No. 11-628

In the

Supreme Court of the United States

October term 2011

IN RE BLOCKBUSTERS, INC., DEBTOR

Natallie Santana, Chapter 11 Trustee

Petitioner

v.

Rachel Ray Warner Bakes, Inc.

Respondent

On Writ of Certiorari
to the United States Court of Appeals
for the Thirteenth Circuit

BRIEF FOR RESPONDENT

Team R42
Counsel for Respondent
QUESTIONS PRESENTED

1. Whether a debtor’s misuse of cash collateral permits the bankruptcy trustee to recover funds transferred to an innocent third-party vendor in the ordinary course of business, where there is no harm to the bankruptcy estate.

2. Whether the bankruptcy court exceeded its constitutional authority as a non-Article III tribunal when it entered a final judgment in a non-core proceeding.
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**OPINIONS BELOW**

The judgment and order of the United States Bankruptcy Court for the District of Moot is unpublished and can be found in the Record on Appeal. (R. at 6.) The opinion of the United States District Court for the District of Moot is unpublished and is found in the Record. (R. at 6.) The opinion of the United States Court of Appeals for the Thirteenth Circuit is also unpublished and set out in the Record on Appeal. (R. at 2.)

**STATEMENT OF JURISDICTION**

The formal statement of jurisdiction is waived pursuant to Competition Rule VIII.

**STATUTORY PROVISIONS**

STATEMENT OF THE CASE

I. Statement of Facts

_The rise and fall of Blockbusters, Inc._ About fifteen years ago, Blockbusters, Inc., (the “Debtor”) began hosting conventions where fans of composers Stephen Sondheim and Andrew Lloyd Webber could converge and celebrate their favorite musical theater productions. (R. at 2-3.) The conventions were successful for several years, but as fickle fans began to lose interest in Sondheim’s and Webber’s Broadway shows, attendance at the conventions waned and revenue fell. (R. at 3.) An ill-timed fall 2008 convention, just weeks after the collapse of Lehman Brothers, proved to be the fatal blow to the Debtor. (R. at 3.) Potential convention-goers decided to stay home and save their ticket money, and the die-hard fans who did attend were hesitant to spend money on memorabilia. (R. at 3.) The Debtor found itself unable to make its scheduled loan payment to Broadway Bank (the “Bank”) and ultimately filed for Chapter 11 bankruptcy after negotiations to refinance the loan failed. (R. at 3.)

_The chance to rebuild._ The Debtor saw its upcoming spring 2009 convention as a chance to recoup some losses. (R. at 4.) To finance what it hoped would be its “biggest show ever,” the Debtor sought financing from the Bank and obtained court approval for a stipulated cash collateral order. (R. at 3-4.) The order allowed the Debtor to spend $1.5 million on the spring convention, with $500,000 of that designated for payments to vendors. (R. at 4.)

_The plan that takes the cake._ The Debtor contacted Rachel Ray Warner Bakes, Inc., (the “Respondent”) with an unusual request: a full-scale model of the “West Side Story” set, made exclusively of cake. (R. at 4.) The Respondent and the Debtor agreed on a cost of $250,000 for the cake. Because the Respondent knew that the Debtor was in Chapter 11 bankruptcy, it was initially hesitant to commit to such a massive undertaking. (R. at 4.)
Respondent’s fears were allayed, however, when the Debtor produced the cash collateral order authorizing payments to vendors totaling twice what the cake would cost. (R. at 4.) The Respondent asked for $100,000 in advance, with the balance of $150,000 due before delivery. (R. at 4.) The Debtor paid the advance and the Respondent began working on the project. (R. at 4.) On the day before the scheduled delivery of the cake, the Debtor paid the balance owed and the Respondent delivered and assembled the cake. (R. at 4-5.)

**The convention.** The Respondent’s baked masterpiece was the star of the show. (R. at 5.) The uniqueness of the project drew the attention of local media, whose feature stories directly resulted in increased attendance at the convention. (R. at 5.) Thanks in no small part to the Respondent’s cake-engineering prowess, the convention was a huge success. (R. at 5.) The Debtor’s gamble paid off and the convention was profitable. (R. at 5.)

**The Debtor’s impropriety comes to light.** What the Respondent could not have known when it delivered and assembled the cake was that the Debtor had violated the terms of its cash collateral order with the Bank. (R. at 5.) The legitimacy of the initial $100,000 paid in advance of the cake’s construction was not questioned, but the second payment of $150,000 exceeded both the designated budget for vendors and the overall cash collateral budget. (R. at 5.) When the Bank discovered this, it sought and obtained a Chapter 11 trustee to manage the Debtor’s business. (R. at 5.) The Bank then demanded that the trustee initiate a proceeding in bankruptcy court to avoid the post-petition transfer of funds under 11 U.S.C. § 549(a) and to recover the $150,000 from the Respondent pursuant to 11 U.S.C. § 550(a)(1). (R. at 5-6.)

**II. Nature of the Proceedings**

**Proceedings in bankruptcy court.** A bench trial proceeded in the bankruptcy court for the District of Moot, the Honorable Ivy Grey presiding. (R. at 6.) Judge Grey denied the
Respondent the opportunity to present evidence showing that the transferred funds were received in good faith and that the cake contributed to the convention’s success, which resulted in profit exceeding the amount of the transfer in question. (R. at 6.) Judge Grey also denied the Respondent’s objections based on the bankruptcy court’s lack of jurisdictional authority to enter a final judgment. (R. at 6.) The judge then ruled against the Respondent on all issues, holding that the bankruptcy court was authorized to “issue orders for actions arising under the Bankruptcy Code,” and that the payment of $150,000 was unauthorized and avoidable. (R. at 6.) Judge Grey then entered a final order awarding judgment against the Respondent in the amount of $150,000. (R. at 6.)

**Proceedings in district court.** The Respondent appealed Judge Grey’s decision in the district court for the District of Moot. (R. at 6.) There, the Honorable Mary-Tipton Thalheimer summarily affirmed the bankruptcy court’s holding. (R. at 6.)

**Proceedings in the Court of Appeals.** Judges Leggett, Cornell, and Khatchatourian heard the case on appeal to the Thirteenth Circuit Court of Appeals and reversed the holding of the lower court. (R. at 2, 7.) Judge Cornell, writing for the majority, held that the trustee’s ability to recover funds from a post-petition transferee is subject to equitable defenses when the transferee is innocent and the error is harmless. (R. at 7, 11.) Further, the majority held that the bankruptcy court exceeded its jurisdictional authority as a non-Article III tribunal when it entered a final order in light of this Court’s recent holding in *Stern v. Marshall*, 131 S. Ct. 2594 (2011). (R. at 7, 12.)

**SUMMARY OF THE ARGUMENT**

The Court is presented with two issues: (1) whether a transfer of cash collateral funds in excess of the permitted amount is subject to avoidance and recovery from the transferee
when there is no harm to the bankruptcy estate and the transferee is innocent; and (2) whether
a bankruptcy court has the constitutional authority to enter a final order and judgment in a non-
core proceeding under the principles set forth in this Court’s holding in *Stern*.

First, the bankruptcy court incorrectly characterized the transfer of funds at issue as
unauthorized. While it is true that the second transfer of $150,000 was in excess of the amount
allowed under the cash collateral order, that fact alone does not render the transaction
unauthorized; it is instead a matter of unfortunate timing for which the Respondent cannot be
held liable. Moreover, 11 U.S.C. § 1108 and § 363(c)(1) provide additional authorization for
the transaction, which was completed as part of the debtor-in-possession’s operation of the
business and which occurred in the ordinary course of business.

As a court of equity, a bankruptcy court is empowered to fashion equitable solutions
for parties when a strict application of the law would create absurd results. The Respondent is
an innocent third party whose only blunder was allowing the Debtor to pay for the cake in two
installments. Additionally, the cake that Respondent made was the key component that
enabled the Debtor’s spring 2009 convention to be profitable—so profitable, in fact, that the
total revenue generated far exceeded the $150,000 at issue here. Thus, there is no harm to the
bankruptcy estate; on the contrary, the Bank is now in a better position financially as a result
of the convention’s success by virtue of its lien on the Debtor’s assets. To now forcibly extract
the $150,000 from the Respondent would be to allow the Bank or the estate to profit from the
Debtor’s misuse of the cash collateral funds. This result is contrary to the goal of § 550(a)—to
restore the estate to the condition it would have enjoyed had the transfer not been made.

Second, the bankruptcy court overstepped both its statutory and its constitutional
jurisdictional authority when it entered the final order. The Framers built in constitutional
protections of lifetime tenure and irreducible salary for Article III judges in order to protect the judiciary’s independence and maintain the separation of powers. Bankruptcy courts are created legislatively and bankruptcy judges do not enjoy those same protections. For that reason, bankruptcy judges are not given broad judicial power but instead have limited jurisdiction. The post-petition transfer in this case, because it is not a core proceeding under 28 U.S.C. § 157, must be adjudicated in an Article III court and not a bankruptcy court. Further, based on the principles this Court advanced in Stern, the bankruptcy court’s issuance of a final order violated Article III of the Constitution. Finally, the public rights doctrine, a limited exception to exclusive Article III jurisdiction, does not apply here. Thus, only an Article III court has the authority to enter a final order in this case.

This Court should affirm the decision of the Thirteenth Circuit Court of Appeals and hold that recovery of the post-petition transfer funds from an innocent vendor is subject to equitable defenses when there is no harm to the estate, and this Court should remand the case to the United States District Court in the District of Moot for further proceedings, as the bankruptcy court lacks jurisdiction over the matter.

ARGUMENT

I. The transfer of cash collateral funds to the Respondent was not unauthorized, and principles of equity demand an exception to an avoidance action under § 549(a) when the transferee is innocent and the error is harmless.

The bankruptcy court’s final judgment ordering the Respondent to return the $150,000 received in exchange for the cake was based on its finding that the transfer of funds was unauthorized and thus avoidable under § 549(a). (R. at 6.) Although the amount of the transfer exceeded the amount allowed in the cash collateral order (R. at 5), the transaction itself was
not unauthorized, as statutory authority for the transfer of funds can be found in § 1108 and in § 363(c)(1). But even if this Court finds that the transfer is avoidable and recoverable under § 550(a), a literal interpretation of that statute leads to an inequitable result. This Court should acknowledge that the Respondent is blameless and that forcing it to repay the $150,000 will effectively enrich the Bank or the estate at the Respondent’s expense. (R. at 10.) Instead, the Court should allow the Respondent to present evidence of equitable defenses on remand to the District Court for the District of Moot.

A. The transfer of funds was not an unauthorized transfer under § 549 of the Bankruptcy Code.

Under § 549, a bankruptcy trustee “may avoid a transfer of property of the estate—(1) that occurs after the commencement of the case; and . . . (2)(B) that is not authorized under this title or by the court.” The purpose of § 549 is to protect creditors by providing a remedy when a debtor makes an unauthorized transfer from the bankruptcy estate to a third party, after the bankruptcy petition has been filed. See In re Paige, 413 B.R. 882, 913-14 (Bankr. D. Utah 2009).

To succeed on an avoidance action, a trustee must show “(1) a post-petition transfer (2) of estate property (3) which was not authorized by the Bankruptcy Code or the court.” In re Delco Oil, Inc., 599 F.3d 1255, 1258 (11th Cir. 2010); see also In re Russell, 227 B.R. 196, 198 (Bankr. M.D. Ga. 1998) (establishing a similar, four-part test for avoidance). Once the trustee has met that threshold, the burden of proving that the transfer was valid shifts to the party asserting its validity. Delco, 599 F.3d at 1259. Then, if a court finds a transaction to be avoidable, under § 550(a) the trustee may recover the property or the value of the property from the initial transferee.
Here, neither party disputes that the first two elements of an avoidance action have been satisfied. The Debtor transferred money to the Respondent after filing a bankruptcy petition. (R. at 4-5.) The money transferred was from a cash collateral order with the Bank, which is considered part of the bankruptcy estate, and the Debtor may not transfer that property without authorization. § 363(c)(2). Thus, having established that there was a post-petition transfer of estate property, the pertinent question is whether the transaction was authorized under the Code or by the court.

1. The transfer was authorized under §§ 1108 and 363(c)(1) of the Bankruptcy Code.

Importantly, the Bankruptcy Code specifies that an avoidance action will not succeed if the transfer of funds was authorized “under this title or by the court.” § 549(a)(2)(B). At first glance, it may appear that the transfer of $150,000 in cash collateral funds was unauthorized because that amount exceeded the amount of total cash collateral funds and the budget allocated for payments to vendors. (R. at 5.) But review of other relevant sections of the Code reveals that the transfer in question was an authorized transaction. The Debtor had statutory authorization to operate the business and to use the property of the estate in the ordinary course of business.

a. The transfer of funds was proper because the debtor-in-possession had statutory authority to operate the business under § 1108.

Section 1108 permits a trustee to “operate the debtor’s business” except as otherwise ordered by the court. When no trustee has been appointed, as is the case here at the time of the transfer, § 1107(a) bestows the powers of the trustee to the debtor-in-possession. The debtor-in-possession is granted broad authority in this regard, in the hope that continued business activity will help to improve the viability of its business. “A Chapter 11 debtor should be given

Of course, the authority under § 1108 is not without limits. The debtor-in-possession must exercise its business judgment in good faith, on a reasonable basis, and in accordance with its authority in the Code. *In re Consol. Auto Recyclers, Inc.*, 123 B.R. 130, 140 (Bankr. D. Me. 1991). But where the transaction is “based on well articulated reasons supported by facts and is not on unsupported, speculative assumptions or based on decisions made arbitrarily and capriciously without any basis,” the court will not intervene. *Matter of S. Biotech, Inc.*, 37 B.R. 318, 322-23 (Bankr. M.D. Fla. 1983).

The Debtor’s decision here to commission a cake for the convention certainly falls within these boundaries. As the majority in the Thirteenth Circuit opinion noted, the Debtor realized that a successful 2009 spring convention was crucial to the business’s future viability. (R. at 4.) The strategy of creating a publicity-generating spectacle in the form of a life-sized cake replica of the “West Side Story” set may have been a gamble, but it was not arbitrary or capricious. In fact, the soundness of the strategy is reflected by the fact that it was successful in drawing large numbers of people to the convention, which resulted in a profit for the business. (R. at 5.) The Debtor’s use of its authority to operate its business here led to the very result that was intended in formulating the statute: the rehabilitation of the business.

**b. The transfer of funds was proper because it was made in the ordinary course of business pursuant to § 363(c)(1).**

Section 363(c)(1) allows the debtor-in-possession to use the estate’s property in the ordinary course of business. The purpose of that provision is similar to the purpose of § 1108 in that it is designed to allow a viable business the opportunity to rehabilitate itself during
bankruptcy proceedings. *In re Johns-Manville Corp.*, 60 B.R. 612, 617 (Bankr. S.D.N.Y. 1986). “The policy behind the Code recognizes that the debtor needs a certain degree of freedom on its road to reorganization so that it might avoid precisely those pitfalls which brought it into bankruptcy initially.” *Id.* This flexibility must be balanced with the need to maximize the value of the estate for the protection of creditors. *United States ex rel. Harrison v. Estate of Deutscher*, 115 B.R. 592, 599 (M.D. Tenn. 1990).

The Bankruptcy Code does not provide a definition of “ordinary course of business”; however, the courts have constructed a two-part test for determining the nature of a transaction. *Habinger, Inc., v. Metro. Cosmetic and Reconstructive Surgical Clinic, P.A.*, 124 B.R. 784, 786 (D. Minn. 1990). The two parts of the test were developed separately, but both must be met for a transaction to have occurred in the ordinary course of business. *In re Dant & Russell, Inc.*, 853 F.2d 700, 705 (9th Cir. 1988). The tests are guidelines rather than rigid rules. “If either test or dimension is not satisfied, then the disputed transaction is ‘most likely’ not in the ordinary course of business.” *Habinger*, 124 B.R. at 786.

The horizontal dimension test compares the transaction in question with typical transactions of like businesses. “In this comparison, the test is whether the post-petition transaction is of a type that other similar businesses would engage in as ordinary business.” *Dant & Russell*, 853 F.2d at 704; *see also Johns-Manville*, 60 B.R. at 618. The transaction is viewed from an industry-wide perspective to ensure that the debtor did nothing extraordinary to gain an advantage over its creditors. *Dant & Russell*, 853 F.2d at 704. Whether the type of transaction occurs frequently or even regularly is not indicative of its ordinariness, however. “The transaction need not have been common; it need only be ordinary. A transaction can be

Here, the Debtor’s business is hosting conventions at which fans of Broadway musicals can meet cast members, commune with fellow Broadway fans, and purchase memorabilia. (R. at 3.) The purchase of the life-sized cake replica of the “West Side Story” set was accomplished in order to lure potential convention attendees. (R. at 4.) Any convention-hosting business would be expected to spend money on props, displays, and exhibits to enhance the convention’s atmosphere, and the purchase of this cake was no different. To be sure, the fact that the set was made of cake is highly unusual, but it is not the composition of the set that is relevant to this inquiry; rather, it is the general nature of the set replica and its direct relationship to the theme of the convention that make it sufficient to pass the horizontal dimension test.

The second half of the test for determining whether a transaction was in the ordinary course of business is the vertical dimension test, which views the transaction from the perspective of a hypothetical creditor. Johns-Manville, 60 B.R. at 616. The question here is “whether the transaction subjects a creditor to economic risks of a nature different from those he accepted when he decided to extend credit.” Id. The debtor’s pre-petition transactions are compared to post-petition activities in light of changing circumstances based on the reasonable expectations of the creditor. Id. at 617. Thus, for example, a business that was engaged in selling mobile homes pre-petition was allowed to continue selling mobile homes post-petition in the ordinary course of business. In re Cnty. Line Homes, Inc., 43 B.R. 440, 441 (E.D. Mo. 1984).
Similarly, before filing its bankruptcy petition, the Debtor here was engaged in hosting conventions for Broadway fans (R. at 2-3), and that same activity post-petition is part of its ordinary course of business. The specifics of the promotional materials and props the Debtor purchased in preparation for its spring 2009 convention are not critical to the finding that they were made in the ordinary course of business. Instead, the important point is that the Debtor’s post-petition transaction in purchasing the cake, while creative and novel, was not out of the ordinary. Had the Debtor chosen to have a mock-up of the “West Side Story” set made of wood instead of cake, there would be no question about the ordinariness of the transaction. Further, the transaction in question did not expose the creditors to any different level of risk than they assumed when extending credit. In fact, the Bank extended cash collateral explicitly for the purpose of financing the spring 2009 convention. (R. at 3-4.) The purchase of the cake was made in the ordinary course of business and thus also passes the vertical dimension test.

In sum, the Petitioner’s claim that the post-petition transfer of $150,000 to Respondent was unauthorized fails on two grounds. First, the transfer of funds was authorized under § 1108, which authorizes the debtor-in-possession to operate the business. Second, the transfer was made in the ordinary course of business pursuant to § 363(c)(1) because it passes both the horizontal dimension test and the vertical dimension test. Therefore, the transfer was not unauthorized and is not avoidable under § 549.

2. The Delco holding is inapplicable to this case because the transfer here was not specifically prohibited.

To the extent that the Petitioner relies on Delco, 599 F.3d 1255, as the Thirteenth Circuit below noted, that reliance is misguided because the facts of Delco are dissimilar to the facts here. There, Delco Oil filed for Chapter 11 bankruptcy and requested cash collateral from CapitalSource Finance. Id. at 1257. The bankruptcy court denied the request, but Delco, as
debtor-in-possession, proceeded with the purchase of almost two million dollars’ worth of petroleum products from Marathon Petroleum Company. *Id.* When Delco converted to Chapter 7 bankruptcy and the court appointed a trustee, the trustee filed an action against Marathon to avoid the transfers and recover the funds. *Id.* The bankruptcy court granted summary judgment in favor of the trustee, the district court affirmed, and Marathon appealed. *Id.*

The Eleventh Circuit upheld the lower courts’ rulings, rejecting Marathon’s argument that the funds it received could not be cash collateral, because the court had not authorized the use of cash collateral. *Id.* at 1259. Marathon claimed that any security interest that CapitalSource Finance might have had in the funds was stripped when Marathon received them. *Id.* at 1260 n.2. But the court found authority for the avoidance “not because CapitalSource continued to have a security interest in the funds once they were in the hands of Marathon, but because Debtor was not authorized to transfer the funds to anyone post-petition without the permission of CapitalSource or the bankruptcy court.” *Id.* at 1260.

The transfer of funds in *Delco* was notably different than the transfer of funds in this case. Delco’s transfer of nearly two million dollars was unauthorized in that the court had specifically denied Delco’s request to use cash collateral for any purpose. *Id.* at 1257. Delco transferred funds in exchange for petroleum products in direct opposition to the court’s ruling on the matter. *Id.* Thus, not only was that transfer unauthorized, any post-petition transfer would have been unauthorized and thus avoidable under § 549. *Id.*

In contrast, the transfer of funds in this case was authorized under the cash collateral order between the Bank and the Debtor. (R. at 3-4.) The stipulated order was for $1.5 million total cash collateral, with only $500,000 being allocated for payments to vendors. (R. at 4.) While it is true that the Debtor’s second transfer of funds to the Respondent was in excess of
both the amount specified for vendors and the total amount approved, the transaction itself was not unauthorized. Payment to the Respondent has been singled out for this avoidance action solely because of the timing of the payment, not because the transfer was unauthorized. Had the Respondent requested payment in full before construction of the cake began, rather than asking for two installment payments, there would be no avoidance action pending against the Respondent. Instead, some other honest vendor that received its funds after the Debtor exceeded its budget would be the Respondent here. Thus, it is not accurate to say that the transfer of funds was an unauthorized transaction. The Debtor violated the terms of the cash collateral order, which is a matter for the Bank and the Debtor to settle; the Respondent should not be held liable for the amount of the transfer.

B. Principles of equity mandate that a § 549 avoidance action is subject to equitable defenses when the transferee receives funds in good faith and there is no harm to the estate.

Bankruptcy courts are courts of equity, authorized to apply principles of equity to cases brought before them. Pepper v. Litton, 308 U.S. 295, 303-04 (1939); see also Larson v. First State Bank of Vienna, S.D., 21 F.2d 936, 938 (8th Cir. 1927). As such, bankruptcy courts are concerned with applying the law in such a way as to prevent harsh or unjust results. Pepper, 308 U.S. at 304. “[Equitable powers] have been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done.” Id. at 304-05. The equitable powers of the bankruptcy court include the ability to disallow claims that are otherwise deemed valid. See Adelphia Recovery Trust v. Bank of America, N.A., 390 B.R. 64, 76 (S.D.N.Y. 2008).
1. As a court of equity, the bankruptcy court is empowered to create exceptions to bankruptcy provisions to avoid inequitable results.

Admittedly, the bankruptcy court’s ruling is based on the plain language of the statutes, which generally do not authorize exceptions for innocent third parties. (R. at 6.) As a court of equity, however, the bankruptcy court is not necessarily bound by the strict language of the Code, especially when the result of such an interpretation is unfair. See Pepper, 308 U.S. at 304-05. Instead, the court has the discretion to apply the law in a way that does not create an inequitable result. Id.

In Delco, Marathon argued that because Delco had received an equivalent value of petroleum products in exchange for almost two million dollars in cash, there was effectively no harm to the estate, at least on paper. 599 F.3d at 1262. The Eleventh Circuit rejected that argument, however, stating that § 549 does not provide an exception for a harmless error. Id. Employing a narrow, literal reading of the statutes, the court refused to consider a defense for Marathon based on its status as an “innocent vendor,” finding no authority to create an exception where Congress had not already done so. Id. at 1263. As the Thirteenth Circuit noted in its majority opinion, this “tortured reading” of the statute “produces an absurd and unworkable system.” (R. at 9.)

In fact, the Eleventh Circuit itself recognized the need for equitable exceptions when recovering funds from post-petition transferees in In re Harwell, 628 F.3d 1312 (11th Cir. 2010). Harwell involved fraudulent transfers and whether the “initial transferee” in § 550(a) could “equitably escape” the recovery action. Id. at 1323-24. The court acknowledged that it would employ a “flexible, pragmatic, equitable approach of looking beyond the particular transfer in question to the circumstances of the transaction in its entirety.” Id. at 1322. Thus, while the facts of Harwell are different from the facts here, the court’s recognition that it need
not adopt a rigid interpretation of the statute when the circumstances demand otherwise is “consistent with the equitable concepts underlying bankruptcy law.” Id. (citing In re Chase & Sanborn Corp., 848 F.2d 1196, 1199 (11th Cir. 1988)); see also Bank of Marin v. England, 385 U.S. 99, 103 (1966) (“There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction.”). The Respondent here is merely asking for the same consideration.

2. **Even if the transfer is avoidable under § 549(a), the funds are not recoverable under § 550(a)(1) because the estate was restored by virtue of the convention’s profit.**

Finally, even if this Court finds that the transfer of funds was unauthorized and is avoidable under § 549, the bankruptcy court erred when it awarded judgment against the Respondent for the amount of the transfer pursuant to § 550(a)(1). In pertinent part, § 550(a)(1) provides that “to the extent that a transfer is avoided under section . . . 549 . . . the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from the initial transferee of such transfer.” The phrase “for the benefit of the estate” indicates that a § 550(a)(1) recovery action is intended to reverse the consequences of the unauthorized transfer from the bankruptcy estate. In re Classic Drywall, Inc., 127 B.R. 874, 876 (D. Kan. 1991). “Section 550(a) is intended to restore the estate to the financial condition it would have enjoyed if the transfer had not occurred.” Id. Further, the language of the statute need not be interpreted strictly if the result would be inherently unfair. Matter of R.A. Beck Builder, Inc., 34 B.R. 888, 894 (W.D. Pa. 1983). “In the absence of mandatory language, the Court does not favor a literal application of § 550(a)(1) . . . when such an application would lead to an inequitable result.” Id.
As a result of the spring 2009 convention, the Debtor was able to generate a profit. (R. at 5.) The profit from the convention did not only restore the bankruptcy estate to the condition it was in before the transfer of funds to the Respondent—it enhanced the bankruptcy estate such that the Bank’s cash collateral position is now improved beyond what it was before the transfer. (R. at 6.) For the bankruptcy court to order the Respondent to repay the $150,000 at issue would be superfluous because the estate has already been restored.

In fact, a ruling against the Respondent would result in the unjust enrichment of either the estate or the Bank, at the expense of the Respondent, whose sole misstep was agreeing to accept payment in two installments rather than as one lump sum. (R. at 4, 10.) If the purpose of allowing transfers of cash collateral is to allow a viable business to continue to operate while reorganizing its debts, then it is essential that vendors and other third parties continue to do business with the debtor. See Delco, 599 F.3d at 1258. A debtor’s misuse of cash collateral funds must not result in a profit for a bank, to the detriment of a third-party vendor, if this goal is to be achieved.

If this Court reverses the holding of the Thirteenth Circuit, it will chill the relations between third parties and businesses in Chapter 11 proceedings, which is the antithesis of the stated purpose of bankruptcy laws. The only equitable result is for this Court to affirm the decision of the Thirteenth Circuit Court of Appeals and remand the case for the matter to be settled between the Debtor and the Bank, leaving the Respondent’s revenue intact.

II. The bankruptcy court exceeded its judicial authority when it entered a final order in a non-core proceeding.

Even if this Court finds that the post-petition transfer of funds to the Respondent can be avoided under § 549, the lower court’s ruling is invalid because the bankruptcy court lacked both statutory and constitutional jurisdiction to enter a final order or judgment. While the
bankruptcy court is charged with hearing and determining matters in core proceedings, the
court is not empowered to enter a final order in a non-core proceeding. 28 U.S.C. § 157(c)(1).
Adjudication of the post-petition transfer at issue is neither explicitly listed in the statute as a
core proceeding nor related to administration of the bankruptcy case, which is a narrow
delegable category under § 157(b)(2)(A), and therefore does not fall under the jurisdiction of
the bankruptcy court. Thus, the only court with jurisdiction to enter a final order on avoidance
of the post-petition transfer is an Article III tribunal.

Further, even if the action is a core proceeding, the bankruptcy court lacked
constitutional authority to enter a final judgment in this case based on this Court’s holding in
Stern v. Marshall, 131 S. Ct. 2594 (2011). The jurisdiction of non-Article III courts is limited
to specialized areas of law, while traditional causes of action such as contract disputes or
actions to deprive a person of her property belong in an Article III court. See Northern
concurring). The bankruptcy court’s exercise of jurisdiction over the post-petition transfer
avoidance violated Article III because although the cause of action originated from a
bankruptcy claim, its relationship with that claim is tangential at best. Finally, the avoidance
action does not fall under the public rights doctrine as an exception to exclusive Article III
jurisdiction because it is a private right, not a public right “integrally related to particular
federal government action.” Stern, 131 S. Ct. at 2613. Thus, this Court should affirm the
Thirteenth Circuit’s holding and remand the case to the district court for further proceedings.

A. Because the bankruptcy court is not an Article III tribunal, it lacks the
authority to adjudicate this case.

Article III, § 1 of the United States Constitution establishes the federal government’s
judicial branch, creating a supreme court and various inferior courts. The judges of these
courts “shall hold their Offices during good Behavior, and shall, at stated Times, receive for their Services a Compensation which shall not be diminished during their Continuance in Office.” U.S. Const. art. III, § 1. Recognizing that judges might be required to make unpopular or controversial rulings, the Framers built in constitutionally mandated protections for judges of Article III courts. These protections both strengthen the independence of the judiciary and fortify the separation of powers between the three branches of government.

1. The Framers mandated lifetime tenure and irreducible salary to Article III judges as fundamental safeguards to maximize the independence of the judiciary and preserve the separation of powers.

Judicial rulings are sometimes controversial because each party advocates a position supported by case law that is subject to interpretation. In creating the judiciary, the Framers sought to insulate judges from outside pressures that might influence their rulings, freeing them to make legal decisions without fear of reprisal. See, e.g., Stern, 131 S. Ct. at 2608-09.

An independent judiciary is the keystone to the administration of justice and the protection of liberty. “A Judiciary free from control by the Executive and the Legislature is essential if there is a right to have claims decided by judges who are free from potential domination by other branches of government.” United States v. Will, 449 U.S. 200, 218 (1980). If a judge’s livelihood depends upon his being reappointed at the end of a term by either the executive branch or the legislative branch, or both, the judge is at least somewhat beholden to those bodies if he wishes to continue his judicial appointment. Similarly, if a judge were periodically subjected to popular elections, he would be acting against his self-interest if he did not at least consider the political ramifications of any ruling he makes.

The same reasoning underlies the Framers’ constitutional mandate that neither the people nor the legislative or executive branches of government may reduce a judge’s salary

“Next to permanency in office, nothing can contribute more to the independence of the judges than a fixed provision for their support . . . In the general course of human nature, a power over a man’s subsistence amounts to a power over his will.” The Federalist No. 79, at 472 (A. Hamilton) (Clinton Rossiter ed., 1961). If either Congress or the Executive retained the power to decrease a judge’s salary, judges would be forced to weigh the political implications of their rulings rather than being free to rule based on existing law and the merits of each case.

It follows, then, that a strong, independent judiciary is crucial to maintaining the separation of powers—the hallmark of American federal government. Each of the three branches stands as a check and balance against the other two, occasionally at the expense of convenience, in the hope that trifurcation will prevent an excessive accumulation of power in any one branch. United States v. Brown, 381 U.S. 437, 443 (1965).

This ‘separation of powers’ was obviously not instituted with the idea that it would promote governmental efficiency. It was, on the contrary, looked to as a bulwark against tyranny. For if governmental power is fractionalized . . . no man or group of men will be able to impose its unchecked will.

Id. In creating these protections for Article III judges and incorporating them into the Constitution—which is not easily or quickly amended—the Framers indicated their fundamental importance and guaranteed their endurance.

2. Because bankruptcy judges are not Article III judges, jurisdiction of bankruptcy courts is limited primarily to core proceedings.

The Constitution empowers Congress to “constitute Tribunals inferior to the supreme Court.” U.S. Const. art. I, § 8. Bankruptcy courts were first created with the Bankruptcy Act of 1841 and are presently authorized by the Bankruptcy Reform Act of 1978,¹ which enacted the

Bankruptcy Code, later modified by the Bankruptcy Amendments and Federal Judgeship Act (BAFJA) of 1984. A bankruptcy court is structured as a unit of each federal district court and the bankruptcy judge acts as a judicial officer of the district court. 28 U.S.C. § 151. As such, bankruptcy courts are not Article III tribunals, and Article III protections do not extend to bankruptcy judges. Thus, bankruptcy judges are not permitted to exercise judicial power under Article III of the Constitution.

If the purpose of Article III protections is to ensure that judicial decisions are rendered without fear of legislative, executive, or popular backlash, then any tribunals Congress creates with Article I power must be given only limited jurisdiction. See Stern, 131 S. Ct. at 2609. “Article III could neither serve its purpose in the system of checks and balances nor preserve the integrity of judicial decisionmaking if the other branches of the Federal Government could confer the Government’s ‘judicial power’ on entities outside Article III.” Id. To allow Congress to delegate judicial authority unfettered would be to undermine the core principles of Article III.

Under § 157(b)(1), a bankruptcy judge is authorized to “hear and determine” all bankruptcy cases and all core proceedings “arising under” the Bankruptcy Code or “arising in” a bankruptcy case. A bankruptcy judge may hear non-core proceedings “related to” a bankruptcy case, but he is explicitly prohibited from entering a final order or judgment. § 157(c)(1). Rather, he is to submit proposed findings of fact and conclusions of law to the district judge, who then performs a de novo review and enters the final order or judgment. Id. This case, then, turns in part on whether the action to avoid the post-petition transfer of funds is a core proceeding.

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B. The bankruptcy court had neither statutory nor constitutional jurisdiction to enter a final order in the action to avoid a post-petition transfer.

Irrespective of the merits of the case and the reasoning behind the bankruptcy judge’s ruling, Judge Grey lacked the authority to enter a final order or judgment. The bankruptcy court is only authorized to hear and determine matters of bankruptcy cases and their core proceedings. § 157(b). A post-petition transfer avoidance action does not appear on the statutory list of core proceedings, though admittedly the list is non-exclusive. § 157(b)(2). Further, the post-petition transfer avoidance action at issue here does not fall into the broad, catch-all categories of “matters concerning the administration of the estate” in § 157(b)(2)(A) or “proceedings affecting the liquidation of the assets of the estate” in § 157(b)(2)(O). Thus, the bankruptcy court was statutorily prohibited from entering a final order.

But even if this Court determines that the post-petition transfer avoidance action is a core proceeding, giving the bankruptcy court the statutory authority to hear and determine the case, that court lacked the constitutional authority to enter the final order under Stern. Because the avoidance action is ancillary to bankruptcy proceedings and not integral to the administration of the estate, it must be adjudicated in an Article III tribunal.

1. The bankruptcy court lacked statutory jurisdiction because the post-petition transfer avoidance action is not a core proceeding under § 157.

The Bankruptcy Reform Act of 1978 conferred upon bankruptcy courts “original and exclusive jurisdiction” of all bankruptcy cases and matters related to bankruptcy proceedings, and “original but not exclusive jurisdiction of all civil proceedings” arising under the Bankruptcy Code. 28 U.S.C. § 1471(a)-(b) (repealed 1984). Bankruptcy courts were to be “adjuncts” of federal district courts but were to be functionally independent from the district court. In re Grewe, 4 F.3d 299, 304 (4th Cir. 1993) (citing S.Rep. No. 989, 95th Cong., 2d
Sess. 16 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5801). Notwithstanding this grant of broad jurisdictional authority, Congress declined to bestow bankruptcy judges with Article III status. Rather than enjoying lifetime tenure and irreducible compensation, bankruptcy judges were to be appointed to fourteen-year terms by the President and their salaries were subject to adjustment. 28 U.S.C. §§ 152-154 (repealed 1984).

This Court found the jurisdictional scheme of the 1978 Act to be unconstitutional in Northern Pipeline. 458 U.S. 50. There, Northern Pipeline had first filed for Chapter 11 bankruptcy and later filed suit in bankruptcy court against Marathon Pipe Line, seeking damages for, among other things, breach of contract and warranty. Id. at 56. The civil suit against Marathon was filed in bankruptcy court for no reason other than because Northern Pipeline had filed its petition for reorganization in that court. Id. at 90. The bankruptcy court denied Marathon’s motion to dismiss the suit for lack of jurisdiction under Article III. Id. at 56-57. The district court granted the motion on appeal, however, and Northern Pipeline appealed to this Court. Id. at 57.

Justice Brennan, writing for the plurality, rejected the argument that the bankruptcy court was equivalent to a specialized legislative court as authorized in Article I of the Constitution, citing specific concerns regarding the separation of powers.

The potential for encroachment upon powers reserved to the Judicial Branch through the device of ‘specialized’ legislative courts is dramatically evidenced in the jurisdiction granted to the courts created by the Act before us . . . [A]ppellants’ analysis fails to provide any real protection against the erosion of Article III jurisdiction by the unilateral action of the political Branches. Id. at 74. Holding that the 1978 Act conferred unconstitutionally broad jurisdiction to non-Article III tribunals, he concluded, “Article III bars Congress from establishing legislative
courts to exercise jurisdiction over all matters related to those arising under the bankruptcy laws.” *Id.* at 76.

Congress responded to *Northern Pipeline* by enacting BAFJA in 1984, resulting in the jurisdictional framework that is in force today. Bankruptcy judges are no longer considered adjuncts but are “units” and “judicial officers” of each federal district court. § 151. Importantly, Congress again refused to bestow bankruptcy judges with Article III status; rather, they are appointed by their respective circuit courts of appeals for fourteen-year terms. § 152(a)(1).

The current jurisdictional scheme gives original jurisdiction in bankruptcy cases to the district courts under 28 U.S.C. § 1334(a). The district court is authorized to refer to the bankruptcy court “any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11.” § 157(a). Additionally, bankruptcy courts “may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11.” § 157(b)(1). Congress has provided a non-exclusive list of core proceedings in § 157(b)(2). Whether a matter is a core proceeding or a proceeding otherwise related to a case under title 11 is for the bankruptcy judge to determine. § 157(b)(3). Only if all parties consent may the district judge authorize the bankruptcy judge to enter a final order in a non-core proceeding. § 157(c)(2). Simply put, if the proceeding is related to a bankruptcy case but is not a core proceeding, the bankruptcy judge does not have the statutory authority to enter a final order on the matter absent the consent of all parties. As this Court has acknowledged, however, in core proceedings “the bankruptcy courts under the 1984 Act exercise the same powers they wielded under the Bankruptcy Act of 1978.” *Stern*, 131 S. Ct. at 2610.
a. A post-petition transfer avoidance action is not explicitly included in the statutory list of core proceedings.

Congress’s limitation of the jurisdiction of bankruptcy courts to that of core proceedings was in response to Justice Brennan’s complaint in *Northern Pipeline* about the lack of protections against “unilateral erosion” of Article III power by the legislative branch. 458 U.S. at 74. The term “core proceedings” was novel at the time and was apparently derived from Justice Brennan’s statement that the “restructuring of debtor-creditor relations, which is at the core of the federal bankruptcy power, must be distinguished from the adjudication of state-created private rights, such as the right to recover contract damages.” *Id.* at 71.

Though failing to provide a definition for a core proceeding, Congress did provide a non-exclusive list of core proceedings in § 157(b)(2). Included on this list are “proceedings to determine, avoid, or recover preferences,” § 157(b)(2)(F), and “proceedings to determine, avoid, or recover fraudulent conveyances.” § 157(b)(2)(H). It is evident that Congress considered various avoidance actions in creating the illustrative list of core proceedings; it is notable that an action for avoidance of a post-petition transfer is not included on that list. And while the statutory list is admittedly not exclusive, it is not unreasonable to surmise that the exclusion of this category of actions was intentional. See § 157(b)(2) (including actions to avoid fraudulent conveyances and preferences as core proceedings, but excluding actions to avoid post-petition transfers, despite the fact that all three are avoidance actions).

b. The Chapter 11 trustee’s post-petition transfer avoidance action is not a matter concerning the administration of the estate or a proceeding affecting the liquidation of the assets of the estate.

Congress anticipated other actions not explicitly listed in the statute that would also fall under the category of core proceedings. To accommodate those, Congress included two broad,
catch-all categories: § 157(b)(2)(A), “matters concerning the administration of the estate,” and § 157(b)(2)(O), “other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship.” Yet neither of these is an appropriate category for the post-petition transfer avoidance proceeding in this case.

“A matter concerning the administration of an estate is a matter that the bankruptcy court’s adjudication of which is an integral, if not essential, part of administering the estate.” In re J. Baranello & Sons, Inc., 149 B.R. 19, 25 (Bankr. E.D.N.Y. 1992). Even if the Debtor is in the midst of bankruptcy proceedings, it does not necessarily follow that a separate action against a third party concerns the administration of the estate. This is true regardless of whether the Debtor’s possible success on that action would inure to the benefit of the estate. See In re Orion Pictures Corp., 4 F.3d 1095, 1102 (2d Cir. 1993). Further, “[s]ubsection (O) does not render a proceeding core merely because the resolution of the action may result in more, or less, assets in the estate.” Baranello, 149 B.R. at 26.

What the statutorily enumerated core proceedings have in common is that they are all “matter[s] which would have no existence outside of the bankruptcy case.” In re Burger Boys, Inc., 183 B.R. 682, 685 (Bankr. S.D.N.Y. 1994). It follows that any cause of action to be encompassed in the catch-all statutes should share that same quality. The prudent course is to construe the catch-all categories in a manner so as to avoid the unconstitutional overreach of jurisdictional authority that was present in Northern Pipeline. See Stern, 131 S. Ct. at 2605 (“[W]e will, where possible, construe federal statutes so as ‘to avoid serious doubt as to their constitutionality.’”) (citing Commodity Futures Trading Comm’n v. Schor, 478 U.S. 833, 841 (1986)). In fact, a broad interpretation of the catch-all statutes would, in theory, also include
the type of action that was found to be unconstitutional in *Northern Pipeline*, certainly an absurd result.

While it is true that the avoidance action here would not exist if not for the cash collateral order that was provided to the Debtor after filing for bankruptcy, the crux of this case involves the Debtor’s misuse of the cash collateral funds. As Judge Cornell noted in the Thirteenth Circuit Court of Appeals’ majority opinion, it is “an internal matter between the Debtor, the Bank, and the bankruptcy court.” (R. at 9.) The action arose in the course of the Debtor’s bankruptcy proceeding, but that is where the relationship to the bankruptcy proceeding ends. The outcome of the avoidance action will have no effect on the administration of the Debtor’s bankruptcy case; it could be severed from the bankruptcy claim and both cases would proceed unfazed. The cause of action against the Respondent, a third-party vendor who did not file a proof of claim and did not subject herself to the bankruptcy court’s jurisdiction (R. at 5), is not a matter concerning administration of the Debtor’s estate or affecting the liquidation of the estate’s assets. In short, it is not a core proceeding.

c. Because this post-petition transfer avoidance action is not a core proceeding, only an Article III tribunal—not a bankruptcy court—has statutory jurisdiction to enter a final order in the case.

Having established that the post-petition transfer avoidance in this case is a non-core proceeding, it is a simple matter to conclude that the bankruptcy judge lacked the statutory authority to adjudicate the proceeding. Under § 157(c)(1), a bankruptcy judge is empowered with hearing—but not hearing and determining—non-core proceedings, after which he submits findings of fact and conclusions of law to the district judge, who then conducts a de novo review and issues a final order. That did not happen here, and the only appropriate course of action now is for this Court to affirm the Thirteenth Circuit and remand the case to the district
court for further proceedings. To conclude otherwise “would require that we replace the
principles delineated in [the Supreme Court’s] precedents, rooted in history and the
Constitution, with a rule of broad legislative discretion that could effectively eviscerate the
constitutional guarantee of an independent Judicial Branch of the Federal Government.”
Northern Pipeline, 458 U.S. at 74.

2. The bankruptcy court lacked constitutional jurisdiction to enter the
final order under the Stern holding.

Even if this Court finds that the bankruptcy judge did have statutory authority to enter
the final order on the post-petition transfer avoidance as a core proceeding, the judge’s final
order should be vacated because it violates Article III. Under this Court’s holding in Stern,
“[w]hen a suit is made of ‘the stuff of the traditional actions at common law tried by the courts
at Westminster in 1789,’ and is brought within the bounds of federal jurisdiction, the
responsibility for deciding that suit rests with Article III judges in Article III courts.” 131 S.
Ct. at 2609 (citing Northern Pipeline, 458 U.S. at 90 (Rehnquist, J., concurring)). This case
involves a federal statutory cause of action between two private parties regarding the misuse of
cash collateral funds. It is most similar to a contract dispute, and its adjudication belongs in an
Article III court.

a. The Stern decision signals a return to the strict limitations on
jurisdictional authority of non-Article III tribunals
consistent with the original mandate.

The majority in the Thirteenth Circuit disagreed with the dissent’s characterization of
Stern as “a minor decision that changes very little,” stating, “nothing could be farther from the
truth.” (R. at 12.) In fact, both opinions have some merit. While the Stern holding is a narrow
one, dealing specifically with a counterclaim originating in state law and not stemming from
the bankruptcy itself, it has generated abundant speculation as to its potentially far-reaching
effects. But to the extent that *Stern* changes anything, it is not so much a radical change as it is a return to the original principles of bankruptcy jurisdiction that had been expanded legislatively.

The *Stern* Court made clear that the Constitution does not allow for congressional delegation of judicial power to non-Article III judges. “A statute may no more lawfully chip away at the authority of the Judicial Branch than it may eliminate it entirely.” *Stern*, 131 S. Ct. at 2620. The 1978 Bankruptcy Reform Act kicked off a tug-of-war between Congress and this Court regarding the extent of a bankruptcy court’s jurisdiction. The *Stern* decision is simply the latest movement of the knot in the middle of the rope, and the knot is now closer to where it started when bankruptcy courts were first created. With *Stern*, this Court has returned bankruptcy courts closer to their original mandate of limited and specialized jurisdiction.

Bankruptcy jurisdiction in the United States is a product of the English system, under which jurisdiction extended only to the bankruptcy estate and not to the determination of what constituted the bankruptcy estate. See, e.g., *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989). Legislation in 1841 and 1867 expanded the jurisdiction of bankruptcy courts, but the Bankruptcy Act of 1898 again reigned in the jurisdictional power. David A. Skeel, Jr., *The Genius of the 1898 Bankruptcy Act*, 15 Emory Bankr. Dev. J. 321, 323, 331-32, 334-35 (1999). Then, the 1978 Act significantly expanded bankruptcy courts’ jurisdiction, and this Court responded with its holding in *Northern Pipeline*. With the *Stern* decision, this Court is merely returning to the basic principles of bankruptcy jurisdictional jurisprudence that were essential to its founding.

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b. Even though the Stern holding is a narrow one, its reasoning still applies to this case.

Admittedly, the Stern holding pertained to “one isolated respect” where the bankruptcy court’s jurisdiction was unconstitutionally broad. Simply because the holding is narrow, however, does not preclude its reasoning from applying elsewhere when the facts require it. The nature of the avoidance action at issue here shares enough qualities with the counterclaim in Stern to make the Stern holding applicable in this case.

At issue in Stern was the counterclaim that Vickie Lynn Marshall filed in bankruptcy court against her stepson, E. Pierce Marshall, for tortious interference with the inheritance she anticipated from her deceased husband. 131 S. Ct. at 2601. Vickie had filed for bankruptcy in California after her husband’s death, and Pierce filed a proof of claim to collect damages from Vickie’s bankruptcy estate for a defamation action; Vickie’s counterclaim followed. Id. Pierce contested the bankruptcy court’s jurisdiction to hear the counterclaim, but the bankruptcy court found it to be a core proceeding under § 157(b)(2)(C). Id. at 2601-02. After multiple appeals in three states and a ruling by this Court, which remanded to the Court of Appeals, the case made its second appearance before this Court. Id. at 2601-03.

Chief Justice Roberts, writing for the majority, held that although the bankruptcy court had statutory jurisdiction to adjudicate the counterclaim under § 157(b)(2)(C), that exercise of authority was unconstitutional under Article III. Id. at 2608. Likening Vickie’s counterclaim to a fraudulent conveyance claim, the Court applied its reasoning in Granfinanciera, and found that because the counterclaim was essentially a state law claim between two private parties, it was more suited to an Article III court. Id. at 2614. Additionally, the fact that Vickie’s counterclaim was not limited to bankruptcy law—and could effectively be heard in any court of general jurisdiction—weighed in favor of Article III exclusive jurisdiction. Id. In short,
although the counterclaim at issue originated from a bankruptcy action and might not have 
existed without it, the substance of the counterclaim was so far removed from the bankruptcy 
proceedings that it required an Article III court rather than a bankruptcy court to enter a final 
order. “Congress may not bypass Article III simply because a proceeding may have some 
bearing on a bankruptcy case; the question is whether the action at issue stems from the 
bankruptcy itself or would necessarily be resolved in the claims allowance process.” Id. at 
2618.

Here, the trustee’s action against the Respondent is similar enough to the counterclaim 
in *Stern* that the *Stern* reasoning should apply. Just as the fraudulent conveyance action in 
*Granfinanciera* did not “arise as part of the process of allowance and disallowance of claims,” 
492 U.S. at 58, the avoidance action here is ancillary to the claims allowance process. This is 
true, in part, because the Respondent is not a creditor but a third-party vendor who has no 
claim against the bankruptcy estate. Not only is the avoidance action here not “integral to the 
restructuring of debtor-creditor relations,” *id.*, it is irrelevant to the restructuring of debtor-
creditor relations; a debtor-creditor relationship does not exist between these parties. (R. at 13.) 

This avoidance action, though authorized by bankruptcy statutes, is a “garden variety 
lawsuit” that seeks to deprive the Respondent of her property. (R. at 13.) The counterclaim in 
*Stern* was related to the bankruptcy claim only by virtue of its being the only venue in which 
Pierce could have filed the proof of claim on his defamation action. *Stern*, 131 S. Ct. at 2614. 
Likewise, the transfer avoidance action here is only related to the bankruptcy claim in that the 
Bank extended a line of credit to the Debtor in an effort to finance the Debtor’s ordinary 
course of business during the bankruptcy process. Apart from that far-removed relationship, 
the merits of the claim against the Respondent are not dependent upon the bankruptcy
proceedings. The post-petition transfer avoidance action, like the counterclaim in *Stern*, is best suited to Article III jurisdiction, and the bankruptcy court exceeded its constitutional authority when it entered a final order in the case.

C. **The public rights doctrine is a limited exception to exclusive Article III jurisdiction that does not apply in this case.**

The Thirteenth Circuit’s majority opinion notes that the best argument against the Respondent’s position is the public rights doctrine, which is a very limited exception to exclusive Article III jurisdiction for disputes over public rights. But the public rights doctrine “has never been recognized by the Court to extend to bankruptcy matters” (R. at 13), and this case provides no impetus that compels this Court to break with precedent. Public rights cases are those in which “the Government is involved in its sovereign capacity under an otherwise valid statute creating enforceable public rights. Wholly private tort, contract, and property cases, as well as a vast range of other cases, are not at all implicated.” *Atlas Roofing Co. v. Occupational Safety and Health Review Comm’n*, 430 U.S. 442, 458 (1977). This case is essentially a private contract action; but for the fact that the need for the cash collateral arose because of the Debtor’s bankruptcy, the Debtor’s misuse of the Bank’s funds is unrelated to the bankruptcy. No public rights are at issue in this case.

1. **The public rights doctrine allows Congress to create legislative courts and administrative agencies to adjudicate cases involving public rights, which do not include bankruptcy proceedings.**

This Court’s first mention of the public rights doctrine was in *Murray’s Lessee v. Hoboken Land & Improvement Co.*, 59 U.S. 272 (1856). There, the federal government used a nonjudicial procedure—a warrant of distress filed against property—to recover embezzled funds from Samuel Swartwout, a former customs collector. *Id.* at 274-75. Swartwout challenged the proceedings as an unconstitutional exercise of judicial power by a non-Article
III entity. *Id.* In ruling against Swartwout, the Court noted that while Congress cannot “withdraw from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty,” the nature of the dispute did not lend itself to judicial disposition. *Id.* at 284. The Court found an exception for “matters, involving public rights, which may be presented in such form that the judicial power is capable of acting on them, and which are susceptible of judicial determination, but which congress may or may not bring within the cognizance of the courts of the United States.” *Id.*

Although there were interim cases addressing the public rights doctrine, *Northern Pipeline* was the first case where it was discussed in the bankruptcy context. This Court drew a distinction between private rights, which “lie at the core of the historically recognized judicial power,” and public rights, which “must at a minimum arise ‘between the government and others.’” *Northern Pipeline*, 458 U.S. at 69 (quoting *Ex parte Bakelite Corp.*, 279 U.S. 438, 451 (1929)). Additionally, the Court emphasized the limited nature of the public rights doctrine, which applies only when the Constitution assigns Congress exceptional powers, such as the authority to create territorial courts in geographic areas where there is no sovereign state, and the administration of courts-martial. *Id.* at 64-66. “Only in the face of such an exceptional grant of power has the Court declined to hold the authority of Congress subject to the general prescriptions of Article III.” *Id.* at 70.

The *Northern Pipeline* Court held that although the restructuring of debtor-creditor relations in bankruptcy “may well be a ‘public right,’” the state action at issue in that case—a breach-of-contract claim—was not. *Id.* at 71. It noted that “[a]ppellant Northern’s right to recover contract damages to augment its estate is ‘one of private right, that is, of the liability of one individual to another under the law as defined.’” *Id.* at 71-72 (quoting *Crowell v. Benson*,}
285 U.S. 22, 51 (1932)). Thus, while the Court refused to define the difference between public and private rights, it was clear about what public rights are not: matters that are “customarily cognizable in the courts.” *Id.* at 68.

The avoidance action here is analogous to a contract action and, like the contract claim in *Northern Pipeline*, does not fall under the public rights exception to Article III jurisdiction. The Bank extended cash collateral through a stipulated cash collateral order (R. at 3-4)—essentially a contract for a line of credit—to the Debtor, which the Debtor misused. The Respondent here, like Marathon Pipe Line, is not a creditor but a third party. Just as the breach-of-contract action in *Northern Pipeline* had a tangential relationship to the original bankruptcy petition, this action to avoid the transfer of funds is only tangentially related to the Debtor’s bankruptcy proceedings. In *Northern Pipeline*, that relationship was not sufficient to trigger the public rights doctrine because “[e]ven in the absence of the federal scheme, the plaintiff would be able to proceed against the defendant on the state-law contractual claims.” *Id.* at 71 n.26. The same set of circumstances exists here. Irrespective of the disposition of the bankruptcy estate, the action against the Respondent in this case could be pursued in a federal district court. Thus, under this Court’s holding in *Northern Pipeline*, the public rights doctrine does not apply in the present case.

2. **The Stern decision reaffirms that the public rights doctrine exception is both limited and inapplicable in this case.**

The *Northern Pipeline* decision is almost thirty years old, but its holding regarding the public rights doctrine is still valid, though the Court no longer requires that the federal government be a party to an action to involve a public right. *Thomas v. Union Carbide Agric. Prods. Co.*, 473 U.S. 568, 586 (1985). But the trend has been toward narrowing the exception rather than expanding it. “The Court has continued, however, to limit the exception to cases in
which the claim at issue derives from a federal regulatory scheme, or in which resolution of
the claim by an expert government agency is deemed essential to a limited regulatory objective
within the agency’s authority.” Stern, 131 S. Ct. at 2613. In addition, Stern clarified the public
rights doctrine as it applies—or, rather, does not apply—in bankruptcy cases. The fact that the
public rights exception is not applicable in this case under Northern Pipeline remains true after
Stern.

The Stern Court discussed Granfinanciera, the only other bankruptcy case after
Northern Pipeline in which the public rights doctrine was considered. There, a bankruptcy
trustee filed a fraudulent conveyance action against a non-creditor third party and argued that
the proceeding was properly adjudicated in the bankruptcy court because of the public rights
exception. Granfinanciera, 492 U.S. at 37. The Court rejected that argument because the
fraudulent conveyance action was more similar to “state law contract claims brought by a
bankrupt corporation to augment the bankruptcy estate than . . . creditors’ hierarchically
ordered claims to a pro rata share of the bankruptcy res.” Id. at 56.

Importantly, the fraudulent conveyance action in Granfinanciera, like the transfer
avoidance action here, was a private right “even when asserted by an insolvent corporation in
the midst of Chapter 11 reorganization proceedings” because it “constitute[d] no part of the
proceedings in bankruptcy but concern[ed] controversies arising out of it.” Id. That is precisely
the situation in this case. The transfer avoidance action—because it involves a third party and
not a creditor—is not part of the bankruptcy proceeding but rather arises out of it. That is
insufficient to meet the limited public rights doctrine exception to Article III jurisdiction.

Stern also put to rest any lingering doubts as to whether bankruptcy proceedings are a
public right, reaffirming the Court’s statement in Granfinanciera that “we did not mean to
‘suggest that the restructuring of debtor-creditor relations is in fact a public right.’” 131 S. Ct. at 2614 n.7 (quoting Granfinanciera, 492 U.S. at 56 n.11). The Court analyzed multiple cases in which the public rights doctrine had been applied and found no corollary in the counterclaim at issue in Stern, noting the “extent to which this case is so markedly distinct from the agency cases discussing the public rights exception.” Id. at 2615. To the extent that this case is similar to Stern, it is also dissimilar to the cases in which the public rights doctrine was applicable.

Regardless of this Court’s finding as to whether the post-petition transfer of funds is avoidable under § 549 and recoverable from the Respondent under § 550(a)(1), this Court should remand the case to the District Court of the District of Moot—the only court with jurisdiction over the case—for further proceedings.

CONCLUSION

For the foregoing reasons, the Respondent respectfully requests that this Court affirm the Thirteenth Circuit Court of Appeals and hold that the post-petition transfer avoidance action is subject to the Respondent’s equitable defenses. Further, the Respondent requests that this Court remand the case to the district court for further proceedings, as the bankruptcy court lacks jurisdiction over the matter.

Respectfully submitted on the 30th day of January 2012.

__________________________________________
Team R42
Counsel for Respondent
APPENDIX A


(a) Except as provided in subsection (b) or (c) of this section, the trustee may avoid a transfer of property of the estate--

(1) that occurs after the commencement of the case; and

(2) (A) that is authorized only under section 303(f) or 542(c) of this title; or

(B) that is not authorized under this title or by the court.

(b) In an involuntary case, the trustee may not avoid under subsection (a) of this section a transfer made after the commencement of such case but before the order for relief to the extent any value, including services, but not including satisfaction or securing of a debt that arose before the commencement of the case, is given after the commencement of the case in exchange for such transfer, notwithstanding any notice or knowledge of the case that the transferee has.

(c) The trustee may not avoid under subsection (a) of this section a transfer of an interest in real property to a good faith purchaser without knowledge of the commencement of the case and for present fair equivalent value unless a copy or notice of the petition was filed, where a transfer of an interest in such real property may be recorded to perfect such transfer, before such transfer is so perfected that a bona fide purchaser of such real property, against whom applicable law permits such transfer to be perfected, could not acquire an interest that is superior to such interest of such good faith purchaser. A good faith purchaser without knowledge of the commencement of the case and for less than present fair equivalent value has a lien on the property transferred to the extent of any present value given, unless a copy or notice of the petition was so filed before such transfer was so perfected.

(d) An action or proceeding under this section may not be commenced after the earlier of--

(1) two years after the date of the transfer sought to be avoided; or

(2) the time the case is closed or dismissed.
APPENDIX B


Unless the court, on request of a party in interest and after notice and a hearing, orders otherwise, the trustee may operate the debtor’s business.

(c) (1) If the business of the debtor is authorized to be operated under section 721, 1108, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

(2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless--

(A) each entity that has an interest in such cash collateral consents; or

(B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.
APPENDIX D


(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from--

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
(2) any immediate or mediate transferee of such initial transferee.

(b) The trustee may not recover under section1 (a)(2) of this section from--

(1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or
(2) any immediate or mediate good faith transferee of such transferee.

(c) If a transfer made between 90 days and one year before the filing of the petition--

(1) is avoided under section 547(b) of this title; and
(2) was made for the benefit of a creditor that at the time of such transfer was an insider;

the trustee may not recover under subsection (a) from a transferee that is not an insider.

(d) The trustee is entitled to only a single satisfaction under subsection (a) of this section.

(e) (1) A good faith transferee from whom the trustee may recover under subsection (a) of this section has a lien on the property recovered to secure the lesser of--

(A) the cost, to such transferee, of any improvement made after the transfer, less the amount of any profit realized by or accruing to such transferee from such property; and
(B) any increase in the value of such property as a result of such improvement, of the property transferred.

(2) In this subsection, “improvement” includes--

(A) physical additions or changes to the property transferred;
APPENDIX D (cont.)

(B) repairs to such property;

(C) payment of any tax on such property;

(D) payment of any debt secured by a lien on such property that is superior or equal to the rights of the trustee; and

(E) preservation of such property.

(f) An action or proceeding under this section may not be commenced after the earlier of--

(1) one year after the avoidance of the transfer on account of which recovery under this section is sought; or

(2) the time the case is closed or dismissed.
APPENDIX E


(a) Each district court may provide that any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11 shall be referred to the bankruptcy judges for the district.

(b) (1) Bankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11, referred under subsection (a) of this section, and may enter appropriate orders and judgments, subject to review under section 158 of this title.

(2) Core proceedings include, but are not limited to--

(A) matters concerning the administration of the estate;

(B) allowance or disallowance of claims against the estate or exemptions from property of the estate, and estimation of claims or interests for the purposes of confirming a plan under chapter 11, 12, or 13 of title 11 but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a case under title 11;

(C) counterclaims by the estate against persons filing claims against the estate;

(D) orders in respect to obtaining credit;

(E) orders to turn over property of the estate;

(F) proceedings to determine, avoid, or recover preferences;

(G) motions to terminate, annul, or modify the automatic stay;

(H) proceedings to determine, avoid, or recover fraudulent conveyances;

(I) determinations as to the dischargeability of particular debts;

(J) objections to discharges;

(K) determinations of the validity, extent, or priority of liens;

(L) confirmations of plans;
(M) orders approving the use or lease of property, including the use of cash collateral;

(N) orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate;

(O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims; and

(P) recognition of foreign proceedings and other matters under chapter 15 of title 11.

(3) The bankruptcy judge shall determine, on the judge's own motion or on timely motion of a party, whether a proceeding is a core proceeding under this subsection or is a proceeding that is otherwise related to a case under title 11. A determination that a proceeding is not a core proceeding shall not be made solely on the basis that its resolution may be affected by State law.

(4) Non-core proceedings under section 157(b)(2)(B) of title 28, United States Code, shall not be subject to the mandatory abstention provisions of section 1334(c)(2).

(5) The district court shall order that personal injury tort and wrongful death claims shall be tried in the district court in which the bankruptcy case is pending, or in the district court in which the claim arose, as determined by the district court in which the bankruptcy case is pending.

(c) (1) A bankruptcy judge may hear a proceeding that is not a core proceeding but that is otherwise related to a case under title 11. In such proceeding, the bankruptcy judge shall submit proposed findings of fact and conclusions of law to the district court, and any final order or judgment shall be entered by the district judge after considering the bankruptcy judge's proposed findings and conclusions and after reviewing de novo those matters to which any party has timely and specifically objected.

(2) Notwithstanding the provisions of paragraph (1) of this subsection, the district court, with the consent of all the parties to the proceeding, may refer a proceeding related to a case under title 11 to a bankruptcy judge to hear and determine and to enter appropriate orders and judgments, subject to review under section 158 of this title.
APPENDIX E (cont.)

(d) The district court may withdraw, in whole or in part, any case or proceeding referred under this section, on its own motion or on timely motion of any party, for cause shown. The district court shall, on timely motion of a party, so withdraw a proceeding if the court determines that resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce.

(e) If the right to a jury trial applies in a proceeding that may be heard under this section by a bankruptcy judge, the bankruptcy judge may conduct the jury trial if specially designated to exercise such jurisdiction by the district court and with the express consent of all the parties.