors and the discharge for honest debtors.[16] It does not require any representation or misrepresentation.

It is a rather strong "plain meaning" argument that § 523(a)(2)'s reference both to "a false representation" and to "actual fraud" implies that "actual fraud" must mean something more than "a false representation." To this argument the Fifth Circuit's opinion rather lamely responded that the canon against surplusage is not dispositive but merely a guide that can be overcome by other indications of congressional intent.[17] For evidence of this contrary congressional intent, the opinion references Collier's comment that the addition of "actual fraud" to § 523(a)(2) in the 1978 code "was intended to codify case law . . . which interpreted 'fraud' to mean actual or positive fraud rather than fraud implied by law."[18]

In this respect the Fifth Circuit's legislative history is factually wrong, as well as Collier's comment if it meant what the Fifth Circuit says. Clearly, of course, use of the word "actual" was intended to exclude constructive fraud, as the Congressional Record Statements accompanying the Reform Act of 1978 made clear.[19] But that does not explain why "actual fraud" was added to the predecessor of § 523(a)(2)(A). The predecessor was Bankruptcy Act § 17a(2), which made nondischargeable "liabilities for obtaining money or property by false pretenses or false representations." It did not reference "fraud" at all, and it is difficult to believe that any court would have concluded that "false representations" could have included constructive fraud. So, although the Code's addition of "actual fraud" was clearly not intended to add constructive fraud, what was it intended to add to § 523(a)(2)? Nothing in either the Fifth Circuit or the Seventh Circuit opinion suggests what must have been intended: the Seventh Circuit assumes something must have been intended; the Fifth Circuit assumes no addition must have been intended, only a limitation.

The answer is not hard to find. Under Bankruptcy Act § 17a, "fraud" was referenced only in § 17a(4), the predecessor to § 523(a)(4). That section rendered nondischargeable debts "created by his fraud, embezzlement, misappropriation or defalcation while acting as an officer or in any fiduciary capacity." It was the 1973 Bankruptcy Commission that first proposed moving the "standard of 'fraud' . . . to a more appropriate location in clause 2."[20] Thus, the Commission's intent was not to *narrow* the kind of fraud made nondischargeable, but rather to *broaden* it by removing it from the context of "embezzlement, misappropriation or defalcation while acting as an officer or in any fiduciary capacity," as Act § 17a(4) had read.

Even if the Commission's report is not regarded as reliable legislative history, it should be sufficient to refute the Fifth Circuit's conclusion that the legislative intent was to add mere surplusage to "misrepresentation." Indeed, the incontrovertible fact that "fraud" was moved from § 17a(4) to § 523(a)(2) implies that Congress intended to accomplish something by making that change, and that "fraud" in § 523(a)(2) should reference the same kind of frauds as it had in § 17a(4) so long as it was actual and not constructive. If it was not intended to encompass the kind of intentionally fraudulent transfers by Ritz, and like those of Pitkin and by Pierce to Twyne, then what kind of nonrepresentational actual frauds was is it intended to include? Nothing in the Fifth Circuit opinion suggests what could have been intended.

Perhaps a better argument against the application of § 523(a)(2) is that it applies only to debts for money "obtained by" actual fraud. Ritz could have argued that the debt to Husky was not obtained by fraud, but was merely a debt arising from his corporation's purchase of goods on credit. But on that argument Judge Posner's analysis in *McClellan* is also very precise. The allegedly nondischargeable debt in *McClellan* was not that of Mr. Cantrell but rather that of his sister. Similarly in *Ritz*, the debt at issue was not the debt of Chrysalis Manufacturing, but rather the personal debt of Ritz. Just like in *McClellan*, the "original debt arose from a loan, but is not the debt at issue here. The debt at issue here is the debt that [Ritz] incurred . . . by committing a fraud against [the creditor]. Because it was an actual fraud, the debt that it gave rise to is not dischargeable."[21]

The *Ritz* opinion creates a circuit split and is demonstrably wrong. Perhaps this is a good case for the Fifth Circuit's unique procedure for *sua sponte* panel reconsideration.[22]

Author's Note:

After this article went to press, the First Circuit issued an opinion contrary to the Fifth Circuit's holding in Ritz, and concurring with the Seventh Circuit's holding in McClellan that participation in an actual fraudulent transfer can render a debt nondischargeable under section 523(a)(2) without a misrepresentation. It contains good analysis based not only on the text, history and structure of the Bankruptcy Code and Act but also on the Restatement (Second) of Torts section 871 which identifies a type of fraud that is broader than misrepresentation. The case is Sauer Inc. v. Lawson (In re Lawson), No. 14-2058, 2015 WL 3982395 (1st Cir. July 1, 2015).

ENDNOTES:

[1]Husky Int'l Elecs., Inc. v. Ritz (In re Ritz), 787 F.3d 312 (5th Cir. 2015).

[2]In re Ritz, 787 F.3d at 321.

[3]McClellan v. Cantrell, 217 F.3d 890 (7th Cir. 2000).

[4]Field v. Mans, 516 U.S. 59, 116 S. Ct. 437, 133 L. Ed. 2d 351 (1995).

[5]McClellan v. Cantrell, 217 F.3d at 892 ("Actually *Field* has nothing to do with this case. The fraud there took the form of a misrepresentation, and the only issue was the nature of the reliance that a plaintiff must show to prove fraud in such as case.").

[6]Field v. Mans, 516 U.S. at 62, 116 S. Ct. at 439.

[7]In re Ritz, 787 F.3d at 318.

[8]Twyne's Case, 3 Co. Rep. 806, 76 Eng. Rep. 809 (Star Chamber 1601) (emphasis added).

[9]In re Ritz, 787 F.3d at 319.

[10]Sumner v. Hicks, 67 U.S. (2 Black) 532, 534, 17 L. Ed. 355 (1862) ("The Statute of Elizabeth was declaratory of the common law. In the absence of such legislation the common law would have accomplished the same results."). See also Coder v. Arts, 213 U.S. 223, 29 S. Ct. 436, 53 L. Ed. 772 (1909) ("This form of expression [intent to hinder, delay, or defraud creditors] is familiar to the law of fraudulent conveyances, and *was used at the common law*, and in the statute of Elizabeth . . . . [I]n [Act] § 67e, transfers fraudulent under the *well-recognized principles of the common law* and the statute of Elizabeth are invalidated.") (emphasis added).

[11]See, e.g., Stern v. Marshall, ____ U.S. ____, 131 S. Ct. 2594, 2614, 180 L. Ed. 2d 475 (2011) ("[In *Granfinanciera,*] [w]e reasoned that fraudulent conveyance suits were 'quintessentially suits at common law[.]"); Granfinanciera, S.A. v. Nordberg, 492 U.S. 33, 56, 109 S. Ct. 2782, 106 L. Ed. 2d 26 (1989) ("There can be little doubt that fraudulent

conveyance actions by bankruptcy trustees . . . are quintessentially suits at common law[.]").

[12]McClellan v. Cantrell, 217 F.3d at 892.

[13]McClellan v. Cantrell, 217 F.3d at 892.

[14]McClellan v. Cantrell, 217 F.3d at 892.

[15]McClellan v. Cantrell, 217 F.3d at 893.

[16]Emily Kadens, *The Pitkin Affair: A Study of Fraud in Early English Bankruptcy*, 84 Am. Bankr. L.J. 483 (2010).

[17]In re Ritz, 787 F.3d at 320.

[18]In re Ritz, 787 F.3d at 320 (quoting Alan N. Resnick & Henry J. Sommer, Collier on Bankruptcy ¶ 523.08[01][e] (16th ed. 2014)).

[19]"Subparagraph (A) is intended to codify current case law. [See,] e.g., Neal v. Clark, 95 U.S. (5 Otto) 704, 24 L. Ed. 586 (1877), which interprets 'fraud' to mean actual or positive fraud rather than fraud implied in law." 124 Cong. Rec. H11095-96 (daily ed. Sept. 28, 1978); S17412 (daily ed. Oct. 6, 1978) (remarks of Rep. Edwards and Sen. DeConcini).

[20]Report of the Commission of the Bankruptcy Laws of the United States, H.R. Doc. 93-137, at 139 (1973).

[21]McClellan v. Cantrell, 217 F.3d at 895.

[22]See, e.g., Smith v. Associates Comm. Corp. (In re Clark Pipe & Supply Co.), 893 F.2d 693, 695 (5th Cir. 1990) ("Treating the suggestion for rehearing en banc filed in this case by Associates Commercial Corporation . . . , as a petition for panel rehearing, we hereby grant the petition for rehearing. After re-examining the evidence in this case and the applicable law, we conclude that our prior opinion was in error. We therefore withdraw our prior opinion and substitute the following.").

From the Appellate Courts

RECENT DECISIONS FROM THE APPELLATE COURTS

Alexandra E. Dugan

Jay Watkins

Bradley Arant Boult Cummings, LLP

Nashville, TN
Birmingham, AL

FIFTH CIRCUIT

Cantu v. Schmidt (In re Cantu), 784 F.3d 253 (5th Cir. 2015). The estate suffered injury prior to conversion from Chapter 11 to Chapter 7 caused by counsel's failure to timely request use of cash collateral, failure to schedule assets and failure to submit a confirmable plan. The estate was entitled to all malpractice settlement funds because the proper method for determining whether the cause of action belongs to the estate or the debtor under § 541 is the accrual approach.

Buescher v. First United Bank & Trust (In re Buescher), 783 F.3d 302 (5th Cir. 2015). Bankruptcy court did not err in denying discharge of both husband and wife. Husband's guaranty of business loan gave lender an *in rem* claim against all community property under Texas law giving lender standing under 11 U.S.C.A. § 727(c)(1) as creditor of wife to object to wife's discharge under § 727(a)(3). Creditor was under no obligation to seek discovery directly from debtors and could prevail on discharge complaint based on discovery obtained from trustee.

Barron & Newburger, P.C. v. Texas Skyline, Ltd. (In re Woerner), 783 F.3d 266 (5th Cir. 2015) (en banc). Overruling *Andrews & Kurth L.L.P. v. Family Snacks, Inc. (In re Pro-Snax Distributors, Inc.)*, 157 F.3d 414 (5th Cir. 1998), prospective, "reasonably likely to benefit the estate" standard applies to determine awards of attorney fees under § 330.

SEVENTH CIRCUIT

Sullivan v. Glenn, 782 F.3d 378 (7th Cir. 2015). Debtors' agent's fraud will not be imputed to debtors for purposes of nondischargeability under § 523(a)(2)(A) unless " 'it is accompanied by proof which demonstrates or justifies an inference that the debtor knew or should have known of the fraud.' " Moreover, creditor was in as good a position as the debtors to have detected the fraud by performing due diligence.

NINTH CIRCUIT

Pensco Trust Co. v. Tristar Esperanza Props., LLC (In re Tristar Esperanza Props., LLC), 782 F.3d 492 (9th Cir. 2015). Claim based on state court judgment arising from minority membership interest in debtor is subject to mandatory subordination because the claim is "for damages arising from the purchase or sale" of "a security of the debtor" under § 510(b).

TENTH CIRCUIT

Davis v. Pham (In re Nguyen), 783 F.3d 769 (10th Cir. 2015). Chapter 7 debtor's transfer of bare legal title to real property to sister less than two years prior to bankruptcy filing was not avoidable under § 548(a)(1)(B). Under Kansas law, the transfer resulted in a trust comparable to joint tenancies. Debtor held only bare legal title to the real property, an interest that could not be avoided under § 548(a)(1)(B).