

Supreme Court Restricts Bankruptcy Courts' Jurisdiction to Consider Certain Counterclaims

On June 23, 2011, in *Stern v. Marshall*,¹ the Supreme Court addressed whether a bankruptcy court had the statutory and constitutional authority to adjudicate to final judgment a state law tort counterclaim against a creditor. Although the Court unanimously agreed that 28 U.S.C. § 157 gave the bankruptcy court the statutory authority to resolve such and similar claims, the Court split 5-4 in holding that Congress' delegation of that authority was unconstitutional. This decision, which affirmed the decision of the United States Court of Appeals for the Ninth Circuit, implicitly curbed the authority of bankruptcy judges to issue final, binding judgments on issues seemingly unrelated to federal law or federal regulatory schemes, even though such judges often adjudicate such issues.

I. Facts and Procedural History

Vickie Lynn Marshall, better known as Anna Nicole Smith, married billionaire Texas oil executive J. Howard Marshall II in 1994. Prior to Marshall's death in 1995, Smith claimed that his son, E. Pierce Marshall, fraudulently induced his father to exclude her from his will. Smith, who alleged that Marshall intended to leave her half of his estate, commenced an action in Texas state probate court. Marshall died during the pendency of that action, and Smith then filed for relief under Chapter 11 of the Bankruptcy Code in the Central District of California. In Smith's bankruptcy proceeding, Pierce alleged that Smith had defamed him, and he filed a proof of claim for damages. In response to the defamation claim, Smith filed a counterclaim, asserting essentially the same contentions she had raised earlier in the pending Texas probate action, alleging this time that Pierce tortiously interfered with her right to be willed half of Marshall's estate.

The bankruptcy court found for Smith on the counterclaim, awarding her compensatory and punitive damages, determining that the counterclaim constituted a "core proceeding" under 28 U.S.C. § 157(b)(2)(C) for which it could enter a final, binding judgment. Following a complicated series of appellate reversals, during the course of which the Texas probate court entered judgment in favor of Pierce, the Court of Appeals held that the bankruptcy court lacked authority to enter a final judgment on Smith's counterclaim.² In particular, it held that a counterclaim under 28 U.S.C. § 157(b)(2)(C) constitutes a core proceeding only when it 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."³ The Court of Appeals thus concluded that the district court should have given the Texas state court decision, rendered in Pierce's favor, preclusive effect because the bankruptcy court lacked authority to render a binding judgment, and the Texas state court was the first court to enter a final judgment on the merits.⁴

II. The Court's Decision

The Court affirmed the Court of Appeals' holding that the bankruptcy court lacked authority to render a binding judgment on Smith's counterclaim, holding that Congress exceeded its Constitutional authority in permitting this type of counterclaim to constitute a core proceeding for which the bankruptcy court could issue a final ruling. Specifically, the Court focused on the tension between and Article III, § 1 of the Constitution, and 28 U.S.C. § 157(b), which provides that a bankruptcy court may render final judgments in "all core proceedings

¹ No. 10-179, slip op. (2011), available at <http://www.supremecourt.gov/opinions/10pdf/10-179.pdf>. Citations are to the slip opinion.

² *Id.* at 5-6.

³ *Id.* at 6 (quoting *In re Marshall*, 600 F.3d 1037, 1058 (9th Cir. 2010)).

⁴ *Id.* at 1-6. (quoting *In re Marshall*, 600 F.3d at 1064-65).

arising under title 11, or arising in a case under title 11” and defines core proceedings as “counterclaims by [a debtor’s] estate against persons filing claims against the estate.”

Under the plain language of 28 U.S.C. § 157(b)(2)(C), Smith’s counterclaim against Pierce was a core proceeding, but as the majority noted, bankruptcy court judges are not Article III judges appointed by the President for life with salary assurances. Relying on the argument that this distinction is fundamental to the separation of powers doctrine (*i.e.*, separation of the legislature and judiciary), the Court concluded that Congress generally may not devise an end run around these protections by delegating judicial authority to non-Article III bankruptcy courts.

The Court acknowledged that, in “limited circumstances” when claims fall within the “public rights” doctrine, they may be constitutionally delegated to a non-Article III court for final adjudication. On the facts at issue, however, the Court found that the bankruptcy court could not constitutionally render a final judgment on Smith’s counterclaim because the state common law claim was “independent of the federal bankruptcy law and not necessarily resolvable by a ruling on the creditor’s proof of claim in bankruptcy.”⁵ Acknowledging that its jurisprudence in this area has been inconsistent, the Court nonetheless emphasized that Smith’s claim would not fall under the public rights exception under any prior articulation thereof⁶ because it was not “closely intertwined with a federal regulatory program,”⁷ nor did Smith’s right to recovery “flow from a federal statutory scheme.”⁸ Moreover, the resolution of Pierce’s claim was not integral to the determination of Smith’s counterclaim, and accordingly, there was no constitutional authority for a non-Article III court to resolve the counterclaim.

In a concurring opinion, Justice Scalia rejected the “public rights” test relied upon by the majority as unsupported by “the text or tradition of Article III,”⁹ but he agreed that under the Court’s Article III precedents, the bankruptcy court lacked authority to adjudicate Smith’s counterclaim.¹⁰ In dissent, Justice Breyer opined that the delegation of power under 28 U.S.C. § 157(b)(2)(C) to bankruptcy courts to adjudicate counterclaims did not run afoul of the Constitution.¹¹

III. Significance of the Decision

By restricting this “public rights” exception and limiting the jurisdiction of bankruptcy courts, the Court has curbed the power of bankruptcy courts to render final decisions on many counterclaims such courts have historically routinely adjudicated. Given the potential frequency of certain of these claims, the decision could implicate the efficiency of bankruptcy proceedings and increase the burden on district courts.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Joel Levitin at 212.701.3770 or jlevitin@cahill.com; or Richard Stieglitz at 212.701.3393 or rstieglitz@cahill.com.

⁵ *Id.* at 21.

⁶ *Id.* at 21-22, 27-36.

⁷ *Id.* at 26 (quoting *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 54-55 (1989)).

⁸ *Id.* at 27 (quoting *Thomas v. Union Carbide Agric. Prods. Co.*, 473 U.S. 568, 584-585 (1985)).

⁹ *Id.* at 2 (Scalia, J., concurring). Justice Scalia would reserve the doctrine solely for claims in which the government is a party. *Id.* at 1.

¹⁰ *Id.* at 2.

¹¹ *Id.* at 2, 10 (Breyer, J., dissenting).