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Statement of Affairs

PORZIO BANKRUPTCY WIRE

# The Evolution of Bankruptcy Court Authority in Light of *Stern v. Marshall*

By Brett S. Moore and Rachel A. Segall

Irving Picard, the trustee appointed under the Securities Investor Protection Act (the "Trustee"), 15 U.S.C. § 78aaa *et seq*. ("SIPA"), to administer the estate of Bernard L. Madoff Investment Securities, LLC, has brought hundreds of actions seeking to avoid transfers that were purportedly fraudulent or preferential (the "Avoidance Actions"). Some of the Avoidance Action defendants sought to withdraw the reference to the Bankruptcy Court, basing their motions on the Supreme Court's decision in *Stern v. Marshall*, 131 S. Ct. 2594 (2011). The *Stern* case held that, notwithstanding the designation as "core" under 28 U.S.C. § 157(b)(2), a bankruptcy court is not constitutionally authorized to enter final judgment on a state law counterclaim that is not resolved in the process of adjudicating a creditor's proof of claim.

However, the *Stern* decision did not expressly define the particular scope and authority of bankruptcy courts to hear and make final decisions in connection with cases such as the Avoidance Actions. Accordingly, the United States District Court for the Southern District of New York (the "District Court"), in *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 2013 U.S. Dist. LEXIS 2517 (S.D.N.Y. Jan. 4, 2013) (hereinafter, "*SIPC v. Madoff*"), consolidated numerous motions to withdraw the reference in order to clarify three specific issues in connection with the Avoidance Actions:

1. Whether the Bankruptcy Court has the judicial authority to finally decide the Avoidance Actions;

2. Whether the Bankruptcy Court has the judicial authority to recommend proposed findings of fact and conclusions of law to the District Court; and

3. Whether the District Court should withdraw the reference in light of *Stern*.

## Constitutional and Statutory Background

To resolve these issues, the District Court initially reviewed Article III of the Constitution, noting that Congress is restricted in withdrawing certain issues from the "judicial cognizance" of Article III judges. Bankruptcy judges are not Article III judges (they are sometimes referred to as "Article I" judges), and therefore, Congress may only empower bankruptcy courts to determine and finally resolve certain claims involving "public rights," but not matters involving "private rights." *Stern*, 131 S. Ct. at 2609. The District Court noted that public rights "relate to the performance of the constitutional functions of the executive or legislative departments," (*id.* at 2612) and are "closely integrated into a public regulatory scheme[,]" (*id.* at 2613) while private rights relate to the "liability of one individual to another under the law as defined" (*id.* at 2612).

The Supreme Court previously held that a fraudulent transfer is more similar to a private right because fraudulent conveyance actions "are quintessentially suits at common law that more nearly resemble state-law contract claims brought by a bankrupt corporation to augment the bankruptcy estate than they do creditors'

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hierarchically ordered claims to a pro rata share of the bankruptcy res." *Granfinanciera, S.A. v. Nordberg,* 492 U.S. 33, 55-56 (1989). The Supreme Court in *Stern* applied that precedent and held that bankruptcy courts may not enter a final judgment on state law counterclaims that have not been resolved as part of a ruling on a creditor's proof of claim, notwithstanding that the counterclaim is considered a "core" bankruptcy proceeding. *Stern*, 131 S. Ct. at 2620.

### The District Court's Decision

Although the Trustee brought the Avoidance Actions under SIPA rather than the Bankruptcy Code, the District Court concluded that avoidance actions under SIPA, just like those under the Bankruptcy Code, assert private rights, which are ordinarily reserved for final judgment by an Article III judge. The District Court supported its holding by noting that avoidance actions under SIPA share characteristics with claims that assert private rights because they: (i) are referred to bankruptcy courts rather than a regulatory agency, (ii) do not necessitate a final decision by a bankruptcy court to make SIPA's statutory scheme "workable," and (iii) generally do not include consensual submission to the adjudicative scheme (as is the case in *SIPC v. Madoff*, where the Avoidance Action defendants did not consent to the Bankruptcy Court's jurisdiction). The District Court noted, however, that a bankruptcy court may, in fact, have authority to finally resolve avoidance actions to the extent that it must decide a claim that raises the same issues as the avoidance action.

Although the District Court held that the Bankruptcy Court may not ordinarily enter final judgments on avoidance actions, it nevertheless determined that the Bankruptcy Court does have the judicial authority to hear the proceedings and recommend proposed findings of fact and conclusions of law to the District Court. The District Court reasoned that Congress would have wanted bankruptcy courts to exercise the lesser power it implicitly conferred on them—i.e., the power to propose findings of fact and conclusions of law.

Finally, the District Court determined that it would not withdraw the reference "for cause shown" before the Bankruptcy Court issued its findings of fact and conclusions of law. In doing so, the District Court followed a growing trend based on other decisions in the district, as well as its own prior precedent, and took into account considerations of "efficiency" and "uniformity," finding that the Bankruptcy Court's report and recommendation would likely save both the District Court and the parties an "immense" amount of time.

### Conclusion

In *SIPC v. Madoff*, the District Court provided some clarity on some of the outstanding issues concerning the authority of bankruptcy courts to hear and finally decide certain claims. Relying on *Stern*, the District Court held that the Bankruptcy Court lacks authority to enter final judgments on pending Avoidance Actions. Rather than withdrawing the reference and hearing the cases in the first instance, however, the District Court held that the Bankruptcy Court does have the judicial authority to hear the proceedings and recommend proposed findings of fact and conclusions of law. While the ultimate contours of *Stern v. Marshall* are still being determined, the *SIPC v. Madoff* case is consistent with the growing trend that while bankruptcy courts may ordinarily lack authority to finally decide avoidance actions, they may nevertheless hear such claims and submit proposed findings of fact and conclusions of law to the district court.

# Bankruptcy Court Blocks Alleged Abuse Survivors from Pursuing $35 Million Archdiocese Transfers

By John S. Mairo and Kelly D. Curtin

In 2005, as the Archdiocese of Milwaukee (the "Archdiocese" or "Debtor") faced numerous lawsuits by alleged abuse survivors, it transferred in excess of $35 million from its "Parish Deposit Fund" to its parishes and a newly created Southeastern Wisconsin Catholic Parishes Investment Management Trust (the "Trust").

After the Archdiocese filed for bankruptcy protection on January 4, 2011 following its failure to settle more than twenty-three abuse lawsuits, the Official Committee of Unsecured Creditors (the "Committee") of the Archdiocese, which five-member committee was comprised of four personal injury plaintiffs and alleged abuse survivors, investigated those transfers and alleged that they were recoverable as fraudulent conveyances.

Notwithstanding, on December 10, 2012, the United States Bankruptcy Court for the Eastern District of Wisconsin (the "Court") held that the Committee did not have the derivative standing necessary to commence litigation seeking the avoidance and recovery of the $35 million. *See In re Archdiocese of Milwaukee*, 483 B.R. 855 (Bankr. E.D. Wis. 2012).

### Background

According to the Debtor, the Parish Deposit Fund was formed by the Archdiocese in 1969 to allow local

Catholic entities (primarily parishes) the option of investing into one pooled fund that provided favorable interest rates and permitted investments to be redeemed upon request.

The Committee alleged that in March 2003, in the face of mounting abuse litigation, the Archdiocese's Finance Council met and discussed paying claims of "legitimate victims" of abuse from insurance and/or borrowed funds and setting up the Trust to shelter the Parish Deposit Fund from further abuse claims. Two years later, on June 30, 2005, the Archdiocese closed the Parish Deposit Fund and investors were given the option of having their investments returned to them or transferred to the new Trust. Accordingly, the Committee asserted that the Archdiocese transferred in excess of $35 million from the Parish Deposit Fund to the Trust and/or directly to parishes and other affiliates of the Debtor (collectively, the "Parishes") with actual intent to hinder, delay, or defraud creditors in 2005.

In light of the Debtor's refusal of the Committee's demand that it attempt to recover the $35 million for the benefit of the estate, on May 25, 2012, the Committee filed a motion for authority to file adversary complaints to avoid and recover the alleged fraudulent transfers pursuant to Wisconsin state law and the Bankruptcy Code's fraudulent transfer provisions.

### The Court's Decision

Before getting to the merits of the Committee's motion, the Court held that despite the fact that four years had passed since the transfers were made, the Committee's claims may satisfy the relevant statute of limitations because it was plausible that a creditor could not have reasonably discovered the transfers before January 5, 2010 (within one year of the Debtor's petition), even though the Archdiocese's financial statements were published each year online and disclosed the existence of the Parish Deposit Fund and its "fishy" closing in 2005 when the alleged abuse survivors were involved in a mediation program with the Debtor. *Id.* at 865-66.

Nevertheless, the Court denied the Committee's motion as failing to satisfy the relevant standard for derivative standing because (i) the Committee's claims were not "colorable" and (ii) the Debtor did not "unjustifiably" refuse to bring those claims. "Colorable" claims, as the Court explained, are claims that would survive a motion to dismiss, are plausible on their face, contain "more than a sheer possibility" of unlawfulness, and are not subject to affirmative defenses. *Id.* at 858-59. (citations omitted).

First, the Court held that the Parishes likely had a defense to the litigation because they received funds "in good faith." *Id.* at 866-67. On this point, the Court held that, despite being an officer and board member of each parish corporation, the Archbishop's knowledge of the allegedly fraudulent transfers could not be imputed to the Parishes because the Archbishop did not exercise his authority or control over the Parishes with respect to the transfers. Instead, the Archbishop gave each of the Parishes the opportunity to either withdraw their funds or invest in the new Trust. *Id.*

Second, the Court held that the Committee had not stated a plausible claim that the transfers were made with the Debtor's property. *Id.* at 869. Instead, the Court held that the Parish Deposit Fund belonged to the Parishes because, unlike similar funds present in some of the seven other diocesan cases prompted by the ongoing abuse crisis, (i) the Archdiocese did not hold title to the Parishes' property because Parishes are considered separate corporations under Wisconsin law, (ii) the Parishes' funds were not commingled in the Archdiocese's operating account, but were deposited into one segregated bank account and easily traceable, (iii) participation in the Parish Deposit Fund was voluntary, and (iv) the Parishes could withdraw their funds on request. *Id.* at 867-69.

Finally, despite its conclusion that the claims were not colorable, the Court went on to state that the Archdiocese justifiably refused to attempt to recover the funds given (i) the significant cost and delay associated with pursuing such claims, (ii) the dubious merit of the claims, (iii) the likely difficulty in collecting any judgment, and (iv) the adverse effects on the reorganization effort of the Debtor, which relies upon its Parishes for support. *Id.* at 869-71.

In sum, the Court held that the Committee's claims were not colorable, and even assuming that they were, the Debtor did not unjustifiably refuse to bring such claims given that the cost outweighed any apparent benefit.

### Conclusion

Dioceses and parishes facing financial distress or potential catastrophic liability events should take note. Although the Archdiocese was successful in opposing the Committee's actions in this instance, pooled investment vehicles are subject to scrutiny during a bankruptcy case. The operation and structure of such funds, the level of disclosure of any related transfers, and governing state law will likely dictate the outcome of future similar cases.

# Advantages of Serving on an Official Committee of Unsecured Creditors

By Mark J. Politan

In many Chapter 11 business bankruptcies, the Office of the U.S. Trustee (the "UST") will appoint a representative body of unsecured creditors (the "Committee") to represent the interests of all unsecured creditors. The Committee is selected from unsecured creditors of the debtor who generally hold the largest unsecured claims against the debtor, are not "insiders" of the debtor and are willing to serve. A potential Committee member's willingness to serve is demonstrated through returning the creditor questionnaire to the UST and/or attending the formation meeting when scheduled. Typically, the formation meetings are scheduled one to three weeks after the filing of the petition provided the UST determines there is sufficient interest and need for a Committee. With Porzio's extensive experience serving as counsel to various committees, we are often asked to describe the advantages of serving on a Committee. Below are some of the key advantages to consider:

**Information–**Serving on a Committee is the most effective way to be informed of significant case developments in real time. One of the primary functions of a Committee is to keep the general unsecured creditor body as a whole informed and, as a consequence, a Committee will typically receive status reports from its professionals with the most up to date information. These status reports will include summaries of case developments and provide insight into anticipated next steps in the Chapter 11 case. From these status reports, the members of a Committee will learn in real time the likelihood of liquidation or reorganization of the debtor's business and expected distribution/dividends to be received by unsecured creditors. The value of receiving this information to a potential Committee member may vary depending on the size of the creditor's unsecured claim, however, without question, the Committee stands in a superior position concerning receipt of this vital information.

**Impact–**The Committee can play a defining role in a Chapter 11 case, whether the case is ultimately a liquidation or reorganization. Among the duties of a Committee is the examination of the operation of the debtor's business and the conduct of the debtor's principals. Additionally, the Committee will influence the administration of the Chapter 11 case and actively participate in developing the plan for emergence from Chapter 11. Given the impact a Committee has on essentially all major decisions in a Chapter 11 case, by participating on the Committee, a creditor can protect the interests and ensure the fair treatment of all unsecured creditors as a whole.

**Industry Contacts–**Serving on a Committee provides opportunities to meet and expand on industry contacts for effective, targeted networking. Whether fellow Committee members are vendors, competitors or entities in complementary businesses, serving on a Committee provides a framework to develop relationships that will survive the Chapter 11 case in significant ways.

**Education–**In today's economy, it is a reality that certain industries will experience multiple Chapter 11 filings from businesses in their sector. Many creditors in a Chapter 11 case have had or will have experience with multiple bankruptcy filings. While each Chapter 11 case is distinct, by serving on a Committee, a creditor can be educated on the Chapter 11 process from the inside. This knowledge will only serve to help the creditor better protect its interests and understand its rights in subsequent bankruptcy cases.

**Cost Management–**When formed, the first task for the Committee is to select an attorney and other professionals to guide and assist it in fulfilling its duties/responsibilities, as well as to protect the interests of unsecured creditors as a whole. The fees for retained professionals are borne by the debtor's estate and not by the individual members of the Committee—resulting in the sharing of these administrative costs. The professionals will not represent individual creditors or Committee members during the Chapter 11 case, but rather serve to assist the Committee in its representative capacity. Serving on a Committee provides access to these professionals and an opportunity to impact the course of the Chapter 11 case in an efficient, economical manner.

Overall, the advantages of serving on a Committee in a Chapter 11 case are significant and creditors should consider these in deciding whether to seek a seat on the Committee. At Porzio, we can and often do assist creditors in making these decisions. Should you receive a notice of bankruptcy filing or questionnaire from the UST soliciting interest in forming a Committee, please keep these advantages in mind and feel free to contact us with any questions.