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# Financial Restructuring Group Client Alert

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## SUPREME COURT RULING LIMITS BANKRUPTCY COURT AUTHORITY TO ENTER FINAL JUDGMENT ON STATE LAW COUNTERCLAIM ASSERTED BY DEBTOR AGAINST CREDITOR THAT FILED PROOF OF CLAIM WHERE COUNTERCLAIM NEED NOT BE RESOLVED IN PROCESS OF RULING ON CREDITOR'S CLAIM

On June 23, 2011, the United States Supreme Court (the “Supreme Court”) ruled in *Stern v. Marshall*<sup>1</sup> that the United States Constitution prevents the United States Bankruptcy Court for the Central District of California (the “Bankruptcy Court”) overseeing the bankruptcy case of Vickie Lynn Marshall (more commonly known as Anna Nicole Smith, and referred to herein and in the Supreme Court’s decision as “Vickie”) from entering a final judgment on a state law counterclaim asserted by Vickie against E. Pierce Marshall (“Pierce”), the son of Vickie’s late husband J. Howard Marshall II (“J. Howard”), who had filed a proof of claim against Vickie’s estate. In reaching this result, the Court held that a federal statute designating such a counterclaim as a “core” proceeding in which the Bankruptcy Court could enter a final judgment exceeded constitutional authority by allocating to a “legislative court” like the Bankruptcy Court the resolution of a matter that is reserved to a court established pursuant to Article III of the United States Constitution, such as a federal district court.

This ruling has the potential (1) to significantly reduce the scope of bankruptcy courts’ “core” jurisdiction with respect to counterclaims asserted by a debtor against creditors that have filed proofs of claim in the debtor’s bankruptcy case, and (2) to cause a significant proportion of bankruptcy litigation that previously would have been heard in bankruptcy courts to instead be heard in federal district courts, thereby likely increasing the costs and delays attendant to such litigation. Although the Supreme Court declared only a portion of the Bankruptcy Court’s jurisdiction unconstitutional, the Court’s reasoning could apply more broadly to other core proceedings that have generally been thought to be subject to final resolution by bankruptcy courts.

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<sup>1</sup> No. 10-179, 2011 U.S. LEXIS 4791 (U.S. June 23, 2011).

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## ***Background – Lower Court Proceedings***

The Supreme Court's decision stemmed from litigation conducted in numerous jurisdictions with respect to a series of disputes between Vickie and Pierce over the late J. Howard's fortune.<sup>2</sup> Vickie was J. Howard's third wife, having married him approximately one year before his death, but was not included in J. Howard's will. She filed suit in Texas state probate court (the "Texas Court") alleging that, although J. Howard intended to give her half of his property, Pierce fraudulently induced J. Howard to sign a living trust that omitted her.

After J. Howard's death, Vickie filed for bankruptcy. In Vickie's bankruptcy case, Pierce sought a determination from the Bankruptcy Court that (1) Vickie had defamed him by publicly alleging that Pierce had engaged in fraud to gain control of his father's estate, and (2) his defamation damages claim could not be discharged in Vickie's bankruptcy case. Pierce also filed a proof of claim for the defamation action. Vickie filed a counterclaim (the "Counterclaim") alleging that Pierce had tortiously interfered with the property she had expected to receive from J. Howard. The Bankruptcy Court determined that the Counterclaim was a "core proceeding" and that, under 28 U.S.C. § 157(b)(1), it therefore had the ability to enter a final judgment with respect to the Counterclaim. The Bankruptcy Court ruled in favor of Vickie, awarding her over \$400 million in compensatory damages and \$25 million in punitive damages.

Pierce appealed the Bankruptcy Court's ruling to the United States District Court for the Central District of California (the "District Court"), which reversed the Bankruptcy Court's ruling. The District Court recognized that the Counterclaim fell within the literal language of 28 U.S.C. § 157(b)(2)(C), which provides that core proceedings include "counterclaims by the estate against persons filing claims against the estate." The District Court determined, however, that (1) under applicable Supreme Court precedent, a counterclaim is not a core proceeding when it "is only somewhat related to the claim against which it is asserted,"<sup>3</sup> and therefore (2) the Counterclaim was not a core proceeding. As a result, the District Court treated the Bankruptcy Court's judgment as a proposed judgment rather than a final one, and reconsidered the entirety of the Bankruptcy Court's ruling *de novo*.

Like the Bankruptcy Court, the District Court concluded that Pierce had tortiously interfered with Vickie's expectation of a gift from J. Howard, and awarded Vickie compensatory and punitive damages in the approximate amount of \$89 million. In the meantime, however, the Texas Court considered Vickie's action for fraudulent inducement and entered a judgment in Pierce's favor. Notwithstanding the existence of the Texas Court's judgment at the time it considered the issue, the District Court declined to give that judgment preclusive effect and went ahead and made its own ruling.

On appeal of the District Court's order, the United States Court of Appeals for the Ninth Circuit (the "Court of Appeals") reversed on a different ground, but that ruling was subsequently reversed by the Supreme Court.<sup>4</sup> Considering the matter once more on remand from the Supreme Court, the Court of Appeals held that a bankruptcy court may enter a final judgment only in a proceeding that (1) meets Congress's definition of a core proceeding and (2) arises under, or arises in a case under, the Bankruptcy Code, which is title 11 of the United States Code. With this concern in mind, the Court of Appeals held that a counterclaim "is properly a 'core' proceeding 'arising in a case under' the [Bankruptcy] Code only if the counterclaim is so closely related

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<sup>2</sup> Because both Vickie and Pierce died during the course of the litigation, the parties in the litigation were their respective estates, which are referred to herein as Vickie and Pierce, respectively.

<sup>3</sup> *Stern*, 2011 U.S. LEXIS 4791, at \*19 (quoting *Marshall v. Marshall (In re Marshall)*, 264 B.R. 609, 632 (C.D. Cal. 2001)).

<sup>4</sup> The Court of Appeals held that under the "probate exception," the federal courts lacked jurisdiction over the Counterclaim. Because the probate exception resolved the issue of federal subject-matter jurisdiction, the Court of Appeals did not address whether the Counterclaim was "core." On appeal, the Supreme Court held that the Court of Appeals had read the probate exception too broadly in barring federal jurisdiction in the case. *Marshall v. Marshall*, 547 U.S. 293 (2006).

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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."<sup>5</sup> The Court of Appeals concluded that, because the Counterclaim did not satisfy this test, the Bankruptcy Court could not have entered a final judgment on the Counterclaim. The Court of Appeals also concluded that, because of the intervening final judgment of the Texas Court, the District Court should not have ruled on the matter, but instead should have given the Texas Court's judgment preclusive effect.

### *Supreme Court Decision*

The Supreme Court faced two issues: (1) whether the Bankruptcy Court had statutory authority under 28 U.S.C. § 157(b) to enter a final judgment on the Counterclaim, and (2) if so, whether the exercise of that statutory authority was constitutional.

a) *Section 157(b)(2)(C) Permitted the Bankruptcy Court To Enter Final Judgment on Vickie's Counterclaim*

Bankruptcy courts may hear, and enter final judgments in, "all core proceedings arising under title 11, or arising in a case under title 11."<sup>6</sup> Section 157(b)(2) of title 28 of the United States Code includes a nonexclusive list of sixteen types of "core" proceedings, including counterclaims by a debtor's estate against persons filing claims against the estate. Parties may appeal to a district court a final judgment of a bankruptcy court in a core proceeding. When a proceeding is "non-core" but is related to a case under title 11, however, the bankruptcy court may only submit proposed findings of fact and conclusions of law to the district court, which will enter a final judgment.

The Supreme Court held that the Counterclaim was a core proceeding under the plain terms of 28 U.S.C. § 157(b)(2)(C), and that the Bankruptcy Court therefore had statutory authority under 28 U.S.C. § 157(b) to enter a final judgment on the Counterclaim.

b) *Article III of the Constitution Prohibited the Bankruptcy Court from Entering Final Judgment on the Counterclaim*

Article III of the Constitution provides 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."<sup>7</sup> When a common law suit is brought within the bounds of federal jurisdiction, the Supreme Court has determined that "the responsibility for deciding that suit rests with Article III judges in Article III courts."<sup>8</sup>

In *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*,<sup>9</sup> the Supreme Court had previously faced an Article III challenge to a bankruptcy court's resolution of a debtor's suit. In *Northern Pipeline*, the Court considered whether the Constitution permitted the bankruptcy court to exercise jurisdiction over a state law contract claim filed by a debtor against an entity that was not part of the bankruptcy proceedings. A plurality of the Court recognized that there was a category of cases involving "public rights" that Congress could constitutionally assign for resolution to "legislative" (i.e., non-Article III) courts such as bankruptcy courts. A majority of the Court, while not agreeing on the scope of this exception, rejected the argument that the public rights doctrine permitted a bankruptcy court to adjudicate a state law claim brought by a debtor against a company that had not filed a proof of claim against the estate. In the wake of the Court's decision in *Northern Pipeline*, Congress enacted the Bankruptcy Amendments and Federal Judgeship Act of 1984, under which bankruptcy judges would be appointed

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<sup>5</sup> *Stern*, 2011 U.S. LEXIS 4791, at \*21 (quoting *Marshall v. Stern (In re Marshall)*, 600 F.3d 1037, 1058 (9th Cir. 2010)).

<sup>6</sup> 28 U.S.C. § 157(b)(1).

<sup>7</sup> U.S. CONST. art. III.

<sup>8</sup> *Stern*, 2011 U.S. LEXIS 4791, at \*42.

<sup>9</sup> *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982).

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by the courts of appeals for the circuits in which their districts are located, and bankruptcy courts could enter final judgments only in core proceedings.

Since *Northern Pipeline*, the Supreme Court has attempted, in several instances, to further define the limits of the public rights exception. The only case in which the Court had previously considered that doctrine in the bankruptcy context is *Granfinanciera, S. A. v. Nordberg*.<sup>10</sup> In *Granfinanciera*, which dealt with a defendant's right to a jury trial, the Court rejected a trustee's argument that a fraudulent conveyance action filed in a bankruptcy case on behalf of a bankruptcy estate against an entity that had not filed a proof of claim fell within the "public rights" exception. The Court in *Granfinanciera* held that fraudulent conveyance actions were a private right as opposed to a public right, because fraudulent conveyance actions were "quintessentially suits at common law that more nearly resemble state law contract claims brought by a bankrupt corporation to augment the bankruptcy estate than they do creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res."<sup>11</sup>

Against this precedential backdrop, the Supreme Court held that the Bankruptcy Court's entry of final judgment on the Counterclaim was unconstitutional. First, the Court held that the Counterclaim did not involve a "public right" that could be decided by a non-Article III court, because it neither derived from nor depended on any federal statutory scheme, and it was not completely dependent upon adjudication of a claim created by federal law. The Court concluded that the Counterclaim should be left to the Article III courts, which are the "experts" in the federal system at resolving common law actions like the Counterclaim.

Second, the Court held that the mere fact that Pierce had filed a proof of claim did not give the Bankruptcy Court authority to adjudicate the Counterclaim. In so doing, the Supreme Court expressly rejected the notion that filing a proof of claim makes a creditor subject to a bankruptcy court's jurisdiction for all purposes. In resolving the Counterclaim, the Bankruptcy Court was required to, and did, make "factual and legal determinations that were not 'disposed of in passing on objections' to Pierce's proof of claim for defamation."<sup>12</sup> Though there was some overlap between the Counterclaim – a state tort action that did not derive from or depend on bankruptcy law – and the defamation claim, there was no reason to believe that adjudicating Pierce's proof of claim would resolve the Counterclaim.

Third, the Court rejected Vickie's argument that the Bankruptcy Court's final judgment was constitutional because bankruptcy courts are deemed "adjuncts" of the district courts. The Court stated that bankruptcy courts, which have the power to enter orders and judgments, including final judgments, subject to review only if a party appeals, exercise "the essential attributes of judicial power over a matter"<sup>13</sup> such as the Counterclaim. Following this reasoning, the Court determined that a bankruptcy court is no more an "adjunct" of the district court than a district court is an "adjunct" of the court of appeals.

Finally, the Court rejected practical arguments that its constitutional interpretation would create significant delays in, and impose additional costs on, the bankruptcy process by restricting a bankruptcy court's ability to resolve compulsory counterclaims.

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<sup>10</sup> *Granfinanciera, S. A. v. Nordberg*, 492 U.S. 33 (1989).

<sup>11</sup> *Stern*, 2011 U.S. LEXIS 4791, at \*55 (quoting *Granfinanciera*, 492 U.S. at 56).

<sup>12</sup> *Id.* at \*64.

<sup>13</sup> *Id.* at \*69.

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## Conclusions and Implications

In this decision, the Supreme Court narrowed the authority of bankruptcy courts by holding that they cannot enter final judgments on state law counterclaims that are not resolved in the process of ruling on creditors' proofs of claim. In so holding, the Court determined that Congress had violated Article III when it gave bankruptcy courts the authority to enter a final judgment with respect to a state law action that does not derive from or depend on federal bankruptcy law. Importantly, the Court did not eliminate the authority of bankruptcy courts to enter a final judgment with respect to a state law counterclaim that is so connected with a creditor's claim that the counterclaim must be resolved in the process of ruling on a creditor's proof of claim in a bankruptcy case. But given the Court's narrow conception of public rights – being limited to those cases in which a claim derives from a federal regulatory scheme or in which resolution of the claim by an expert government agency is essential to a limited regulatory objective within the agency's authority – it remains to be seen where bankruptcy courts will view their ability to enter final orders curtailed, and what the impact will be on the conduct of bankruptcy cases – whether, for example, bankruptcy courts may enter final judgments in intercreditor disputes with respect to their state law rights and remedies.

Furthermore, in noting that fraudulent conveyance actions are “quintessentially suits at common law,”<sup>14</sup> the Court's decision seems to suggest that garden variety fraudulent transfer actions brought under state law cannot be adjudicated to a final order in a bankruptcy court, but must instead be heard in the first instance by a federal district court or, alternatively, in a bankruptcy court that could only submit proposed findings of fact and conclusions of law for *de novo* review by a federal district court, which would then enter a final judgment. The Court's decision also seems to suggest that typical state law causes of action are outside the jurisdiction of a bankruptcy court to determine on a final basis, as such causes of action would not fall within the public rights exception. Importantly, it remains unclear whether or not fraudulent transfer actions brought under section 548 of the Bankruptcy Code will be treated similarly to preference actions under section 547 (which the Court has permitted to be determined on a final basis by a bankruptcy court) or to state law fraudulent transfer actions (which the Court indicates must be subject to *de novo* review by a federal district court).

Although the practical effects of the *Stern* decision are yet to be determined, there is little doubt that defendants in state law actions commenced in bankruptcy cases will view *Stern* as another basis for withdrawing from a bankruptcy court its reference to hear an issue or case.<sup>15</sup> Indeed, *Stern* has been cited already in several instances in various motions to withdraw the reference pending in the Madoff Securities Investor Protection Act cases by defendants seeking to have state law fraudulent transfer and other state law claims pending against them heard by a federal district court as opposed to the bankruptcy court overseeing those cases.

Importantly, given the Court's decision, it is now clear that a bankruptcy court cannot adjudicate all of a creditor's rights simply because the creditor has filed a proof of claim in a bankruptcy case. This principle runs counter to the adage that by filing a proof of claim in a bankruptcy case, a creditor has consented to the bankruptcy

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<sup>14</sup> *Id.* at \*55 (quoting *Granfinanciera*, 492 U.S. at 56).

<sup>15</sup> In *In re BearingPoint, Inc.*, No. 09-10691, 2011 Bankr. LEXIS 2585 (Bankr. S.D.N.Y. July 11, 2011), BearingPoint's confirmed plan of reorganization created a liquidating trust by which the trustee could pursue, but only in the bankruptcy court, claims owned by BearingPoint for alleged breaches of fiduciary duty against BearingPoint's former CEO and former directors. After *Stern*, the bankruptcy court held that it should not have required the trustee to litigate such non-core claims in the bankruptcy court, because, among other things, the action would be delayed significantly in the bankruptcy court and in the district court by motion practice premised on the bankruptcy court's lack of constitutional authority to issue findings and orders. The bankruptcy court noted that, in *Stern*, the Supreme Court expressed views inconsistent with the bankruptcy court's original premise – namely, that the parties' consent was sufficient for the bankruptcy court to decide the non-core claims – where the Supreme Court found Pierce's consent to resolution of the Counterclaim in the Bankruptcy Court proceedings to be inadequate. While stating that the “better view” is that the Supreme Court's decision rested on the basis that Pierce's consent was “only implied or under duress,” the bankruptcy court acknowledged that parties will now argue that consent is never sufficient for bankruptcy courts to issue final judgments on non-core matters.

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court's jurisdiction for all purposes. As a result, the decision might change, in any given case, the dynamic of determining whether or not to file a proof of claim.

Although the majority of the Court states that the decision “does not change all that much,”<sup>16</sup> it may in fact create significant problems in administering bankruptcy cases. For instance, assume, as discussed in Justice Breyer's dissent, a typical bankruptcy case where a tenant files for bankruptcy and the tenant's landlord files a proof of claim for unpaid rent. Assume further that the tenant asserts a counterclaim for damages suffered because the landlord (1) failed to fulfill its obligations as lessor, and (2) improperly recovered possession of the premises by misrepresenting the facts in housing court. These state law counterclaims – which, according to Justice Breyer, would not necessarily be resolved in the claims allowance process – would likely have to be adjudicated by a federal district judge (either in the first instance or through *de novo* review of a bankruptcy court's proposed findings of fact and conclusions of law), while the landlord's proof of claim could be adjudicated to a final judgment by a bankruptcy judge. As Justice Breyer warns, this “game of jurisdictional ping-pong between courts”<sup>17</sup> may lead to inefficiency, increased cost, and additional delay.

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<sup>16</sup> *Stern*, 2011 U.S. LEXIS 4791, at \*73.

<sup>17</sup> *Id.* at \*103 (Breyer, J., dissenting).

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