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LITIGATION

Stern v. Marshall bankruptcy case: bombshell or dud?

By Eric J. Fromme and Caroline Djang

Since the U.S. Supreme Court's ruling in *Stern v. Marshall*, 131 S. Ct. 2594 (2011) in June of this year, much has been written about the case — especially its potential impact on the bankruptcy courts. In *Stern*, the Supreme Court held that a bankruptcy court could not, as a constitutional matter, enter a final judgment on a counterclaim that did not arise under the Bankruptcy Code or in a bankruptcy case, even though 28 U.S.C. Section 157(b)(2)(C) expressly permits it to do so. Some have called *Stern* "the most important Supreme Court case on bankruptcy court jurisdiction since *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 459 U.S. 813 (1982)." *Marathon* held that a bankruptcy court had no power to enter a final order with respect to "private" right claims and declared the portions of the Bankruptcy Code that attempted to do so unconstitutional, resulting in a redraft of the Bankruptcy Code in 1984.

FIRST IN A TWO PART SERIES

So, was Chief Justice John G. Roberts Jr. correct — will the Stern decision have little impact or will it wreak havoc in the bankruptcy courts?

Nearly four months after the *Stern* decision, the case is undoubtedly the source of much confusion, inconsistent rulings, and a multitude of so-called "*Stern* motions," i.e. motions alleging that the bankruptcy court does not have constitutional authority to render a final decision in matters ranging from fraudulent or preferential transfers to breach of contract to allowance of claims against the bankruptcy estate. So, was Chief Justice John G. Roberts Jr. correct — will the *Stern* decision have little impact or will it wreak havoc in the bankruptcy courts? Will it lead to a re-draft of the Bankruptcy Code as *Marathon* did?

For those unfamiliar with the back story, the original litigants in *Stern* were Anna Nicole Smith (who filed under her real name, Vickie Lynn Marshall), and E. Pierce Marshall. Smith was married to Pierce's father, J. Howard Marshall II, a Texas billionaire. Prior to J. Howard's death, Smith sued Pierce in Texas probate court, alleging that Pierce fraudulently induced J. Howard to sign a living trust that did not include her. While the Texas proceeding was pending, Smith filed for bankruptcy, and Pierce filed a non-dischargeability complaint and a proof of claim in the bankruptcy case, alleging defamation. Smith filed a counterclaim for alleged tortious interference with J. Howard's gift to her. The Texas probate court ruled in Pierce's favor. Subsequently, the bankruptcy court entered a final judgment in Smith's favor.

Associated Press

Anna Nicole Smith arrives at a federal courthouse in Los Angeles in 1999 to present her case in the U.S. Bankruptcy Court.

On appeal, the 9th U.S. Circuit Court of Appeals held that the bankruptcy court lacked authority to enter judgment on Smith's counterclaim, which was based solely on state law, because it was not a "core" proceeding. The Supreme Court affirmed the 9th Circuit's ruling, but for different reasons. While the Court unanimously concluded that the bankruptcy court had statutory authority under 28 U.S.C. Section 157(b) to issue a final judgment on Smith's counterclaim because it was a "core" proceeding, it held that the bankruptcy court lacked the constitutional authority to decide the state law counterclaim. The Court reasoned that because Smith's counterclaim "did not flow from

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a federal statutory scheme" or "depend... on the will of Congress," the counterclaim could not be characterized as a public right that could be withdrawn from the Article III judiciary's purview.

The Supreme Court grounded its analysis on the difference between public and private rights, just as it did in *Marathon*. Private rights involve traditional common law disputes and other state law based claims, such as the state law contract claims in *Marathon*. Only Article III judges can resolve private rights, assuming subject matter jurisdiction exists. Public rights derive loosely from rights created by federal law or regulatory schemes, integrally tied to federal government action, or matters historically determined by the executive and legislative branches of government. Article I judges, which bankruptcy judges are, may determine public rights. Consequently, where Congress attempts to give bankruptcy judges the authority to finally determine private rights, it has over-stepped its authority as it abrogates litigants of their Article III protections.

28 U.S.C. Section 157 was Congress' attempt to identify the public rights that a bankruptcy court could finally determine. Under this statute, there are two categories of matters that a bankruptcy judge can hear: core matters (for which a bankruptcy judge can determine and enter orders and judgments subject to deferential appellate review) and non-core (for which a bankruptcy judge can only submit proposed findings and conclusions to the district court which are subject to *de novo* review). *Stern* implies that there is now a third category: "unconstitutionally core."

In *Stern*, the Supreme Court affirmed the 9th Circuit and held that a bankruptcy court, as a non-Article III court, did not have the constitutional authority to decide a state law claim brought by a debtor in bankruptcy against a creditor, even though the matter was part of the "core" statutory jurisdiction of the bankruptcy court under 28 U.S.C. Section 157(b)(2)(C) (which applies to counterclaims by the estate against persons filing claims against the estate). Thus, the ultimate holding of the Court is that Section 157(b)(2)(C) is unconstitutionally overbroad. The Court, however, narrowed its holding and specified "Congress, in one isolated respect, exceeded that [Article III] limitation." Furthermore, it stated that the holding was "narrow" and unlikely to have significant "practical consequences."

If this all sounds incredibly confusing, it should come as no surprise that bankruptcy courts around the country, and in some of the largest bankruptcy cases, have expressed frustration with the "cloud of uncertainty" relating to the bankruptcy court's authority to enter final judgments.

Since *Stern*, courts across the country have seen a "flurry of activity," resulting in seemingly inconsistent rulings as to the impact of *Stern*, and, at least initially, a significant impact on the administration of bankruptcy proceedings. A survey of post-*Stern* cases reveals that courts are dealing with *Stern* motions in connection with a wide variety of claims. For example, courts have found that the bankruptcy court *can* enter final judgments in: allowance of claim/interest (Section 157(b)(2)(B)); equitable subordination and preference claims (Section 157(b)(2)(B) and (F)); debtor's counterclaims that must be resolved to rule on creditor's claim (Section 157(b)(2)(C)); trustee's motion to compel turnover of property of the estate (Section 157(b)(2)(E)); (5) trustee's post-petition fraudulent transfer, breach of fiduciary duty, common law fraud claims (Section 157(b)(2)(E) and (H)); trustee's fraudulent transfer claim under Section 548 and post-petition transfer claim under Section 549 (Section 157(b)(2)(H)); motion for relief from stay (Section 157(b)(2)(G)); complaint to determine nondischargeability of debt (Section 157(b)(2)(I)); objection to discharge (Section 157(b)(2)(J)), and others.

By contrast, courts have somewhat surprisingly found that bankruptcy courts do not have the authority to enter final judgments with respect to creditor's claims and estate's counterclaims (Section 157(b)(2)(B) and (C)); trustee's breach of contract claims against creditor (Section 157(b)(2)(C)); trustee's preference claim under Section 547 (Section 157(b)(2)(F)); trustee's fraudulent transfer claims under Sections 544 and 548 (Section 157(b)(2)(H)); trustee's fraudulent transfer claim under Sections 548 and post-petition transfer claim under Section 549 (Section 157(b)(2)(H)); and determination that debt is nondischargeable (Section 157(b)(2)(I)).

These seemingly inconsistent decisions provide little guidance as to what types of claims a bankruptcy court can finally determine.

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Three recent decisions, however, seemingly limit the impact of *Stern v. Marshall* on the administration of proceedings in bankruptcy courts. Judge Dennis Montali's "*Recommendation of Bankruptcy Judge Regarding Motions to Withdraw the Reference*," entered on Sept. 28 in the *In re Heller Ehrman LLP* case, limits the impact of the Stern decision substantively, and if not, at least procedurally.

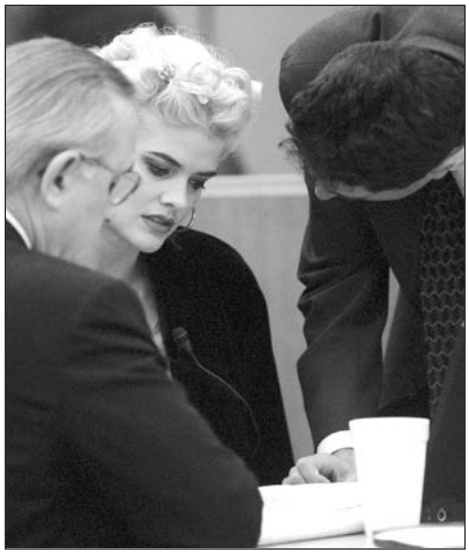
LAST IN A TWO PART SERIES

In the *Heller* opinion, Judge Montali opined that *Stern* was not the "game-changer" that the defendants alleged, and that it was inapplicable to the fraudulent transfer proceedings before him. He explained that post-*Stern*, some courts have concluded that they cannot hear fraudulent conveyance claims as core proceedings because of dicta in the *Stern* case ("Vickie's [Anna Nicole Smith] counterclaim — like the fraudulent conveyance claim at issue in *Granfinanciera* — does not fall within any of the varied formulations of the public rights exception in this Court's cases.") In rejecting the notion that bankruptcy courts cannot hear fraudulent conveyance claims on the ground that

> In the end, Stern may be limited by its unusual facts.

controlling 9th Circuit authority holds that fraudulent transfer claims stem from the bankruptcy itself, Judge Montali also opined that such an approach "thrusts unnecessary burdens on already overworked district courts, especially when bankruptcy courts have a particular expertise in an familiarity with avoidance actions."

Similarly, the Southern District of New York in In *re Coudert Brothers LLP*, decided on Sept. 23, also seemed to limit the impact of *Stern*. The *Coudert* court focused on the analysis of whether the claims at issue (breach of contract, misrepresentation, and tortious interference) involved "public" or "private" rights, and concluded that the claims involved only the vindication of private rights. It held that the breach of contract and misrepresentation claims involved "a right created by state law, a right independent of and antecedent to the reorganization petition that conferred jurisdiction upon the Bankruptcy Court." The remaining claim for tortious interference is "the very type of claim found to only involve 'private rights' per *Stern*." In concluding that the claims at issue involve private rather than public rights, the court held that the bankruptcy court could not finally determine the claims, then treated the bankruptcy court's decision as proposed findings of fact and conclusions of law subject to *de novo* review.



Associated Press

Anna Nicole Smith talks with attorneys after she testified about loan documents she said she did not sign, in Harris County Probate Court in Houston, Texas, in 2001.

In contrast, the Montana bankruptcy court in *Samson v. Blixseth* (*In re Blixseth*) held that the court could not constitutionally hear the fraudulent conveyance claim as a core proceeding, and did not have statutory authority to hear it as a non-core proceeding. Thus, the court in *Blixseth* granted the parties fourteen days to withdraw the reference pursuant to 28 U.S.C. Section 157(e). Otherwise, the court would dismiss the fraudulent conveyance claims for lack of subject matter jurisdiction.

The Southern District of New York and the bankruptcy courts in the Northern District of California and the Northern District of Illinois each disagreed with the *Blixseth* court's interpretation of *Stern*'s effect on subject matter jurisdiction. In I*n re Olde Prairie Block Owner LLC*, 2011 Bankr. LEXIS 3170 (Bankr. N.D. Ill. Aug. 25, 2011) the court explained, "although bankruptcy practitioners and judges often use the shorthand terms 'core jurisdiction' and 'related jurisdiction' when discussing [Section] 157, that provision is not jurisdictional. Rather, as *Stern* emphasized: Section 157 allocates the authority to enter final judgment between the bankruptcy court and the district court. See [Sections] 157(b)(1), (c)(1). That allocation does not implicate questions of subject matter jurisdiction. See [Section] 157(c)(2) (parties may consent to entry of final judgment by a Bankruptcy Judge in non-core case)."

Likewise, Judge Montali stated in the *Heller* opinion that he disagreed that the *Stern* decision "stripped this court of jurisdiction" over the adversary proceeding. He explained, "In *Stern v. Marshall*, the Su-

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preme Court addressed the issue of when the bankruptcy judge has the power and authority to enter final orders, and did not address subject matter jurisdiction found in 28 U.S.C. [Section] 1334."

Perhaps the best course of action is for bankruptcy courts to follow the lead of the Southern District of New York and the bankruptcy courts of the Northern District of California and the Northern District of Illinois and treat core matters that are "constitutionally suspect" as non-core. As the bankruptcy court in *Heller* explained, "It is clear from *Stern*, however, that the bankruptcy court there should have treated the matter before it as non-core and adhered to the proposed findings procedure in Section 157(c)(1) and [Federal Rule of Bankruptcy] 9033. In fact, the district court in *Stern* treated the bankruptcy judge's findings as proposed and modified them. The Supreme Court found no fault with that procedure but simply ruled that the district court judgment was too late: a Texas probate judgment was entered between the time of the bankruptcy court's ruling and the district court's judgment and was thus entitled to preclusive effect."

Stern's impact may not be limited to bankruptcy courts. An interesting issue created by the *Stern* holding is the effect on the role of the Bankruptcy Appellate Panel. The panel, as opposed to the district court, hears an estimated 75 to 80 percent of bankruptcy appeals from the Central District of California's bankruptcy courts. *Stern* could be interpreted to mean that the panel, as a non-Article III court, does not have constitutional authority to hear certain "unconstitutionally core" matters.

Another similar unintended consequence of *Stern* is its potential impact on the magistrate system. In the *Technical Automation Services Corp. v. Liberty Surplus Insurance Corp.* case, the 5th U.S. Circuit Court of Appeals issued an order requesting briefing on the issue of whether a magistrate judge's civil consent authority under 28 U.S.C. Section 636(c) violates Article III of the Constitution under *Stern*.

The immediate holding of *Stern* makes clear that bankruptcy courts will, at least, no longer be able to enter final judgments on a common law cause of action, when the action neither derives from nor depends on any agency regulatory regime and is not resolved in the process of ruling on a creditor's proof of claim unless the parties consent. The decisions in *Heller*, *Coudert Bros.* and *Old Prairie* suggest that while this may immediately impact bankruptcy courts as they resolve the many *Stern* motions, it will soon dissipate.

The practical result is that the Supreme Court does not prohibit the bankruptcy court from hearing counterclaims, only from entering a final order, thus bankruptcy courts will continue to hold full hearings on relevant matters then submit findings of fact and conclusions of law to the district court. The district court will then review those findings of fact and conclusions of law and issue a final order.

In contrast, however, many state law claims that might be brought by a bankruptcy estate against a non-consenting creditor must be decided by a non-bankruptcy court, even where the creditor has consented to the jurisdiction of the bankruptcy court by filing a proof of claim. But, these occurrences may be rare. In the end, *Stern* may be limited by its unusual facts. The counterclaim asserted by Smith had very little overlap between the defamation claim asserted by E. Pierce Marshall, and the state law counterclaim asserted by Smith. It is much more typical that counterclaims will share key questions of fact and law with the original claim, particularly with compulsory counterclaims.