

Client Alert

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Supreme Court Limits Reach of Non-Article III Courts' Jurisdiction

"Under Article III, the judicial power of the United States may be vested only in courts in which judges enjoy life tenure, contingent on good behavior and receive salary without diminution. *Stern* held that the Bankruptcy Court, a non-Article III court, lacked constitutional authority to enter a final judgment on a state law counterclaim that will not be resolved in the adjudication of a creditor's proof of claim. Bankruptcy courts now may issue only *proposed* rulings on such counterclaims. Final judgment must be issued by a district court, after *de novo* review of those matters to which any party has objected."

On June 23, 2011, the US Supreme Court issued a narrowly-divided decision in *Stern v. Marshall*, limiting Bankruptcy Court jurisdiction over certain types of claims. The Court found that while the Bankruptcy Court was statutorily authorized to enter final judgment on a tortious interference counterclaim (as a core proceeding under 28 U.S.C. § 157(b)(2)(C)), it was not constitutionally authorized to do so. The Court held that section 157(b)(2)(C), as broadly written to include all "counterclaims by the estate against persons filing claims against the estate," violates the limitations of Article III of the Constitution.

Under Article III, the judicial power of the United States may be vested only in courts in which judges enjoy life tenure, contingent on good behavior and receive salary without diminution. The *Stern* Court held that the Bankruptcy Court, a non-Article III court, lacked constitutional authority to enter a final judgment on a state law counterclaim that will not be resolved in the adjudication of a creditor's proof of claim. Under *Stern*, bankruptcy courts may issue only *proposed* rulings on such counterclaims. Final judgment must be issued by a district court, after *de novo* review of those matters to which any party has objected.¹ Prior to *Stern*, many

bankruptcy courts and practitioners believed that claims like those at issue in *Stern* were subject to entry of final judgments by the bankruptcy courts because such claims were covered by the plain text of 28 U.S.C. § 157(b)(2)(C). By holding that section 157(b)(2)(C) is unconstitutional, the *Stern* opinion likely will cause courts and litigants to reconsider the constitutional limits on bankruptcy court authority in a wide variety of contexts.

The *Stern v. Marshall* Litigation

The Court's opinion likely will be the last chapter in the remarkably long legal dispute between Vickie Lynn Marshall, commonly known as Anna Nicole Smith, and the heirs of her husband — J. Howard Marshall. At its most basic level, the dispute is "over the fortune of [J. Howard,] a man believed to have been one of the richest people in Texas."² A year after their marriage, J. Howard died, and Vickie was not provided for in his will. Before J. Howard's passing, Vickie filed suit in Texas probate court asserting that E. Pierce Marshall, J. Howard's son, "fraudulently induced J. Howard to sign a living trust that did not include [Vickie], even though J. Howard meant to give her half of his property."³

Following J. Howard's death, Vickie filed a bankruptcy petition in the Bankruptcy Court for the Central District of California. In a complaint filed in the same court, Pierce alleged that Vickie defamed him by inducing her attorneys to inform the press that Pierce had engaged in fraud to gain control of his father's assets. Pierce later filed a proof of claim based upon the defamation action. Vickie asserted truth as a defense and filed a counterclaim for tortious interference with the gift she expected from J. Howard.

The Bankruptcy Court granted summary judgment for Vickie on Pierce's defamation claim and, following a bench trial, issued a judgment on the tortious interference counterclaim in her favor as well. The Court awarded Vickie \$425 million in compensatory and punitive damages. Later, the Texas probate court issued a contrary ruling on the same facts. The question on appeal, therefore, became whether the Bankruptcy Court opinion was "final" or if the Texas probate court ruling was the first final judgment on the relevant facts. If the Texas judgment was the first final ruling, then it typically would be afforded preclusive effect in Vickie's bankruptcy case.

All of the lower courts that considered whether the Bankruptcy Court's ruling was final analyzed the issue by determining whether the dispute met the statutory requirements of 28 U.S.C. § 157. Section 157 permits bankruptcy courts to enter final judgment in "core proceedings." The statute also includes a non-exclusive list of what constitutes "core proceedings." Included in this non-exclusive list is section 157(b)(2)(C) ("counterclaims by the estate against persons filing claims against the estate"). The US Court of Appeals for the Ninth Circuit concluded that "a counterclaim under §157(b)(2)(C) is properly a 'core' proceeding arising in a case under the [Bankruptcy] Code only if the counterclaim 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."⁴ Because Vickie's tortious interference counterclaim failed this test, the Ninth Circuit found that the Bankruptcy Court lacked jurisdiction to issue a final judgment. Therefore, as the earliest final judgment entered on matters relevant to the proceeding, the Texas state probate court's determination of relevant legal and factual issues should have been given preclusive effect and in favor of Pierce.

The Supreme Court's Decision

In a 5-to-4 decision by Chief Justice Roberts, the Court affirmed the Ninth Circuit's decision, but for very different reasons. The Court concluded that "although the Bankruptcy Court had the statutory authority to enter judgment on Vickie's counterclaim, it lacked the constitutional authority to do so."⁵

Bankruptcy Courts Are Statutorily Authorized to Enter Final Judgment on Counterclaims

The Court first undertook a textual interpretation of section 157(b)(1)'s "core proceeding" language. The reading of section 157(b)(1) proposed by Pierce, and adopted by the Ninth Circuit, required a "two-step approach" under which a bankruptcy judge may issue a final judgment only if the matter "meets Congress' definition of a core proceeding *and* arises under or arises in title 11" of the Bankruptcy Code.⁶ The Court rejected this approach, finding that such an interpretation assumes a category of core proceedings that neither arises under Title 11 nor arises in a Title 11 case. The Court held that section 157 "does not provide for a proceeding that is simultaneously core and yet only related to the bankruptcy case." Core proceedings are those that arise in a bankruptcy case or under Title 11. The Court concluded that

under the plain language of section 157(b)(2)(C), Vickie's counterclaim against Pierce was a "core proceeding." And, therefore, *under section 157*, the Bankruptcy Court was permitted to enter final judgment.⁷

Although Section 157 Permits Bankruptcy Courts to Enter Final Judgment on Counterclaims, Article III of the Constitution Does Not

While the Court held that the Bankruptcy Court had 'statutory authority' to enter a final judgment on Vickie's counterclaim, it found that section 157(b)(2)(C) exceeded the limitations imposed by Article III of the Constitution. Article III vests judicial power solely in judges who enjoy life tenure, contingent on good behavior and receive salary without diminution.

In *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982) (plurality), the Court recognized a category of cases involving "public rights" that Congress could constitutionally assign to "legislative" courts for resolution. *Northern Pipeline* extended the "'public rights' exception . . . 'only to matters arising between' individuals and the Government 'in connection with the performance of the constitutional functions of the executive or legislative departments . . . that historically could have been determined exclusively by those' branches."⁸ Although the Court later rejected the *Northern Pipeline* strict limitation of the "public rights" exception, it has continued "to limit the exception to cases in which the claim at issue derives from a federal regulatory scheme, or in which resolution of the claim by an expert government agency is deemed essential to a limited regulatory objective within the agency's authority."⁹

The *Stern* Court held that Vickie's interference claim did not fall within any of the Court's formulations of the "public rights" exception. The Court

concluded that, in preservation of the separation of powers, final judgment on such a claim may be entered only by an Article III judge, and may not be entered by an Article I bankruptcy judge. In doing so, the Court rejected Vickie's argument that bankruptcy courts under the 1984 Act were deemed "adjuncts" of Article III courts. The Court noted that the Article III requirement that judges receive life tenure, contingent on good behavior and salary without diminution differentiates Article III judges from bankruptcy judges, who serve 14-year terms and receive no salary protection. The Court also considered that a bankruptcy court resolving a counterclaim under section 157(b)(2)(C) has the power to enter "appropriate orders and judgments" — including final judgments — subject to review only if a party chooses to appeal. Thus, the Court held that "a court exercising such broad powers is no mere adjunct of anyone."¹⁰

Finding that section 157(b)(2)(C) exceeds the limitations of Article III, and that the Bankruptcy Court therefore lacked the constitutional authority to enter a final judgment on Vickie's tortious interference counterclaim, the Court affirmed the judgment of the Ninth Circuit.

Likely Impact of the Decision

Vickie and her *amici* argued that restrictions on a bankruptcy court's ability to resolve and enter final judgment as to compulsory counterclaims will create significant delays and impose unnecessary costs.¹¹ The Court reasoned that convenience and efficiency, standing alone, will not save a law or procedure contrary to the Constitution.¹² Moreover, the Court was unconvinced that the limitations imposed on the authority of bankruptcy courts to enter final judgment are as significant as many suggest, and observed that bankruptcy courts may continue to hear counterclaims and propose to the district court findings

of fact and conclusions of law in such matters. Indeed, the Court did “not think [that] the removal of counterclaims such as Vickie’s from core bankruptcy jurisdiction meaningfully changes the division of labor in the current statute.”¹³

Writing for the dissent, and observing that counterclaims such as Vickie’s are frequently brought in bankruptcy court and involve the same factual disputes as claims that may be finally adjudicated by bankruptcy courts, Justice Breyer urged that the majority decision risks creating “a constitutionally required game of jurisdictional ping-pong between courts [that] would lead to inefficiency, increased cost, delay, and needless additional suffering among those faced with bankruptcy.”¹⁴ In the short run, this fear may prove well-founded. Litigants frequently have strong opinions as to whether a bankruptcy court will be a “better” or “worse” venue for their claims than a state or federal district court. Moreover, jurisdictional disputes related to bankruptcy court determination of claims that are not squarely within the “four corners” of the reorganization process have proven highly contentious and time-consuming (as demonstrated by the long saga of *Stern v. Marshall*). Section 157 had previously set the ground rules for such disputes. With one aspect of section 157 now deemed unconstitutional, litigants and courts will be called upon to revisit section 157’s application to a myriad of other contexts.

For example, subsection (b)(2)(H) of section 157 deems as “core” “proceedings to determine, avoid, or recover fraudulent conveyances” and lengthy fraudulent conveyance trials have regularly been conducted by bankruptcy judges. However, in *Stern*, the Court discussed its prior holding in *Granfinanciera, S. A. v. Nordberg*, 492 U.S. 33 (1989), and read that decision to stand for the proposition that state law fraudulent conveyance claims do not fall within the “public rights” exception to Article III.¹⁵ How this dictum will influence lower courts is unclear and a consensus may not be reached for some time.

In the long term, however, the impact of *Stern* may be mitigated by Congressional action or by agreed upon, efficient procedures whereby bankruptcy courts enter proposed findings of fact and conclusions of law but defer entry of final judgment to Article III courts. For now, the extent to which *Stern* might alter bankruptcy court practice remains uncertain.

Endnotes

- ¹ See 28 U.S.C. § 157(c).
- ² Slip op at 1.
- ³ *Id.* at 3.
- ⁴ *Id.* at 6 (citing *Marshall v. Stern (In re Marshall)*, 600 F.3d 1037, 1058 (9th Cir. Cal. 2010) (internal quotation marks omitted; second brackets added)).
- ⁵ *Id.* at 2.
- ⁶ *Id.* at 5 (citing 600 F.3d at 1058).
- ⁷ The Court also rejected Pierce's argument that section 157(b)(5), requiring personal injury tort claims to be tried to a district court, deprived the Bankruptcy Court of jurisdiction to enter final judgment on the defamation claim. The Court held that section 157(b)(5) is not jurisdictional. The Court also concluded that Pierce consented to the Bankruptcy Court's resolution of his defamation claim.
- ⁸ Slip op. at 19 (quoting 458 U.S. at 67-68).
- ⁹ *Id.* at 25. See *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 54-55 (1989) (rejecting bankruptcy trustee's argument that a fraudulent conveyance action against a noncreditor fell within the "public rights" exception on the basis that "[i]f a statutory right is not closely intertwined with a federal regulatory program Congress has the power to enact, and if that right neither belongs to nor exists against the Federal Government, then it must be adjudicated by an Article III court."); see also *Thomas v. Union Carbide Agricultural Products Co.*, 473 U.S. 568, 571-75 (1985) (dispute involving data-sharing arrangement under a federal statute); *Commodity Futures Trading Commission v. Schor*, 478 U.S. 833, 836 (1986) (area of law in question was governed by a "specific and limited federal regulatory scheme").
- ¹⁰ *Id.* at 22.
- ¹¹ *Id.* at 36.
- ¹² *Id.* at 36 (citing *INS v. Chadha*, 462 U.S. 919, 944 (1983)).
- ¹³ *Id.* at 37.
- ¹⁴ *Id.* at 17 (Breyer Dissent).
- ¹⁵ *Id.* at 27.

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