

NAVIGATING BANKRUPTCY JURISDICTION

I. Basics

Constitutional Limitations

- Pursuant to the Judicial Code, Title 28 USC, a separate bankruptcy court is established within, and is a unit of, each judicial district in the U.S. As a result, a bankruptcy judge's authority still derives, at least in part, from the district court.
- Bankruptcy judges, who receive ultimately their power through Article 1 of the Constitution, versus Article III for district, appellate, and Supreme Court judges, are appointed to the bankruptcy court by the applicable Court of Appeals, and sit for a term of 14 years.
- When Congress adopted the Bankruptcy Reform Act of 1978, it tried to give bankruptcy judges jurisdictional powers equivalent to those provided to Article III judges, but the Supreme Court shot that down in Northern Pipeline Construction Co v Marathon Pipeline Line Co (1982). The Supreme Court held this to be unconstitutional on the basis that a non-tenured judge may not decide questions of state law and enter final orders absent consent. In the 1984 amendments to the Bankruptcy Code, Congress developed the current jurisdictional scheme for bankruptcy courts, narrowing the scope of the bankruptcy court's power.
- Litigation has continued as to constitutional limits of bankruptcy jurisdiction.

District Courts have jurisdiction over bankruptcy matters

- Per 28 U.S.C. 1334, it is the district courts with Article III judges that have jurisdiction over bankruptcy matters. Specifically, district courts are granted original and exclusive jurisdiction of cases under title 11 and have original (but not exclusive) jurisdiction of the following civil proceedings:
 - those arising under title 11—held to be proceedings that depend on some substantive right that title 11 grants,
 - those arising in cases under title 11—held to be proceedings that that relate to a matter unique to the bankruptcy process, and
 - those related to cases under title 11—held to be proceedings where the outcome of same proceeding could have an effect on the administration of the estate.
- But post Marathon Pipeline, all district courts automatically refer all bankruptcy cases to bankruptcy court via standing orders of reference. 28 USC 157(a).

Core Proceedings

- Bankruptcy judges can enter final judgments only in core proceedings arising under title 11 or arising in a case under title 11, including the 16 types of proceedings listed in 28 USC 157(b)(2), including, for example,
 - matters concerning the administration of the estate,
 - allowance-disallowance of claims against estate,
 - counterclaims by the estate against persons filing claims against the estate (see discussion on Stern v Marshall below),
 - proceedings to avoid/recover fraudulent conveyances, and
 - plan confirmations.

- Bankruptcy judges can only enter proposed findings of fact/conclusions of law in non-core proceedings, for determination by the district court.

II. Stern v Marshall

Background

- In 1994, 26 year old Playboy Playmate and model Anna Nicole Smith married 89 year old Texas oil magnate J Howard Marshall II. He died 14 months later. Smith was not named in the will, and a probate fight commenced in TX probate court between Smith and Marshall's younger son Pierce.
- While the TX case was pending, Smith filed for bankruptcy in California. Pierce filed a proof of claim against Smith alleging defamation; Smith counterclaimed alleging tortious interference. The bankruptcy court ruled in Smith's favor and awarded her damages of \$474 million.

Final Outcome in Supreme Court

- In a 2011 opinion by Chief Judge Roberts, the Supreme Court affirmed the 9th Circuit's decision finding that bankruptcy courts lack authority to enter final judgments in state counterclaims that are not resolved in the process of ruling on creditors' proofs of claim.
- The Court also held that to enter final judgment a bankruptcy court must have both statutory authority and constitutional authority. Stern v. Marshall (2011).
- In Stern, the Supreme Court recognized that a bankruptcy court's statutory jurisdiction emanates from 28 U.S.C. 157, which empowers bankruptcy courts to enter final judgments in "core" proceedings "arising in" and "arising under" Title 11 of the Bankruptcy Code, but not in "related to" cases.
- The Court further found that this statutory authority of bankruptcy courts is constrained by the Constitution, which precludes bankruptcy courts from performing duties or assuming the rights and powers of courts created under Article III.

Post-Stern Developments

- Bankruptcy courts have the authority to enter final judgments when the parties consent to the court's jurisdiction Wellness International Network Ltd v. Sharif (2015).
- Bankruptcy courts can hear and submit proposed findings of fact and conclusions of law for Stern claims, *i.e.*, claims that bankruptcy judges are constitutionally prohibited from finally determining despite specific statutory authority to do so. Executive Benefits Insurance Agency v Arkinson (2014).

III. The Jurisdictional Consequences of Filing a Counterclaim and/or Filing a Proof of Claim in an Adversary Proceeding

- Defendants can be hailed into a foreign state court, perhaps unwittingly, by their own well-intentioned actions to defend themselves against a bankruptcy debtor or trustee's claims.
- Many litigants do not realize that by filing a counterclaim or a proof of claim in a case filed in another jurisdiction, they are availing themselves to that Court's jurisdiction as well.

- Filing a Claim – By filing a claim, a creditor triggers the process of allowance and disallowance of claims, thereby subjecting itself to the bankruptcy court’s equitable power.
 - A creditor who files a claim – even a “protective and contingent” claim – submits itself to the bankruptcy court’s equitable jurisdiction and waves any Seventh Amendment right to a jury trial. Travelers Int’l AG v. Robinson (3d Cir. 1992).
- Filing a counterclaim bears the same result.
 - Courts held that creditor’s filing of counterclaim to trustee’s claims against him was a sufficient invocation of the court’s “claim resolution” process to waive creditor’s right to jury trial. In re Hudson, (E.D.N.C. 1994); Shields v. Ciccone (In re Lloyd Sec., Inc.) (Bankr. E.D. Pa 1993).
- Cautionary Tale--**Picard v Mann** (Bankr, SDNY 2019) The defendants filed proofs of claim in the Madoff bankruptcy and the Trustee responded with a \$2.8 MM fraudulent transfer action. The defendants subsequently withdrew their claims with prejudice, moved in the district court to withdraw the reference, and moved in the bankruptcy court to stay a previously scheduled trial of the adversary proceeding. The bankruptcy court concluded that it acquired equitable jurisdiction over the Trustee’s fraudulent transfer action when it was commenced under the time-of-filing rule, and the defendants’ withdrawal of their claims did not destroy it.

IV. Withdrawing the Reference

- District courts have authority to withdraw any referred matter on their own motion or the timely motion of any party for cause shown. 28 U.S.C. 157(d).
 - The reference must be withdrawn if the proceeding involves both title 11 and other U.S. laws regulating organizations or activities affecting interstate commerce. 28 USC 157(d).
- To decide whether to permissively withdraw a case, the district court should consider:
 - (i) whether the claim is core or non-core,
 - **Core:** a proceeding that involves rights created by bankruptcy law or that could arise only in a bankruptcy case.
 - **Non-core:** an action that does not depend on the bankruptcy laws for its existence and which could proceed in a court that lacks federal bankruptcy jurisdiction. Orion Picture Corp v Showtime (In re Orion) (1993), cert denied (1994).
 - A claim alleging pre-petition legal malpractice is non-core. Official Comm Unsecured Cred of VWE Grp (In re VWE Grp) (SDNY 2007).
 - (ii) whether a claim is legal or equitable and thus whether a right to jury trial exists, and
 - A pre-petition malpractice claim is a legal claim Chauffeurs Teamsters & Helpers v Terry (1990).
 - Constitution prohibits bankruptcy courts from holding jury trials in non-core matters. In re Orion.
 - Seventh Amendment preserves right to jury trial in legal, not equitable claims. In re Joseph DelGreco & Co, Inc. (SDNY 2011).

- Where case is non-core and a jury demand has been filed, bankruptcy court's inability to hold trial may be grounds for withdrawal. In re Orion.
- (iii) whether other factors favor withdrawal, such as efficient use of judicial resources, delay and cost to parties, uniformity of bankruptcy administration, and prevention of forum shopping.
 - Examples:
 - Pre-petition legal malpractice claim withdrawn. In re Joseph DelGreco & Co, Inc. (SDNY 2011)
 - Mandatory withdrawal of the reference was warranted so that district court could address:
 - preemption by Securities Litigation Uniform Standards Act (SLUSA). Picard v HSBC Bank PLC, (SDNY 2011).
 - Mandatory withdrawal of the reference was warranted so that district court could address:
 - issue of how securities laws affected “good faith” showing under fraudulent transfer statute;
 - effect of Bankruptcy Code's safe harbor provision on trustee's ability to avoid constructively fraudulent transfers;
 - issue of whether trustee could avoid transfers that, under applicable securities laws, satisfied antecedent debts; and
 - issue of bankruptcy court's constitutional authority to finally adjudicate fraudulent transfer claims.
 - withdrawal not warranted:
 - to resolve argument that trustee could not bring avoidance actions under SIPA; and
 - to resolve issue of trustee's standing to bring fraudulent transfer claims Picard v Avellino (Bankr. SDNY 2012) (JSR)

V. Other Jurisdictional Issues, Traps and Exceptions

- **Nationwide Personal Jurisdiction**
 - Personal jurisdiction in bankruptcy court does not rest on a defendant's contacts with the forum state and whether the contacts are sufficiently compelling to subject the defendant to jurisdiction without violating “traditional notions of fair play and substantial justice.” Instead, personal jurisdiction in bankruptcy court is nationwide and is based simply on Rule 7004 of the Federal Rules of Bankruptcy Procedure which applies in adversary proceedings, i.e., any lawsuit instituted in a bankruptcy case and other contested matters under Rule 9014.
 - Rule 7004(f) provides that if the exercise of jurisdiction is “consistent with the Constitution and laws of the United States,” serving a summons under these rules “is effective to establish personal jurisdiction over the person of any defendant with

respect to a case under the Code or a civil proceeding arising under the Code, or arising in or related to a case under the Code.”

- In determining whether the exercise of personal jurisdiction in a bankruptcy case is consistent with the Constitution and the laws of the U.S., bankruptcy courts tend to look at the defendant’s contacts nationwide, not with the forum state, and the inquiry is whether the defendant could reasonably be expected to be forced into a federal court in any state. (If a creditor has significant issues with litigating in a distant jurisdiction, the creditor can move to transfer venue of the specific adversary proceeding, or even the entire bankruptcy case.)
- The lack of any statute, versus a procedural rule, evidencing Congress’s intent to confer nationwide personal jurisdiction in bankruptcy cases, creates the possibility that someday some litigant will appeal an adverse personal jurisdiction decision and obtain a Supreme Court decision on the limits of the exercise of personal jurisdiction in federal bankruptcy courts.
- **Service via Rule 7004(b)**
 - Rule 7004(b) provides for mailing the summons and complaint to the defendant via first class mail postage prepaid to effect proper service. Gaining nationwide jurisdiction via service of process by mail is easy, well-accepted, and de rigueur in the bankruptcy world.
 - In the case of a corporate defendant in a bankruptcy case, service can be completed by mailing a copy of the summons and complaint to the attention of an officer, a managing or general agent, or to any other agent authorized by statute to receive service.
 - As a result, an adversary complaint will in all likelihood arrive in the mail, simply addressed to an officer or agent, and be considered proper service. This means that a company with very little connection to the forum state may be subject to the court’s jurisdiction.
- **Worldwide Jurisdiction**
 - As part of the grant of exclusive jurisdiction over cases under title 11, the district court in which such cases are commenced are also granted exclusive jurisdiction over “all the property, wherever located, of the debtor as of the commencement of such case, and the property of the estate,” 28 USC 1334(e)(1), which has been interpreted to extend to property located worldwide, although the practical effectiveness of such broad jurisdiction depends on the court’s ability to exercise jurisdiction over the parties.
- **Ways around extraterritoriality – routing payments**
 - Another way in which personal jurisdiction in bankruptcy law may be exerted over an international defendant, despite the presumption against extraterritoriality, is by analyzing payments routed through U.S. bank accounts.
 - In re Arcapita Bank B.S.C. (Bankr. S.D.N.Y.) illustrates the risk of unwittingly bringing a foreign transaction within the reach of U.S. jurisdiction.
 - In In re Arcapita, the litigation focused on an avoidance action of a transfer by the debtor, a Bahraini investment bank, to a third party, two other Bahraini banks.
 - The location of the transfer, however, was routed through a U.S. bank account in New York.

- Because the transfer was routed through a bank in New York, the Bankruptcy Court (on remand) held dismissal was not warranted by the doctrine of international comity or the presumption against extraterritoriality because the Bahraini bank had directed payments to U.S. banks and it was unclear whether the creditors' committee could pursue claims in a foreign jurisdiction.
- Therefore, this routing of funds was sufficient to overrule the presumption against extraterritoriality and to drag Bahraini litigants into a New York bankruptcy court.
- Correspondent bank accounts, "behind the scene" bank accounts used by domestic banks to service transactions originating in foreign countries, must be considered in any analysis of whether your client is subject to bankruptcy court jurisdiction. The most common services provided by correspondent banks are currency exchange, handling business transactions, trade documentation, and money transfers. It is particularly important to consider the role of correspondent banks in your client's cash and securities transactions when looking at transfers to and from foreign/domestic banks to determine if your client will be subject to jurisdiction in a U.S. bankruptcy court.
- **Forum Selection Clauses**
 - Attorneys and litigants must be aware of forum selection clauses which require that actions be brought in a particular forum.
 - Forum selection clauses in contract provisions are "prima facie valid and should be enforced unless enforcement is shown by the resisting party to be 'unreasonable' under the circumstances." Bremen v. Zapata Off-Shore Co. (1972).
 - A bankruptcy debtor is not entitled to a more lenient burden of proof. See In re Diaz Contracting Corp. (3d Cir. 1987).
 - Note: There is a strong public policy interest in centralizing all core matters in bankruptcy, but this has not always held or applied where district courts had withdrawn the reference. In re Bennett Funding Group, Inc. (N.D.N.Y. 2001) (forum selection clause in a promissory note warranted a transfer pursuant to U.S.C. Section 1404(a)).
- **Small Dollar Venue Exception**
 - Venue for an adversary proceeding is generally proper in the district court in which a bankruptcy case is pending. 28 U.S.C. 1409(a) provides that except as provided in subsections (b) and (d), a proceeding "arising under," "arising in" or "related to" a bankruptcy case under title 11 may be commenced in the district court where the bankruptcy case is pending.
 - However, there are still exceptions in which the Bankruptcy Code provides a way for a litigant to switch out of a given venue.
 - One such exception is the "Small Dollar Venue" exception, in which certain small dollar suits--actions to recover a debt against a non-insider of less than \$12,850--may be brought in the district where the *defendant* resides or maintains its place of business rather than in the debtor's home court.
 - This allows vendors with small businesses or troubled businesses the ability to defend a matter in a more accessible forum without having to defend a preference avoidance (for example) from afar.

- The vendor's attorney can bring a Motion to Dismiss for Improper Venue, which often compels debtors or trustees to settle on favorable terms to avoid litigating this not-so-well-known issue.
- **Abstention**
 - We have covered some ways in which litigants and their attorneys can get themselves in and out of bankruptcy courts' jurisdictions. It should also be noted that bankruptcy courts also have the power to remove themselves from a case via abstention.
 - Abstention is a judicially created doctrine to resolve conflicts between Federal and state court and is based on comity with state courts.
 - Abstention in the context of bankruptcy cases is governed by 28 U.S.C. 1334(c) and is statutory by nature.
 - Abstention in the context of bankruptcy courts has been extended to administrative and federal forums. Eastport Assocs. v. City of Los Angeles (In re Eastport Assocs. (9th Cir. 1991))
 - There are two types of bankruptcy abstention, mandatory and permissive:
 - Mandatory abstention:
 - A bankruptcy court must abstain where:
 1. a timely motion is made by a party,
 2. a proceeding is based on a state law claim or cause of action,
 3. a proceeding is related to a case, not arising under the code or arising in a case (non-core proceeding requirement is the most important factor),
 4. but for the bankruptcy, a proceeding would have been brought in state, not federal court (i.e., no independent ground for federal jurisdiction), or
 5. an action is commenced which the bankruptcy court finds will be timely adjudicated. (Non-core proceedings involving the liquidation or estimation of personal injury tort and wrongful death claims against the estate are not subject to mandatory abstention.)
 - Permissive abstention:
 - A bankruptcy court *may* abstain where:
 1. Abstaining from hearing a proceeding arising under the Code or arising in or related to a case under the Code is in the interest of justice, comity with state courts, or respect for state law. 28 USC 1334(c)(1).
 2. Permissive abstention is not limited to state law claims. Bankruptcy courts have abstained to permit other federal courts and administrative boards to resolve disputes, e.g. government contract issues or other issues where federal law predominates over bankruptcy issues.