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Colusa Mushroom: Is Clarity on Court Jurisdiction Beginning to Bloom Post-Bellingham?

Although the U.S. Supreme Court's holding in *Stern v. Marshall* was described in the majority opinion as being narrow and of limited application, noting that "we do not think [that] the removal of counterclaims such as [the debtor's] from core bankruptcy jurisdiction meaningfully changes the division of labor in the current statute,"¹ the dissent in *Stern* clearly foreshadowed the confusion and unintended consequences of the decision, as well as the anticipated eagerness of practitioners to test the boundaries of bankruptcy court jurisdiction post-*Stern*. Therefore, the bench and bar alike were hopeful when the Court granted *certiorari* in *Executive Benefits Ins. Agency v. Arkison (In re Bellingham Ins. Agency Inc.)*,² as they eagerly expected additional guidance from the Court on the issues of bankruptcy court jurisdiction that have been confounding both lawyers and judges since *Stern* was decided.

As most experienced bankruptcy practitioners now know, however, the *Bellingham* decision, while providing *some* clarity and guidance on the limits of bankruptcy court jurisdiction, which were left unsettled after *Stern*, sidestepped one issue of great importance: whether parties can consent to the entry of a final judgment by the bankruptcy court on a purely state law claim.

Despite the confusion caused by *Stern*, courts have begun to develop a fairly consistent body of law that addresses bankruptcy court jurisdiction, as well as the ability to enter final orders with respect to specific types of state law claims and causes of action. One area of the law where there is fairly consistent agreement on the bankruptcy court's ability to enter final orders is the resolution of legal malpractice claims that arise during the course of a bankruptcy proceeding. For example, in one of the first circuit court opinions to tackle the core-vs.-noncore debate in the post-*Bellingham* world, the Ninth Circuit Court of Appeals recently held that a post-petition legal malpractice claim brought

against a professional employed during the course of a chapter 11 case — and approved by the bankruptcy court — is a core proceeding for the purposes of bankruptcy court jurisdiction. In *Schultze v. Chandler*,³ the Ninth Circuit upheld the dismissal of a malpractice suit against counsel for the creditors' committee in the bankruptcy case of Colusa Mushroom Inc.

The Bankruptcy Court's Decision

Colusa Mushroom filed for chapter 11 protection after it was unable to overcome financial difficulties that arose out of its commercial mushroom-growing business. A creditors' committee was appointed pursuant to § 1102 of the Bankruptcy Code, and the committee hired David Chandler as its counsel, which was approved by the court pursuant to § 1103(a) of the Code.⁴

Ultimately, the debtor confirmed a chapter 11 plan that provided for the sale of its assets to Premier Mushroom LP. Unsecured creditors were to receive a *pro rata* share of the sale proceeds, and pursuant to the sale terms, Premier made an initial down payment and executed a promissory note for the remainder of the sale price, which provided for three annual payments of \$100,000 and a final balloon payment of \$1,022,453.⁵ The note was to be secured by a deed of trust on certain real property, as well as a junior security interest in certain personal property. Attorneys for Colusa and Premier, not committee counsel, conducted the closing, and the case was eventually closed.⁶

Four years later, Premier defaulted on the note, and it was discovered that Colusa's attorney had failed to file the financing statements that were necessary to perfect the junior security interest in the personal property that Premier had posted as collateral for the note.⁷ As the security interest had not been properly perfected, Premier was able to take out further loans and grant additional security interests that essentially overencumbered the personal property. The net recovery from the assets as a result of Premier's default was significantly less



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1 ---U.S. ---, 131 S. Ct. 2594, 2620 (2011).

2 134 S. Ct. 2165 (2014). For more on this case, see Danielle Spinelli and Craig Goldblatt, "Constitutional and Statutory Limits After *Executive Benefits*," XXXIII *ABI Journal* 8, 14-15, 74-75, August 2014. ABI also hosted a media teleconference in June 2014 with Danielle Spinelli (WilmerHale; Washington, D.C.), and Profs. John A.E. Pottow (University of Michigan Law School; Ann Arbor, Mich.) and Ralph Brubaker (University of Illinois College of Law; Champaign, Ill.). The audio is available in ABI's Newsroom at <http://news.abi.org/educational-brief/bankruptcy-experts-discuss-supreme-courts-ruling-in-executive-benefits-insurance-ag>.

3 *Schultze v. Chandler*, ---F.3d ---, 2014 WL 3537030 (9th Cir. Aug. 1, 2014).

4 *Id.* at *1.

5 *Id.*

6 *Id.*

7 *Id.*

than it would have been had the security interest been perfected, and the recovery of the unsecured creditors was substantially diminished.⁸

After discovering the failure to perfect the security interest, certain members of the creditors' committee initiated a malpractice action against Chandler in state court and alleged that he was negligent in the performance of his duties as counsel to the committee for his failure to ensure that the debtor's counsel properly perfected the security interest.⁹ Chandler removed the suit to bankruptcy court, and the plaintiffs moved to remand the action.¹⁰

In denying the plaintiffs' motion to remand for lack of jurisdiction, the bankruptcy court held that "[i]f a malpractice action is directed against a professional appointed by a bankruptcy court, there is federal jurisdiction over the matter and it is treated as a core proceeding.... In such cases, the malpractice claims are inseparable from the bankruptcy context."¹¹ The court concluded that as the creditors' committee is strictly a creation of a federal statute, the liability of court-appointed committee counsel is an issue that by its very nature can only arise in the bankruptcy context.¹² The court also granted Chandler's motion to dismiss on the basis that he did not owe a duty to the plaintiffs individually because he represented the committee as a whole.

District Court Affirms

On appeal, the plaintiffs argued that the malpractice claim was not a core proceeding in bankruptcy because such claims are based purely on state law.¹³ The plaintiffs further argued that because the claim did not affect the debtor, other creditors or the administration of the estate, the claim was not related to the bankruptcy proceeding.¹⁴ The district court affirmed, finding that the state law malpractice claim was core, as the allegations supporting the malpractice claim were unique to the bankruptcy proceeding and bankruptcy law.¹⁵ These allegations included the following: (1) the plaintiffs were allegedly harmed because they were members of the creditors' committee; (2) the action was against the attorney whose employment was approved by the bankruptcy court; (3) Chandler's role as committee counsel was unique to bankruptcy; and (4) the plaintiffs were requesting damages for money that they would have received pursuant to the confirmed plan.¹⁶

The Ninth Circuit

A unanimous three-judge panel of the Ninth Circuit Court of Appeals affirmed the district court's finding that the bankruptcy court properly exercised jurisdiction over the malpractice suit and correctly dismissed the case on the merits.¹⁷ The Ninth Circuit defined a core proceeding arising in title 11 as one that is "not based on any right expressly created by title 11, but nevertheless, would have no existence outside of

the bankruptcy."¹⁸ By contrast, where the post-petition action involves rights that are not connected to the bankruptcy, the matter has been declared noncore.¹⁹ The Ninth Circuit noted that it had previously determined that post-petition claims brought against a court-appointed professional are core proceedings,²⁰ and reasoned that a *sine qua non* in bankruptcy is the court's ability to police court-appointed professionals and other fiduciaries that are responsible for managing the estate in the best interests of the creditors.²¹

The Ninth Circuit found that the malpractice claim "easily" fell within the definition of a core proceeding as Chandler was appointed pursuant to § 1103, his compensation was approved by the court pursuant to §§ 328, 330 and 331, his duties pertained to the administration of the estate, the claim was predicated on acts that occurred during the bankruptcy and in the administration of the estate, and any alleged duties arose from obligations created under bankruptcy law.²² The court ultimately concluded that the particular malpractice claim was inseparable from the bankruptcy case.

Schultze Is Consistent with the Law in Most Circuits

As noted by the Ninth Circuit in *Schultze*, other circuits that have been faced with the malpractice issue have similarly held that malpractice actions against court-appointed professionals are core proceedings.²³ In fact, the Fourth Circuit in *Grausz v. Englander* went so far as to hold that the failure to raise a malpractice claim in connection with counsel's fee application filed in a bankruptcy case precludes a later attempt to bring the malpractice action based on the principles of *res judicata*.²⁴

In *Frazin v. Haynes and Boone LLP (In re Frazin)*,²⁵ a post-*Stern* but pre-*Bellingham* case from the Fifth Circuit Court of Appeals, the court held that pursuant to the Supreme Court's decision in *Stern*, bankruptcy courts cannot enter final judgments in a specific type of core proceeding (*i.e.*, state law counterclaims that are not resolved in or related to the claims-allowance process). Moreover, the court held that a bankruptcy court may not constitutionally determine state law counterclaims or noncore proceedings, even with the parties' consent. In that case, the chapter 13 debtor hired, with court approval, Haynes and Boone LLP to represent him in the appeal of certain state court judgments that had been entered in his favor. The parties thereafter settled the appeal for \$3.2 million, which was wired to Haynes and Boone's trust account. The firm then filed a fee

18 *Id.* at *2 (citing *Maitland v. Mitchell (In re Harris Pine Mills)*, 44 F.3d 1431, 1435 (9th Cir. 1995) (quotations omitted)).

19 *Id.*

20 *Id.* (citing *In re Ferrante*, 51 F.3d 1473, 1476 (9th Cir. 1995)).

21 *Id.* at 3 (quoting *In re Southmark Corp.*, 163 F.3d 925, 931 (5th Cir. 1999)).

22 *Id.*

23 See *Baker v. Simpson*, 613 F.3d 346, 350 (2d Cir. 2010) (malpractice claim against debtor's bankruptcy counsel is core); *Billing v. Ravin, Greenberg & Zackin PA*, 22 F.3d 1242, 1244 (3d Cir. 1994) (same); *Southmark Corp.*, 163 F.3d at 932 (state law claim against court-appointed accountant for examiner is core); *Sanders Confectionery Prods. Inc. v. Heller Fin. Inc.*, 973 F.2d 474, 483 n.4 (6th Cir. 1992) (wherein debtor brought claim against trustee and lender, action was core as to trustee but not lender); *In re Tanamor*, 2013 WL 3938978 (Bankr. D. Md. 2013) (although counsel for chapter 7 debtor was not appointed by the court, a malpractice action against counsel was core as the court had obligation to review counsel's fees and compensation received from debtor must be disclosed pursuant to Bankruptcy Rule 2016).

24 321 F.3d 467 (4th Cir. 2003).

25 732 F.3d 313 (5th Cir. 2013).

8 *Id.*

9 *Schultze v. Chandler (In re Colusa Mushroom Inc.)*, 2011 WL 2293140 (Bankr. N.D. Cal. June 9, 2011).

10 *Id.*

11 *Id.* at *1 (citations omitted).

12 *Id.*

13 *Schultze v. Chandler*, 2011 WL 6778823 (N.D. Cal. Dec. 27, 2011).

14 *Id.*

15 *Id.*

16 *Id.*

17 *Schultze v. Chandler*, 2014 WL 3537030 at *4.

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application, but the debtor objected while also asserting state law counterclaims against the attorneys for negligence, violations of the Texas Deceptive Trade Practices Act (DTPA) and a breach of fiduciary duty.

The bankruptcy court overruled the debtor's objections to the attorneys' fee applications, awarded the attorneys the amount that was requested in their original fee applications, and ruled against the debtor on the merits of his negligence claims, DTPA claims, and breach-of-fiduciary-duty claims. The district court affirmed the bankruptcy court's judgment, and the debtor appealed to the Fifth Circuit, arguing for the first time that the bankruptcy court did not have the authority to enter a final judgment on his state law counterclaims.

The Fifth Circuit equated the state law counterclaims to the counterclaims brought in *Stern* as "core proceedings" covered by 28 U.S.C. § 157(b)(2)(C). The law in the Fifth Circuit before *Stern* was that bankruptcy courts had the authority to enter final judgments in all proceedings defined as "core" under § 157(b) of the Bankruptcy Code.²⁶ However, the *Frazin* court held that *Stern* overruled its prior decisions on the issue and that under *Stern*, bankruptcy courts cannot enter final judgments in a specific type of core proceeding: state law counterclaims that are not resolved in the claims-allowance process.

The Fifth Circuit was careful to state that its holding did not apply to other core proceedings under § 157(b)(2), but the ruling was instead limited to state law counterclaims under § 157(b)(2)(C).²⁷ Ultimately, the Fifth Circuit held that the bankruptcy court had jurisdiction to resolve two of the three claims brought by the debtor, and most importantly, "Frazin's claim for malpractice was necessarily decided by the bankruptcy court in the process of ruling on the attorneys' fee applications and thus fell constitutionally within the bankruptcy court's jurisdiction."²⁸ "Frazin's fee-forfeiture action arose as part of the Attorneys' fee application, and the bankruptcy court could not rule on the Attorneys' fee applications without resolving Frazin's fee-forfeiture claim. Thus,

the bankruptcy court had jurisdiction to resolve Frazin's fiduciary duty claim."²⁹

During the course of the appeal, Haynes and Boone argued that Frazin had consented to bankruptcy court jurisdiction and waived any objection to the same by filing his counterclaims in bankruptcy court.³⁰ The Fifth Circuit responded to this argument, albeit in a footnote, by stating that when "separation of powers is implicated in a given case, the parties cannot by consent cure the constitutional difficulty.... When these Article III limitations are at issue, notions of consent and waiver cannot be dispositive because the limitations serve institutional interests that the parties cannot be expected to protect."³¹ "*Stern* makes [it] clear that the practice of bankruptcy courts entering final judgments in certain state law counterclaims 'compromise[s] the integrity of the system of separated powers and the role of the Judiciary in that system.' Thus, structural concerns cannot be ameliorated by Frazin's consent or waiver."³²

Conclusion

The Supreme Court recently granted *certiorari* in the case of *Wellness International Network Ltd., et al. v. Sharif*, a decision out of the Seventh Circuit that held that the bankruptcy court lacked the constitutional authority to determine whether purported trust assets were property of the debtor's bankruptcy estate.³³ In *Wellness*, the Court will have yet another opportunity to address the issue of whether the parties in a bankruptcy matter can consent to the bankruptcy court entering final judgment on a state law claim. Until then, it appears that the bench and bar can at least rest easy regarding a bankruptcy court's jurisdiction over certain types of legal malpractice claims. **abi**

²⁹ *Id.* at 323.

³⁰ With respect to the DTPA claim, the court found that "although the bankruptcy court necessarily had to resolve most, if not all, of Frazin's factual allegations that supported his DTPA claims in the course of addressing claims that were otherwise within the court's jurisdiction, the bankruptcy court was not required to resolve the legal effect flowing from those factual allegations in the context of a DTPA claim." *Frazin*, 732 F.3d at 323. Therefore, the Fifth Circuit concluded that the bankruptcy court lacked the authority to enter a final judgment as to this one claim.

³¹ *Id.* at 320, n. 3 (citing *C.F.T.C. v. Schor*, 478 U.S. 833, 850-51 (1986)).

³² *Id.* (quoting *Stern*, 131 S. Ct. at 2620).

³³ 727 F.3d 751 (7th Cir. 2013).

²⁶ See *In re Hudson Shipbuilders Inc.*, 794 F.2d 1051, 1054-55 (5th Cir. 1986).

²⁷ *Frazin*, 732 F.3d at 320, n.2.

²⁸ *Id.* at 321.

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