

July 1, 2011

Stern v. Marshall - Supreme Court Limits the Scope of Bankruptcy Courts' Core Jurisdiction

Introduction

On June 23, 2011, after fifteen years of hugely acrimonious litigation, the Supreme Court of the United States (the "Court") issued a decision on a narrow legal issue that may end up significantly limiting the scope of bankruptcy courts' core jurisdiction.

The decision concerns whether the bankruptcy court overseeing the chapter 11 case of Vickie Lynn Marshall ("Vickie"), better known as Anna Nicole Smith, had authority to render a final judgment over a state law counterclaim her estate has asserted against creditor Pierce Marshall ("Pierce"), the son of Vickie's deceased husband, for tortious interference with her husband's efforts to grant her an *inter vivos* gift. In a 5-4 decision, the Court held that, although Vickie's counterclaim fell squarely within the bankruptcy court's statutory jurisdiction, Congress' grant of such jurisdiction was unconstitutional. Thus, the Court ruled that the bankruptcy court lacked the ability to finally determine Vickie's counterclaim.

Background

Vickie married J. Howard Marshall III ("J. Howard") approximately a year before his death. Shortly before J. Howard died, Vickie filed suit in Texas state probate court, asserting that Pierce fraudulently induced J. Howard to sign a living trust that did not include her, even though J. Howard meant to give her half his property.

After her husband'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 proof of claim in Vickie's bankruptcy case, seeking damages for defamation. In addition, Pierce commenced an adversary proceeding seeking a declaration that his defamation claim was not dischargeable. Vickie counterclaimed against Pierce alleging tortious interference with the gift she expected from her husband. The Bankruptcy Court ruled in Vickie's favor, awarding her over \$400 million in compensatory damages and \$25 million in punitive damages.

In post-trial proceedings, Pierce argued that the Bankruptcy Court could not finally determine Vickie's counterclaim because it was not a "core" proceeding under 28 U.S.C. §157(b)(2)(C). The District Court agreed and concluded that a "counterclaim should not be characterized as core when it is only somewhat related to the claim against which it is asserted, and when the unique characteristics and context of the counterclaim place it outside of the normal type of set-off or other counterclaims that customarily arise."

Although the Texas state probate court had by that time entered a judgment in Pierce's favor, the District Court declined to give that judgment preclusive effect and proceeded to decide the

matter itself. The District Court decided that Pierce had tortiously interfered with Vickie's expectancy of a gift from J. Howard, but reduced Vickie's award to \$89 million.

The Ninth Circuit Court of Appeals subsequently reversed the District Court, concluding that "a counterclaim under §157(b)(2)(C) is properly a 'core' proceeding 'arising in a case under' the [Bankruptcy] Code only if the counterclaim is so closely related to a [creditor's] proof of claim that the resolution of the counterclaim is necessary to resolve the allowance or disallowance of the claim itself." The court ruled that Vickie's counterclaim did not meet that test and concluded that the District Court should have afforded preclusive effect to the Texas court's ruling. Vickie appealed to the Court.

The Court's Decision

Writing for the majority, Chief Justice Roberts first examined the text of section 157(b)(2)(C) to determine whether the bankruptcy court possessed the statutory authority to finally determine the counterclaim. Section 157(b)(2), among other things, enumerates sixteen examples of "core proceedings" – *i.e.* proceedings in which the bankruptcy court can render a final judgment, as contrasted with non-core proceedings that merely "relate to" a bankruptcy case and in which a bankruptcy court may only submit proposed findings of fact and conclusions of law to the District Court – including "counterclaims by an estate against persons filing claims against the estate." Because Vickie's counterclaim fell squarely within the scope of this definition, the Court concluded that the Bankruptcy Court possessed the statutory authority to finally determine the counterclaim.

Significantly, however, the Court's analysis did not end there. It next considered the constitutionality of the statute in the light of Article III of the Constitution and explained that "[a]lthough we conclude that §157(b)(2)(C) permits the Bankruptcy Court to enter final judgment on Vickie's counterclaim, Article III of the Constitution does not." In other words, it determined that Congress' grant of jurisdiction to the bankruptcy court under section 157(b)(2)(C) was unconstitutional.

The Court's analysis turns on Article III, § 1, of the Constitution, which dictates 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." To ensure the independence of the Judicial Branch, it further provides that judges on such courts shall hold their office during good behavior (generally resulting in a life tenure), without diminution of their salary. As the Court explained:

By appointing judges to serve without term limits, and restricting the ability of the other branches to remove judges or diminish their salaries, the Framers sought to ensure that each judicial decision would be rendered, not with an eye toward currying favor with Congress or the Executive, but rather with the "[c]lear heads . . . and honest hearts" deemed "essential to good judges."

Bankruptcy courts, however, are not “Article III tribunals” and, bankruptcy judges do not have the benefit of Article III’s protections regarding tenure and salary.¹

The Court noted that “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 of Article III.” While the Court has previously recognized a “public rights” exception that permits “legislative” courts (such as the Bankruptcy Court) to hear and finally adjudicate certain types of matters, the Court concluded that no basis existed for applying that exception to Vickie’s counterclaim.² Accordingly, the Court held that the Bankruptcy Court lacked the constitutional authority to enter a final judgment on Vickie’s counterclaim.

Conclusion

So, what, as a practical matter, are the real world consequences of the decision? The majority contends that the question presented was a narrow one and that the decision “does not change all that much.” But is that really true? At least two significant consequences are these:

- A bankruptcy court, as a non-Article III tribunal, may not enter a final judgment on a state law counterclaim that (a) “is not resolved in the process of ruling on a creditor’s proof of claim,” or (b) does not fall squarely within the “public rights” exception.
- Contrary to settled expectations, the filing of a proof of claim by a creditor does not vest the bankruptcy court with authority to enter a final judgment on all counterclaims or establish the creditor’s consent to the bankruptcy court’s adjudication of such counterclaims.

The decision also requires one to pause on whether other components of the bankruptcy courts’ statutorily created core jurisdiction – such as the right to decide state law fraudulent conveyance actions – are susceptible to similar attack. And what about lawsuits that comprise both federal bankruptcy and state law causes of action? Will such lawsuits be withdrawn to the district court or split between the bankruptcy and district courts? Justice Breyer, writing for the dissent, foresees “a constitutionally required game of jurisdictional ping-pong between courts [that] would lead to inefficiency, increased cost, delay, and needless additional suffering among those faced with bankruptcy.”

¹ By way of background, and as the Court noted, with certain exceptions not relevant here, the U.S. district courts have “original and exclusive” jurisdiction of all cases under the Bankruptcy Code. 28 U.S.C. §1334(a). The district courts may refer such proceedings to the bankruptcy judges in their districts, 28 U.S.C. §157(a), and have done so pursuant to a standing order of referral. As noted above, the extent to which a bankruptcy judge can finally decide a referred matter depends on whether it is a “core” or “non-core” proceeding. 28 U.S.C. §157(b), (c).

² In rejecting Vickie’s argument that the counterclaim fell within the “public rights” exception, the Court noted, among other things, that the counterclaim (a) was a “claim under state common law between two private parties;” (b) did not “flow from a federal statutory scheme;” and (c) was not “completely dependent upon adjudication of a claim created by federal law.” The Court also noted that “Pierce did not truly consent to resolution of Vickie’s claim in the bankruptcy court proceedings. He had nowhere else to go if he wished to recover from Vickie’s estate.”

While the full extent to which *Stern* will ultimately curtail the bankruptcy courts' jurisdiction remains to be seen, Justice Breyer's prediction is surely correct, at least until courts can sort out *Stern's* precise meaning.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Alan W. Kornberg
212-373-3209
akornberg@paulweiss.com

Stephen J. Shimshak
212-373-3133
sshimshak@paulweiss.com

Brian S. Hermann
212-373-3545
bhermann@paulweiss.com

NEW YORK
1285 Avenue of the Americas
New York, NY 10019-6064
+1-212-373-3000

BEIJING
Unit 3601, Fortune Plaza Office
Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
+86-10-5828-6300

HONG KONG
12th Fl., Hong Kong Club Building
3A Chater Road
Central Hong Kong
+852-2846-0300

LONDON
Alder Castle, 10 Noble Street
London EC2V 7JU
United Kingdom
+44-20-7367-1600

TOKYO
Fukoku Seimei Building, 2nd Floor
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
+81-3-3597-8101

TORONTO
One Yonge Street, Suite 1801
Toronto, ON M5E 1W7
Canada
+1-416-504-0520

WASHINGTON, D.C.
2001 K Street NW
Washington, DC 20006-1047
+1-202-223-7300

WILMINGTON
500 Delaware Avenue, Suite 200
Post Office Box 32
Wilmington, DE 19899-0032
+1-302-655-4410

Contributing author: Karen R. Zeituni