



Klayman

Felger

Delaware Bankruptcy Court Expounds on Meaning and Significance of *Stern*

Barry M. Klayman and Mark E. Felger

Special to the Delaware Business Court Insider | January 18, 2012

On Dec. 20, Judge Christopher S. Sontchi in *In re USDigital Inc.* became the first Delaware bankruptcy judge to set forth his views on the meaning and significance of the Supreme Court's decision in *Stern v. Marshall*. Sontchi's opinion is significant because it construes the *Stern* decision very narrowly and signals to the bankruptcy bar that the court will continue to protect its judicial authority to enter final orders.

The issue before Sontchi was whether a count in an adversary proceeding seeking equitable subordination of claims against the debtor's estate was a core or noncore proceeding. The court held that it was a core proceeding and *Stern* was not applicable. Sontchi spent most of the 28-page opinion discussing and dissecting the *Stern* decision.

Sontchi began by offering general observations regarding the holding in *Stern*, its limits and its import. First, Sontchi noted that *Stern* does not limit the bankruptcy court's subject matter jurisdiction. Specifically, it does not eliminate the court's "related to" jurisdiction. Second, *Stern* does not affect the statutory distinction between core and noncore proceedings set forth in 28 U.S.C. §157. In order for a matter to be core, it must be core under the statute. Third, if a matter is a core proceeding under the statute, the bankruptcy judge must also have judicial authority under the Constitution to enter final orders for the proceeding to be truly core. Fourth, if a matter is core under the statute and the Constitution, the bankruptcy judge may enter final orders, which are subject to normal appellate review by the district court. Fifth, noncore proceedings are those that are not core under the statute, or are core under the statute but over which the bankruptcy judge lacks the judicial power under the Constitution to enter final orders. Sixth, the bankruptcy judge's power over noncore proceedings is limited to issuing proposed findings of fact and conclusions of law that are subject to de novo review by the district court.

Sontchi noted that the parties may stipulate that a matter is a noncore proceeding, but it is unclear whether they may stipulate that it is a core proceeding. Lastly, a finding that a matter is a noncore proceeding when it has been asserted to be core does not, in and of itself, result in dismissal of the claim.

Sontchi proceeded to outline the test for determining whether a matter is a core or noncore proceeding. In order to be a core proceeding, it must be core under the statute. If it meets the statutory definition of a core proceeding, then the bankruptcy judge must determine whether, under the Constitution, the judge has the judicial power to enter final orders in the matter. If *Stern* is not applicable, or if it is applicable and by its application the bankruptcy judge has sufficient judicial power to enter final orders, then it is a core proceeding. If *Stern* is applicable and by its application the bankruptcy judge has insufficient judicial power to enter final orders, it is a noncore proceeding.

Sontchi then applied this test to the case before him. First, he had to determine whether the claim for equitable subordination is a core proceeding under 28 U.S.C. §157. He noted that if a matter fits into one of the 16 categories enumerated in the statute, it is core. However, after considering and rejecting several possibilities, Sontchi concluded that the trustee's equitable subordination claim does not fall within one of the specific categories in the statute. That does not end the inquiry, however, because Section 157 is not an exclusive list of core proceedings. Sontchi then proceeded to determine whether the equitable subordination claim is a nonenumerated core proceeding. Since *Stern* does not provide any guidance to determine whether a matter is core when it is not specifically enumerated as such, Sontchi looked to existing 3rd U.S. Circuit Court of Appeals law, which establishes a two-step process to determine whether a claim is a core proceeding: (1) Does the claim fit within Section 157's illustrative list of core proceedings; and (2) does it invoke a substantive right provided by Title 11 or is it a proceeding that could arise only in the context of a bankruptcy case. Applying this test, Sontchi concluded that equitable subordination is a substantive right provided by Title 11 and that it can only be raised in a bankruptcy case. Therefore, equitable subordination is a core proceeding under the statute.

That led Sontchi to the constitutional issue and specifically, whether *Stern* is applicable. To answer this question, Sontchi had to examine the holding in *Stern*. Sontchi acknowledged that *Stern* can be interpreted

broadly so as to eliminate the bankruptcy court's authority to enter final judgments on all state common-law tort claims, which would have "broad implications as to the judicial power of bankruptcy courts." Or, he said, *Stern* can be interpreted narrowly to hold only that the bankruptcy court lacks constitutional authority to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim.

Sontchi concluded that *Stern* must be read narrowly and that to read the decision broadly would be contrary to "the letter and spirit" of the Supreme Court's holding. He based his conclusion on statements in *Stern* that indicate the Supreme Court's belief that the ruling would have little effect. He found significant the Supreme Court's statement that it did not think the removal of counterclaims such as the one at issue in *Stern* from core bankruptcy jurisdiction would meaningfully change the division of labor in the current statute. Sontchi argued, "It is simply incredulous to conclude that the Supreme Court contemplated that its holding would transform all state common-law claims from core under the statute to noncore under the Constitution while stating that its ruling would not meaningfully change the division of labor in the current statute." To broadly apply *Stern's* holding, Sontchi said, is to create a mountain out of a mole hill.

Turning back to the specific issue before the court, Sontchi then quickly disposed of the question. Having already found that a claim for equitable subordination is a nonenumerated core proceeding under Section 157, he also found that the Supreme Court's holding in *Stern* is not applicable because it does not involve a state law counterclaim by the trustee to a creditor's proof of claim. Since *Stern* is not applicable, there is no need to inquire further regarding the court's judicial authority under the Constitution to enter a final order and the equitable subordination claim is a core proceeding.

Sontchi's opinion in *USDigital* should be required reading for anyone practicing before the bankruptcy court in the District of Delaware. It signals the court's intention to narrowly construe the Supreme Court's holding in *Stern* and to zealously protect the current allocation of judicial power between the bankruptcy court and the district court.

Barry M. Klayman is a member in the commercial litigation department, and **Mark E. Felger** is co-chair of the bankruptcy, insolvency and restructuring practice group, at [Cozen O'Connor](#).