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Court Restricts Bankruptcy Court Jurisdiction In *Stern v. Marshall*

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The Supreme Court's 5-to-4 decision in *Stern v. Marshall*, 131 S. Ct. 2594, 2011 WL 2472792 (June 23, 2011), drew upon a tortured factual background filled with sensational accusations and revelations, to deliver an opinion that definitively upsets a quarter-century's jurisdiction by bankruptcy courts over a large set of actions. It alters how trustees and debtors-in-possession can (and must) now seek many (if not most) recoveries on behalf of bankruptcy estates, even when the defendants in such suits have voluntarily submitted themselves to the bankruptcy process by filing a proof of claim.

'Very Basic Principles'

Stripped of its contorted background, the Court's holding in *Stern v. Marshall* turns on "very basic principles." *Stern v. Marshall* at *6. Section 157(b)(2)(C) of title 28, United States Code, clearly establishes as "[c]ore proceedings" "counterclaims by the estate against persons filing claims against the estate." 28 U.S.C. § 157(b)(2)(C). Under section 157, U.S. bankruptcy judges have statutory authority to try and enter final orders in all "core proceedings" of a bankruptcy. 28 U.S.C. §§ 157(a) and (b). The Court agreed that such "core proceedings" are only those that arise under title 11 or in a title 11 case; none fall outside of this limited range. *Stern v. Marshall*, at *10. Despite this delimited statutory ambit, however, the Court held unconstitutional section 157's grant of jurisdiction to bankruptcy courts for entering final judgments on counterclaims by bankruptcy estate representatives, except such counterclaims based on "public rights." *Id.* at *18. The Court determined that a bankruptcy court's final adjudication of such counterclaims is an illegitimate invasion of the "'judicial Power of the United States.'" *Id.* at *14 (quoting U.S. Const., Art. III, § 1). Importantly, the Supreme Court clearly extended its decision to where, as in *Stern v. Marshall*, the counterclaim interposed is compulsory in an adversary proceeding brought by the claimant and the claimant has also filed a proof of claim in the bankruptcy case. *Id.*

The Majority

Writing for the majority, Chief Justice Roberts stated that bankruptcy judges authorized under Article I of the U.S. Constitution who do not enjoy the life tenure and salary protections of judges empowered by the Constitution's Article III could not legitimately adjudicate counterclaims involving "'the stuff of the traditional actions at common law tried by the courts at Westminster in 1789,'" because conceding this authority to bankruptcy judges would violate the separation of powers demanded by the Constitution. *Id.* at *14 (citations omitted).

In defending the judiciary branch's authority, the Court further declared unavailing Congress' 1984 overhaul of the statutes governing bankruptcy court jurisdiction to alleviate jurisdictional concerns of the type raised by *Stern v. Marshall*. More than a quarter-century ago, Congress first enacted section 157 and related statutes to address the Supreme Court's ruling at the time that the bankruptcy courts as then constituted invaded the purview of Article III courts. *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 102 S.Ct. 2858 (1982). Congress' solution involved creating the very structure described in today's statute, *i.e.*, bankruptcy courts established by and existing at the discretion of the U.S. district courts (certainly Article III tribunals) from which the district courts can and sometimes must withdraw the reference of a bankruptcy proceeding. 28 U.S.C. §§ 157(a) and (d). Yet in *Stern v. Marshall*, the Court declared that, despite these statutory and other changes, the bankruptcy courts still exercise "the essential attributes of judicial power over a matter such as Vickie's counterclaim." *Id.* at *24. There can be no room for even slight invasion of the cases and controversies cordoned off by Article III, even where clear authority abides under the statutory framework previously created to address the concerns over the bankruptcy courts' constitutionality as raised in *Northern*.

As aggressively as the Roberts majority combated any attempt to "chip away at the authority of the Judicial Branch," *Stern v. Marshall* at *26, the Court did not so defend the assignment of "personal injury torts" to trial only by a district court, rather than a bankruptcy court. In fact, the Roberts decision treats section 157(b)(5)'s direction that all "personal injury tort[s]" "shall be tried" in the district court as a mere "[allocation of] the authority to enter final judgment between the bankruptcy court and the district court," and not a jurisdictional directive. *Stern v. Marshall* at *12. Unlike the jurisdictional question found by the Court in clause

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(b)(2) of the statute, then, the Supreme Court declared that a litigant can (and in this case Pierce did) waive his right to demand a trial in the district court of matters described in section 157(b)(5). *Id*.

What Are the Consequences Of the *Stern v. Marshall* Decision?

Under *Stern v. Marshall*, bankruptcy courts cannot try to final adjudication counterclaims by bankruptcy estate representatives asserting common law torts. Now, bankruptcy estate representatives in every judicial district must undertake potentially more complicated efforts in achieving recoveries from creditors, in many instances by necessarily bringing causes of action for recovery in other courts. For creditors, the Supreme Court's decision conclusively means that a debtor-in-possession or trustee cannot seek a recovery from you in bankruptcy court in most circumstances — even when you have filed a proof of claim in the bankruptcy case.

The dissent in *Stern v. Marshall* described exactly how difficult the work of trustees and debtors-in-possession now becomes. Writing for the dissent, Justice Breyer foresees "jurisdictional ping-pong between courts [leading] to inefficiency, increased cost [and] delay … " *Stern v. Marshall* at *37. To explain, the dissent provided a number of examples where bankruptcy estate representatives, seeking to resolve both claims of and counterclaims against a creditor, would encounter the majority's roadblock to proceeding in bankruptcy court. Thus, according to the dissent, a tenant in bankruptcy, whose landlord files a proof of claim, could not prosecute his asserted counterclaims for "the landlord's (1) failing to fulfill his obligations as lessor, and (2) improperly recovering possession of the premises … " before the bankruptcy judge. *Stern v. Marshall* at *37 (dissent) (citing *In re Beugen*, 81 B.R. 994 (Bankr. N.D. Cal. 1988)). In another example, a Chapter 7 trustee suing a claim-filer for breach of contract, fraud and negligence could not maintain those causes of action in the bankruptcy court, according to the dissent. *Id*. (citing *In re Winstar Commc'ns, Inc.*, 348 B.R. 234 (Bankr. D. Del. 2005), aff'd, 2007 WL 1232185 (D. Del. Apr. 26, 2007), modified, 554 F.3d 382 (3d Cir. 2009)). Similarly, a debtor's state law claims for breach of contract, fraud and conversion against a creditor who filed a proof of claim would lie beyond the bankruptcy court's power of final adjudication. *Id*. (citing *In re Sun West Distributors, Inc.*, 69 B.R. 861 (Bankr. S. D. Cal. 1987)). Further, a state court lawsuit brought prior to the bankruptcy, in which creditors of the debtor sue for control of a company and the debtor responds with a counterclaim over control of the same business, which is later removed as an adversary proceeding to the bankruptcy court, could not stay there, believes the dissent. *Id*. (citing *In re Ascher*, 128 B.R. 639 (Bankr. N.D. Ill. 1991)).

Efficiency and Effectiveness

The *Ascher* example raises a particular concern about the problems of efficiency and effectiveness in bankruptcy case administration. A recognized mission of bankruptcy courts is to either reorganize a bankruptcy estate or liquidate and distribute it as quickly as possible. In *Ascher*, a long lack of progress in the state court litigation lead to the removal of the suit to the bankruptcy court. 128 B.R. at 642. Yet, thanks to the *Stern v. Marshall* holding, Justice Breyer believes that bankruptcy courts could not keep such controversies and, instead, will face undue delay as they wait for other courts to settle numerous matters of asset recovery, crucial to administering many bankruptcy cases.

The dissent even posited that a disbursing agent under a confirmed plan, granted authority by the plan to pursue claims of the estate, would no longer be able to obtain a final judgment in bankruptcy court on state law claims for fraud against the debtor company's former accounting firm that had filed a claim in the case. *Id*. (citing *In re CBI Holding Co.*, 529 F.3d 432 (2d Cir. 2008)). Importantly, the Second Circuit in *CBI Holding* noted that the disbursing agent's claims against the accountants were qualitatively different from those in *Stern v. Marshall*. (The Second Circuit reviewed the underlying facts in *Stern v. Marshall* because the decision of the district court in California's Central District in *Marshall v. Marshall* was then already reported. 264 B.R. 609 (C.D. Cal. 2001)). The Second Circuit described that, unlike Vickie's claims against Pierce, the CBI claims against the accountants "unquestionably share[d] a common transactional nexus with, and raise[d] similar issues of law to, [the accounting firm's] Proof of Claim." 529 F.2d 432, 464. This distinction, according to the Second Circuit, yielded grounds to permit the state law counterclaims to remain in the bankruptcy court for final adjudication. While the majority in *Stern v. Marshall* agreed with the Second Circuit's assessment and determined that there was only minimal overlap between the determination of the *Pierce* proof of claim and the adjudication of Vickie's counterclaim, the majority's holding does not rely on just this distinction as the basis for rejecting bankruptcy court jurisdiction over the counterclaim. *Id*. at *23. Instead, Justice Roberts wrote that "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 *24. Absent these qualities, unless the counterclaim enjoys the exception of the "'public rights' doctrine, the presumption is in favor of Art. III courts,'" and not the bankruptcy court. *Id*. (citation omitted).

Excluding 'Core Matters'

Does the *Stern v. Marshall* holding imply that other "core" matters described in section 157(b)(2) may soon be excluded from final adjudication in the bankruptcy court? The Roberts decision seems to invite a challenge to bankruptcy courts' authority to adjudicate on a final basis "proceedings to determine, avoid, or recover fraudulent conveyances," codified as "core" at subsection 157(b)(2)(H) of title 28, United States Code. In reasoning its conclusion about the proper forum for Vickie's counterclaim, the Court stated that her cause of action should be treated in the same way as "the fraudulent conveyance action in *Granfinanciera*" (*i.e.*, *Granfinanciera, S.A. v. Nordberg*, 492

U.S. 33, 109 S.Ct 2782 (1989)). *Stern v. Marshall* at *24. In *Granfinanciera*, the Supreme Court concluded that "a bankruptcy trustee's right to recover a fraudulent conveyance under 11 U.S.C. § 548(a)(2)" was a "private rather than a public right." *Granfinanciera*, 492 U.S. at 55. Given that determination, and since the petitioner in *Granfinanciera* had never filed a proof of claim in the case, the Supreme Court ruled that the petitioner's right to a jury trial under the Constitution's Seventh Amendment subsisted, despite the matter's assignment to a bankruptcy court pursuant to title 28 of the U.S. Code. *Id*.

Of course, in *Stern v. Marshall*, Pierce had filed a proof of claim to collect against Vickie's estate for her alleged defamation. Yet the Roberts majority refused to pin the choice between an Article I or Article III court on the filing (or not) of a claim. Instead, the Court identified the key difference as whether the action "attempts to augment the bankruptcy estate — the very type of claim that we held in *Northern Pipeline* and *Granfinanciera* must be decided by an Article III court." *Id*. at *21. The Roberts majority shows little interest in any claim that the defendant may have filed; instead, the Court cares whether the action against the creditor seeks "'to augment the bankruptcy estate,'" or instead only attempts to modify the available "'pro rata share of the bankruptcy res.'" *Id*. at *24 (citation omitted). In the former case, the *Stern v. Marshall* holding demands an Article III court's adjudication, regardless of any claim's filing, while, in the latter, the bankruptcy court maintains authority. *Id*. In short, "the question is whether the action at issue stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process" for the suit to stay in the bankruptcy court. *Id*. In this light, it seems likely that an action to recover money on a fraudulent conveyance or fraudulent transfer theory would provide the same basis as the *Stern v. Marshall* holding to insist that an Article III court make the final adjudication, even against a claim-filing creditor.

'Core Proceedings'

The *Stern v. Marshall* holding also indicates two "core proceedings" identified in section 157(b)(2), which appear to remain safely under the bankruptcy court's jurisdiction. First, it seems clear that "allowance or disallowance of claims against the estate … " 28 U.S.C. § 157(b)(2)(B), remains firmly within the bankruptcy court's realm of legitimate, final adjudication, since "the process of allowing or disallowing claims" need not be performed by an Article III court. *Stern v. Marshall* at *22.

Another "core" category that appears to remain in the bankruptcy courts under *Stern v. Marshall* consists of "proceedings to determine, avoid, or recover preferences" against creditors who have filed proofs of claim. 28 U.S.C. § 157(b)(2)(F). For the Roberts majority, there are two reasons that preference suits against claim filers would seem not to require Article III adjudication. First, a preferential transfer constitutes "in effect [an] increase [in a] creditor's proportionate share of the estate," and, so, "resolution of the preference issue [is] part of the process of allowing or disallowing claims … " *Stern v. Marshall* at *21-22. (However, the Court confirmed that a preference action against a party that has not filed a claim lies outside the boundaries of acceptable jurisdiction of an Article I court. *Id*. at *22.) Second, a preference action is "a right of recovery created by federal bankruptcy law." *Id*. at *23.

Consent and Waiver

Consent and waiver issues also draw the Court's attention in *Stern v. Marshall*. The majority's clear ruling that Pierce effectively waived his right to insist that a "personal injury tort" be "tried" by the district court by failing to oppose, and even stating his support of, the bankruptcy court's adjudication, underscores the difference with which the Roberts majority treated statutes it perceives as jurisdictional, versus those it does not. *Id*. at *12–13. The majority bristled at Pierce's perceived attempt at "'sandbagging' the court" when it came to his tardy assertion of the right to have his claim heard in the district court under section 157(b)(5). *Id*. at *13 (citations omitted). Further, the majority took pains to separate the right to trial before a district court under section 157(b)(5) from a statute that addresses the subject-matter jurisdiction of a federal court. As described in another Supreme Court decision from this term, *Henderson v. Shinseki*, 562 U.S. --, 131 S. Ct. 1197, 1202 (2011) (cited in *Stern v. Marshall*), courts have an "independent obligation to ensure that they do not exceed the scope of their jurisdiction," so questions of subject-matter jurisdiction will receive consideration, even if raised belatedly, but not Pierce's new-found argument under section 157(b)(5).

The themes of consent and waiver also play a part in the dissent's criticism of the majority's *Stern v. Marshall* holding. The dissent criticized the majority for failing to find that Pierce consented to the prosecution of Vickie's counterclaim in the bankruptcy court when Pierce filed his proof of claim. Justice Breyer stated in the dissent that Pierce "appeared voluntarily in Bankruptcy Court as one of Vickie Marshall's creditors … " *Stern v. Marshall* at *34. So, Justice Breyer argued, under *Granfinanciera* and *Langenkamp v. Culp*, 498 U.S. 42, 111 S.Ct. 330 (1990). Pierce's voluntary claim filing should have sufficed as consent to the bankruptcy court's jurisdiction, even as to the counterclaim. Of course, the majority clearly staked out a different position.

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