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Stern v. Marshall: Supreme Court Declares Part of the Bankruptcy Code's Jurisdictional Provisions Unconstitutional

In a significant decision that reinforced the U.S. Supreme Court's prior plurality decision in *Marathon*, the Court determined that while bankruptcy courts have the statutory authority to hear state-law compulsory counterclaims to a creditor's proof of claim under section 157(b)(2)(C) of Title 28, Article III of the U.S. Constitution requires such proceedings to be heard by Article III judges where they would not be resolved as part of the claims allowance process. The Court's decision breathes new life into Article III in the bankruptcy context and ensures that its provisions are not "transformed from the guardian of individual liberty and separation of powers . . . into mere wishful thinking."

As Chief Justice Roberts colorfully explained at the outset of the Court's opinion, like the suit in Charles Dickens's Bleak House, the *Stern v. Marshall* case "has, in course of time, become so complicated, that . . . no two . . . lawyers can talk about it for five minutes, without coming to a total disagreement as to all the premises."[1] As the Court explained, the litigation "has worked its way through state and federal courts in Louisiana, Texas, and California, and two of those courts—a Texas state probate court and the Bankruptcy Court for the Central District of California—have reached contrary decisions on its merits."[2]

This update will begin with a brief summary of the statutory background of this case, as well as the background of the litigation itself. It will then provide a summary of the main points of the decision and conclude with some analysis of its implications.

Statutory Background

Article III, section 1 of the U.S. 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."[3] Article III further commands that the judges of those courts must be afforded

1 *Stern v. Marshall*, No. 10-179, 2011 WL 2472792, at *5 (U.S. June 23, 2011) (quoting C. DICKENS, BLEAK HOUSE, IN 1 WORKS OF CHARLES DICKENS 4-5 (1891)).

2 *Id.*

3 U.S. CONST. art. III, § 1.

life tenure during good behavior and a salary that cannot be reduced by Congress.[4]

In 1978, Congress enacted the current Bankruptcy Code, created a new system of non-Article III bankruptcy courts, and vested those courts with broad jurisdiction to hear and determine all "civil proceedings arising under title 11 [the Bankruptcy Code] or arising in or related to cases under title 11."[5] Congress did not, however, provide life tenure or irreducible salary to the bankruptcy judges who were to exercise those broad powers. That led to the Supreme Court's 1982 decision in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co. ("Marathon")*, in which the Court declared the jurisdictional provisions of the 1978 statute to be constitutionally invalid.[6] The Court held that Congress could not grant non-Article III bankruptcy courts jurisdiction to finally decide a state law claim merely because it was "related to" the bankruptcy petition, because doing so "impermissibly removed most, if not all, of 'the essential attributes of the judicial power' from the Art. III district court."[7]

Section 157(b)(2)(C) of the Bankruptcy Code was enacted as part of the Bankruptcy Amendments and Federal Judgeship Act of 1984.[8] That statute was the direct response of Congress to the Supreme Court's decision in *Marathon*. In an effort to remedy the concerns expressed by the Supreme Court in *Marathon*, Congress recast bankruptcy judges as non-Article III "unit[s]" of the district court "to be known as the bankruptcy court for that district,"[9] and enacted sections 1334(b) and 157 of the Bankruptcy Code to govern the exercise of federal bankruptcy jurisdiction.[10]

In relevant part, section 157(b)(1) authorizes a bankruptcy judge to "hear and determine" (in other words, finally decide) all "core proceedings arising under title 11 [the Bankruptcy Code], or arising in a case under title 11," subject to ordinary appellate review.[11] In contrast, section 157(c)(1) authorizes a bankruptcy judge to "hear" a proceeding that is "related to" a case under title 11, but not to finally decide it.[12] For "related to" matters, the bankruptcy judge submits proposed findings of fact and conclusions of law, subject to *de novo* review in the district court.[13] The Supreme Court's decision in *Stern v. Marshall* addressed the constitutionality of part of Congress's response to *Marathon*.

Case Background

Stern v. Marshall concerned the disposition of the estate of J. Howard Marshall ("J. Howard") following his marriage to Vickie Lynn Marshall (also known as Anna Nicole Smith) ("Vickie") and subsequent death. Following his passing, Vickie allegedly defamed J. Howard's son Pierce Marshall ("Pierce"), and Pierce filed suit against Vickie in state court for defamation. Vickie subsequently filed for bankruptcy, and Pierce filed a nondischargeability complaint and proof of claim related to the defamation action. Vickie then filed a counterclaim against Pierce, alleging a state-law claim of tortious interference with her expectancy of a gift from J. Howard. Pierce objected to the counterclaim on various grounds, including jurisdiction.

On September 27, 2000, nearly a year after summarily adjudicating Pierce's defamation claim, the bankruptcy court entered judgment against Pierce on Vickie's counterclaim for over $474 million. The bankruptcy court relied on section 157(b)(2)(C) to hold that Vickie's counterclaim was a "core proceeding" that could be finally decided by the bankruptcy court because it was a "counterclaim[] by the estate against [a] person[] filing [a] claim[] against the estate."[14]

Pierce appealed the $474 million judgment to the district court, contending (among other things) that the bankruptcy court lacked jurisdiction to enter a final judgment on Vickie's counterclaim. The district court agreed and held that despite the "literal language" of section 157(b)(2)(C), the constitutional limits on "core

4 *Stern*, 2011 WL 2472792, at *6.

5 28 U.S.C. §1471(b) (1978) (repealed 1984).

6 458 U.S. 50 (1982).

7 *Id.* at 87 (plurality); *see also id.* at 91-92 (Rehnquist, J., concurring in judgment).

8 28 U.S.C. § 157(b)(2)(C).

9 *Id.* § 151.

10 *Id.* §§ 157, 1334(b).

11 *Id.* §§ 157(b)(1), 158.

12 *Id.* § 157(c)(1).

13 *Id.*

14 28 U.S.C. § 157(b)(2)(C).

proceedings" made Vickie's counterclaim "non-core" because it was only "somewhat related" to Pierce's defamation claim, and Pierce was entitled to an adjudication of Vickie's allegations in an Article III forum. Accordingly, the district court vacated the bankruptcy court's $474 million judgment. Meanwhile, following a five-and-a-half month jury trial, the Texas probate court entered a judgment concluding that Pierce did not owe Vickie anything. Following the Texas jury trial, the district court imposed its own judgment against Pierce for roughly $89 million. Pierce appealed the $89 million judgment to the Ninth Circuit, and Vickie appealed the district court's decision overturning the bankruptcy court's $474 million award.

The Ninth Circuit affirmed the district court's vacatur of the bankruptcy court's $474 million award, reversed the district court's $89 million judgment, and ordered dismissal of the case, concluding that under the "probate exception" to federal court jurisdiction, the federal courts could not decide Vickie's counterclaim. On certiorari review, however, the Supreme Court reversed the Ninth Circuit and remanded. On remand, the Ninth Circuit again reversed the district court's $89 million judgment on the ground that the prior Texas probate judgment precluded further litigation of Vickie's claim in federal district court. The Ninth Circuit also affirmed the district court's vacatur of the bankruptcy court's $474 million judgment, holding that Vickie's counterclaim was not a "core proceeding" because her counterclaim was "not so closely related to Pierce Marshall's defamation claim that it must be resolved in order to determine the allowance or disallowance of his claim against her bankruptcy estate."[15] Accordingly, the Ninth Circuit held that the bankruptcy court lacked jurisdiction to issue a final order on Vickie's counterclaim. Because the bankruptcy court lacked jurisdiction to enter a final order, the Ninth Circuit held that the Texas probate court judgment had preclusive effect and barred the district court's subsequent $89 million judgment. Once again, the Supreme Court granted certiorari to review the case.

[15] *Marshall v. Stern (In re Marshall)*, 600 F.3d 1037, 1059 (9th Cir. 2010).

The Bankruptcy Court's Statutory Authority to Finally Decide a Counterclaim Is Not Enough

In a five-to-four decision affirming the Ninth Circuit, the Supreme Court held that "although the Bankruptcy Court had the statutory authority to enter judgment on Vickie's counterclaim, it lacked the constitutional authority to do so."[16]

The Court began by considering whether the bankruptcy court had the statutory authority to finally adjudicate Vickie's state-law counterclaim. According to the decision, bankruptcy courts have the statutory authority to adjudicate all "core proceedings." The Court then explained that "core proceedings" are those that "arise in a bankruptcy case or under Title 11," and that the "core proceedings" listed in section 157(b)(2) of the Bankruptcy Code are "ready examples of such matters."[17] As a result, the Court held that Vickie's state-law counterclaim was a "core proceeding" that the bankruptcy court had the statutory authority to adjudicate because the plain language of section 157(b)(2)(C) provided that "core proceedings" include "counterclaims by the estate against persons filing claims against the estate."[18]

Having determined that the bankruptcy court had the *statutory* authority to adjudicate Vickie's state-law counterclaim, the Court then considered whether the bankruptcy court had the *constitutional* authority to do so. The Court reiterated its earlier conclusion in *Marathon* that "[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."[19] The Court determined that the adjudication of Vickie's state-law counterclaim in federal court required the exercise of the federal judicial power and

[16] *Stern*, 2011 WL 2472792, at *6.

[17] *Id.* at *10.

[18] *Id.* at *9-10. The Court also concluded that section 157(b)(5) did not eliminate the bankruptcy court's jurisdiction because it decided that section 157(b)(5) is not jurisdictional and that Pierce consented to the bankruptcy court's resolution of his defamation claim by his actions in the bankruptcy court. *Id.* at *11-13.

[19] *Id.* at *14 (quoting *Marathon*, 458 U.S. at 90 (Rehnquist, J., concurring in judgment)).

that under the provisions of Article III, that power must be exercised by a federal judge protected by the guarantees of lifetime tenure and irreducible salary.

The Court explained that the case before it involved "the most prototypical exercise of judicial power: the entry of a final, binding judgment *by a court* with broad substantive jurisdiction, on a common law cause of action, when the action neither derives from nor depends upon any agency regulatory regime."[20] Declining to find a "public right" exception from prior precedent that applied to Vickie's counterclaim, the Court continued, "[i]f such an exercise of judicial power may nonetheless be taken from the Article III Judiciary simply by deeming it part of some amorphous 'public right,' then Article III would be transformed from the guardian of individual liberty and separation of powers we have long recognized into mere wishful thinking."[21]

The Court then considered Vickie's argument that because Pierce filed a proof of claim, the bankruptcy court was permitted to finally adjudicate her counterclaim in light of the Court's prior decisions in *Katchen v. Landy* and *Langenkamp v. Culp*.[22] The Court distinguished its prior precedents and explained that "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."[23] Because "there was never any reason to believe that the process of adjudicating Pierce's proof of claim would necessarily resolve Vickie's counterclaim," the Court declined to accept Vickie's argument.[24]

The Court further held that despite the changes Congress made to the structure of the bankruptcy courts and their appointment process, Congress had not made bankruptcy courts Article III courts under the Constitution. The Court explained that bankruptcy judges are not Article III judges because they do not have life tenure or salary protection and instead are subject to supervision by the circuit courts of appeal that appoint them. The Court also declined to construe the bankruptcy courts as "mere adjuncts" of the district courts because a bankruptcy judge resolving a counterclaim under section 157(b)(2)(C) has the power to enter a final judgment subject only to ordinary appellate review. According to the Court, "[g]iven that authority, a bankruptcy court can no more be deemed a mere 'adjunct' of the district court than a district court can be deemed such an 'adjunct' of the court of appeals."[25]

Implications of *Stern v. Marshall*

The Court did not believe that "the removal of counterclaims such as Vickie's from core bankruptcy jurisdiction meaningfully changes the division of labor in the current statute" and agreed with the United States "that the question presented" was a "'narrow' one."[26] The dissent disagreed, of course.[27] In any event, the potential ramifications of the decision are significant.

One thing is clear: the Court's decision will affect the jurisdictional analysis of the lower courts. Prior decisions from lower courts have frequently viewed the core/non-core determination as conclusive with respect to the jurisdictional issue. Indeed, the Supreme Court acknowledged in *Stern v. Marshall* that in *Granfinanciera*, it had "suggested that a proceeding's 'core' status alone authorizes a bankruptcy judge, as a statutory matter, to enter final judgment in the proceeding."[28] Following this decision, however, determination of whether a matter is "core" will only be the first part of the analysis. Courts will also have to consider the relevant constitutional implications.

It is also likely that, in light of the Court's decision, the new test for whether a matter can constitutionally be finally adjudicated by a bankruptcy court is "whether the action at issue stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process."[29] That test was the basis for the Court's

20 *Id.* at *21 (emphasis in original).

21 *Id.*

22 *See Langenkamp v. Culp*, 498 U.S. 42 (1990) (per curiam); *Katchen v. Landy*, 382 U.S. 323 (1966).

23 *Stern*, 2011 WL 2472792, at *24 (emphasis in original).

24 *Id.* at *23.

25 *Id.* at *25.

26 *Id.* at *26.

27 *Id.* at *37.

28 *Id.* at *9 (citing *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 50 (1989)).

29 *Stern*, 2011 WL 2472792, at *24.

distinction of its prior precedents in *Katchen* and *Langenkamp* and was essentially the same test employed by both the Ninth Circuit and district court in the proceedings below.

The Court did not, however, clearly address how consent affects the analysis. In light of the Court's focus on the "claims allowance process" to determine whether Article III applies to adjudication of a debtor's counterclaim, it may well be advisable to refrain from filing a claim in bankruptcy if a litigant does not want to risk being subjected to the bankruptcy court's jurisdictional reach. On the other hand, the Court also reiterated the point made in *Granfinanciera* that "creditors lack an alternative forum to the bankruptcy court in which to pursue their claims," perhaps suggesting that the mere filing of a state-law claim in bankruptcy may not be enough to subject oneself to the bankruptcy court's equitable jurisdiction.[30] Also, the Court did not think that "Pierce's decision to file a claim should make any difference with respect to the characterization of Vickie's counterclaim."[31]

Litigation on the basis of jurisdiction is sure to increase in the wake of this decision. To those facing potential litigation in bankruptcy, it is important to take heed of the potential pitfalls of filing a claim and to obtain legal advice before doing so.

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30 *Id.* at *20; *see also id.* at *20 n.8 ("as we recognized in *Granfinanciera*, the notion of 'consent' does not apply in bankruptcy proceedings as it might in other contexts.")

31 *Id.* at *21.

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