

July 6, 2011

Stern v. Marshall – Supreme Court Limits Bankruptcy Court’s Powers to Adjudicate Debtors’ Counterclaims

On June 23, 2011, the Supreme Court of the United States (the “Supreme Court”), in a 5-4 vote in the case *Stern v. Marshall*,¹ held that a bankruptcy court lacks the constitutional authority to enter final judgment on a counterclaim asserted by a debtor where the counterclaim is unrelated to the underlying claim. In affirming the decision of the United States Court of Appeals for the Ninth Circuit (the “Court of Appeals”), the Supreme Court found that although the bankruptcy court, which has judges that are appointed for limited terms, had been given the statutory authority under 28 U.S.C. § 157 to make final decisions on such counterclaims, it does not have the authority to do so under Article III of the Constitution. The decision, therefore, distinguishes between “core” and “non-core” counterclaims, and makes clear that only “core” counterclaims can be adjudicated with finality by bankruptcy courts.

Background

The action before the Supreme Court is the culmination of an epic set of lawsuits between Vickie Lynn Marshall (“Vickie”) and E. Pierce Marshall (“Pierce”). Vickie (known to the public as Anna Nicole Smith) was Pierce’s father’s third wife. Although Pierce’s father gave Vickie many gifts during their courtship and marriage, he did not include her in his will. Shortly before Pierce’s father’s death, Vickie filed suit in Texas state probate court against Pierce asserting that he fraudulently induced his father to sign a living trust that did not include her. After Pierce’s father’s death, Vickie filed for bankruptcy protection in the United States Bankruptcy Court for the Central District of California (the “Bankruptcy Court”). Pierce filed a complaint (and an accompanying proof of claim) in Vickie’s bankruptcy proceeding for defamation. Vickie

¹ 564 U.S. ____, Case No. 10-179 (June 23, 2011).

responded to the action by, among other things, filing a counterclaim for tortious interference (the same cause of action as the Texas state probate court suit).

Lower Court Decisions

The Bankruptcy Court concluded that Vickie's counterclaim was a "core proceeding" under 28 U.S.C. § 157(b)(2)(C), and therefore, it had the "power to enter judgment" on it. It ruled in favor of Vickie on all counts – (i) granting her summary judgment on Pierce's defamation claim, and (ii) awarding her over \$400 million in compensatory damages and \$25 million in punitive damages on her counterclaim.

The United States District Court for the Central District of California (the "District Court") disagreed with the Bankruptcy Court's conclusion that the counterclaim was a "core proceeding." It recognized that the counterclaim falls within the literal language of 28 U.S.C. § 157(b)(2)(C), but it understood that Supreme Court precedent suggests that it would be unconstitutional to hold that any and all counterclaims are core proceedings. Thus, the District Court determined that it was required to treat the Bankruptcy Court's judgment as proposed rather than final.² In conducting its own independent review of the record, the District Court declined to give the Texas state court judgment³ preclusive effect, and instead, ruled that Pierce tortiously interfered with Vickie's expectancy of a gift from Pierce's father.

The Court of Appeals reversed the District Court's decision on a different ground,⁴ and the Supreme Court reversed. On remand from the Supreme Court, the Court of Appeals held that in order to constitute a "core proceeding" under § 157, the counterclaim must be so closely related to the creditor's proof of claim that the resolution of the counterclaim is necessary to resolve the allowance or disallowance of the claim itself. It further held that Vickie's claim did not meet this test and that the Texas state court's judgment should be afforded preclusive effect.

The Supreme Court granted certiorari to determine (i) whether the Bankruptcy Court had statutory authority under 28 U.S.C. § 157(b) to issue a final judgment on Vickie's counterclaim; and (ii) if so, whether conferring that authority on the Bankruptcy Court is constitutional.

Statutory Authority

Under 28 U.S.C. § 157(b), bankruptcy judges may hear and enter final judgments "in all core proceedings arising under title 11, or arising in a case under title 11." Section 157(b)(2)(C) enumerates a non-exclusive list of 16 different types of matters that are considered core proceedings, including "counterclaims by [a debtor's] estate against persons filing claims against the estate." When a bankruptcy judge determines that a proceeding is not a core proceeding but "is otherwise related

² As discussed further below, under 28 U.S.C. § 157(b), bankruptcy judges may hear and determine "all core proceedings arising under title 11, or arising in a case under title 11 . . . and may enter appropriate orders and judgments." For all non-core proceedings, under § 157(c)(1), a bankruptcy court may hear the proceeding but it may only "submit proposed findings of fact and conclusions of law to the district court."

³ The Texas state court conducted a jury trial on the merits of the parties' dispute, and entered a judgment in Pierce's favor.

⁴ The Court of Appeals initially ruled that the Bankruptcy Court lacked jurisdiction because the tortious interference was, in substance, nothing more than a thinly veiled wills contest that came within the exclusive jurisdiction of the Texas probate court. 392 F.3d 1118 (2003).

to a case under title 11,” the judge may only “submit proposed findings of fact and conclusions of law to the district court.” The district court then conducts its own independent review before entering a final judgment.

Pierce’s counsel argued that Vickie’s counterclaim does not qualify as a core proceeding within the meaning of § 157(b) because § 157(b) only allows a bankruptcy judge to make a final judgment on a core proceeding if that proceeding also arises in a title 11 case or under title 11 itself. In the alternative, Pierce’s counsel asserted that the Bankruptcy Court lacked jurisdiction to enter final judgment on his defamation claim because his defamation claim is a “personal injury tort” claim that, under § 157(b), shall be tried in the District Court.

Chief Justice Roberts, writing for the majority,⁵ rejected Pierce’s interpretation of § 157(b), and held that Vickie’s counterclaim is a “core” proceeding under the plain text of § 157(b)(2)(C). The majority found that Pierce’s reading contradicts the plain meaning of the statute, and that agreeing with his interpretation would result in a rewriting of the statute. Pierce’s interpretation necessarily assumes that there is a category of non-core proceedings that neither arise under title 11 nor arise in a title 11 case. No such category exists, and the statute does not instruct bankruptcy judges on what to do with respect to such proceedings.

The majority similarly rejected Pierce’s counsel’s jurisdictional argument. Section 157 only addresses where personal injury tort claims “shall be tried,” and does not refer to any court’s jurisdiction or implicate questions of subject matter jurisdiction. Furthermore, Chief Justice Roberts found ample evidence in the record that Pierce consented to the Bankruptcy Court’s resolution of his claim.⁶ On this basis, the Court declined to address what constitutes a “personal injury tort” claim within § 157(b), but noted that this issue raises questions on which there is little consensus or precedent.

Constitutional Authority

While the majority ruled that the Bankruptcy Court had statutory authority to enter a final judgment on Vickie’s counterclaim, it noted that designating all counterclaims as core proceedings “raises serious constitutional concerns.” Chief Justice Roberts, writing for the majority, concluded that while § 157(b)(2)(C) permits the Bankruptcy Court to enter a final judgment on Vickie’s counterclaim, Article III of the Constitution does not.

Article III, § 1, of the Constitution mandates that “[t]he judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish.” The same section provides that the judges of those constitutional courts “shall hold their Offices during good Behaviour” and “receive for their Service[] a Compensation[] [that] shall not be diminished” during their tenure.

⁵ Justice Kennedy, Justice Thomas, Justice Alito and Justice Scalia joined the majority opinion.

⁶ For example, the Court noted that (i) Pierce did not object to any court that § 157(b)(b) prohibited the Bankruptcy Court from resolving his defamation claim until over two years after he filed that claim; and (ii) Pierce advised the Bankruptcy Court that “he was ‘happy to litigate [his] claim’ there.”

Vickie's counsel argued that the Bankruptcy Court's final judgment on Vickie's state common law counterclaim was constitutional under the 1984 amendments to the Bankruptcy Code,⁷ or in the alternative, the counterclaim falls into the "public rights" exception. Vickie's counsel distinguished prior Supreme Court precedent in *Granfinanciera, S.A. v. Nordberg* and *Langenkamp v. Culp* by arguing that Pierce filed a proof of claim against Vickie's estate, and therefore, submitted himself to the jurisdiction of the Bankruptcy Court. Vickie's counsel also asserted that as a practical matter, restrictions on the bankruptcy courts' ability to hear and resolve compulsory counterclaims will create significant delays and impose additional costs on the bankruptcy process.

The majority rejected Vickie's counsel's arguments, and found that the Bankruptcy Court lacked constitutional authority to enter a final judgment on a state law counterclaim that is not resolved through the bankruptcy claims process. It found that the Bankruptcy Court was clearly exercising the "judicial Power of the United States" as the counterclaim is a state law claim. The majority further ruled that the counterclaim does not fall within the "public rights" exception as it is a state common law claim between two private parties and the terms of its adjudication do not depend on Congress. In addition, Vickie's requested relief does not flow from a federal statutory scheme, and is not completely dependent upon adjudication of a claim created by federal law.

In addition, the Court dismissed Vickie's argument distinguishing *Granfinanciera* and *Langenkamp*⁸ because the adjudication of Pierce's claim in no way affects the nature of Vickie's counterclaim. Although the Court did not rule directly on this issue, when *Granfinanciera* and *Langenkamp* are read together with the current decision, fraudulent conveyance and preference actions brought against noncreditors and creditors could be interpreted to be outside of the "public rights" exception and thus outside of the jurisdiction of bankruptcy courts such that they have to be adjudicated by district courts.

Finally, the majority was not convinced that the practical consequences of limiting the bankruptcy courts' authority to enter final judgments are as significant as Vickie's counsel suggests. The 1984 amendments and § 157(c)(1) contemplate that certain state law matters would not be resolved with finality by the bankruptcy courts, and as a result, the majority did not believe that removal of counterclaims such as Vickie's from core bankruptcy jurisdiction would meaningfully change the existing division of labor.

⁷ The Bankruptcy Code amendments of 1984 were enacted after the Supreme Court's decision in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982). In *Northern Pipeline*, the Supreme Court concluded that bankruptcy judges (serving under the Bankruptcy Act of 1978 – appointed by the President and confirmed by the Senate, but lacking the tenure and salary guarantees of Article III) could not, under Article III, be constitutionally vested with jurisdiction to decide state-law contract claims against an entity that was not otherwise part of the bankruptcy proceedings. The Court there explicitly found that state-law contract claims did not fall under the "public rights" exception. After this decision, Congress revised the statutes governing bankruptcy jurisdiction and bankruptcy judges. In the 1984 amendments, Congress provided that (i) judges of the new bankruptcy courts would be appointed by the courts of appeal for the circuit in which their districts are located, and (ii) the newly constituted bankruptcy courts could enter final judgments only in "core" proceedings.

⁸ In *Granfinanciera*, the Court held that a fraudulent conveyance action filed by a bankruptcy trustee against a noncreditor in a bankruptcy proceeding did not fall within the "public rights" exception, and thus, the noncreditor is entitled to a trial by jury. 492 U.S. 33 (1989). In *Langenkamp*, the Court held that parties who submitted claims against the bankruptcy estate are not entitled to a trial by jury when sued by the bankruptcy trustee to recover allegedly preferential transfers. 498 U.S. 42 (1990). Vickie's counsel argued that because Pierce filed a proof of claim against Vickie's estate, he submitted himself to the jurisdiction of the Bankruptcy Court.

Concurring and Dissenting Opinions

Justice Scalia, while agreeing with the majority's opinion, separately wrote a concurring opinion. He noted that the "public rights" exception must be read narrowly, and that unless there is a firmly established historical practice to the contrary, an Article III judge (those appointed by the President and confirmed by the Senate) is required in *all* federal adjudications.

Justice Breyer, joined by Justice Ginsburg, Justice Sotomayor and Justice Kagan, dissented. Justice Breyer agreed with the majority that § 157(b)(2)(C) authorizes a bankruptcy court to adjudicate Vickie's counterclaims, but disagreed with the majority about the statute's constitutionality. The dissent contended that the statute is constitutional because, among other reasons, (i) the resolution of counterclaims often turns on facts identical to, or at least related to, those at issue in a creditor's claim that is undisputedly proper for the bankruptcy court to decide; (ii) bankruptcy judges are appointed by federal courts of appeal, they can functionally be compared to magistrate judges, law clerks and the Judiciary's administrative officials; (iii) Article III judges retain control and supervision over the bankruptcy court's determinations so there are sufficient checks on the bankruptcy court's judgments; and (iv) the parties consented to the jurisdiction of the Bankruptcy Court. Regarding Vickie's counsel's argument of the practical consequences, the dissent agrees and believes that limiting bankruptcy courts' authority would lead to inefficiency, increased cost, delay and needless additional suffering among those faced with bankruptcy.

Implications of the Supreme Court's Decision

As a practical matter, the Supreme Court decision likely does not affect most creditors. Although it discussed both issues briefly, the Court left open the definition of a "personal injury tort" for purposes of § 157(b) and how this decision, when read with *Granfinanciera* and *Langenkamp*, impacts avoidance actions against parties who did not submit proofs of claim against the bankruptcy estate. The only direct implication of the decision is in cases where a debtor files a counterclaim that is unrelated to the underlying claim filed against the debtor. In such a scenario, the counterclaim still may be heard by the bankruptcy judge, who will issue proposed findings of fact and conclusions of law to the district court, and then by the district court, who will conduct an independent review of the record before entering a final order. However, to avoid what could be a substantial inefficiency of having only proposed findings being issued by the bankruptcy court, it is more likely that the counterclaim will be "withdrawn" to the district court to allow it to hear the matter directly.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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