

## Recent Supreme Court Decision May Spark More Litigation

On June 23, 2011, the Supreme Court of the United States decided the most significant bankruptcy court jurisdiction case in almost 30 years. In *Stern v. Marshall*,<sup>1</sup> the Supreme Court held that bankruptcy court judges, as non-Article III judges, lack constitutional authority to enter a final judgment on counterclaims asserted by a debtor where the counterclaim involves issues not essential to the allowance or disallowance of the underlying claim or is otherwise not subject to the “public rights” exception.

*Stern v. Marshall* may have a significant impact on bankruptcy case administration. Despite the seemingly narrow holding, the Supreme Court decision leaves open the possibility that defendants in other bankruptcy litigation matters will challenge the bankruptcy court’s authority to enter final orders. The ultimate result of this decision may be that debtors and creditors spend significant time and resources litigating jurisdictional issues in addition to litigating the underlying merits of their claims.

### Background

The case involves notorious litigation between the estate of Vickie Lynn Marshall (a/k/a Anna Nicole Smith) (the “Debtor”) and the estate of Pierce Marshall (the “Claimant”).

Shortly before the Claimant’s father died, the Debtor filed suit against the Claimant in Texas state court, asserting that the Claimant’s father meant to provide for the Debtor through a trust, and that the Claimant tortiously interfered with that gift. After the Claimant’s father died, the Debtor filed for bankruptcy. The Claimant filed a proof of claim in the bankruptcy case, asserting a claim for defamation. The Debtor responded by filing a counterclaim for tortious interference with the gift she expected from the Claimant’s father.

The Bankruptcy Court granted the Debtor summary judgment on the defamation claim and eventually awarded her hundreds of millions of dollars in damages on her counterclaim. The Claimant objected that the Bankruptcy Court lacked jurisdiction to enter a final judgment on the counterclaim because it was not a “core proceeding” as defined by 28 U. S. C. §157(b)(2)(C). The District Court reversed, holding that the Debtor’s counterclaim was not core because it was only “somewhat related” to the Claimant’s claim. On appeal, the Ninth Circuit Court of Appeals held that the Bankruptcy Court lacked authority to enter a final judgment on the Debtor’s counterclaim under 28 U. S. C. §157(b)(2)(C) because the claim was not “so closely related to [the Claimant’s] proof of claim that the resolution of the counterclaim is necessary to resolve the allowance or disallowance of the claim itself.”

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<sup>1</sup> *Stern v. Marshall*, No. 10-179, 564 U.S. \_\_\_, 131 S. Ct. 63, 177 L. Ed. 2d 1152, 201 U.S. LEXIS 4791 (June 23, 2011).

### Opinion of the Court

In a 5-4 decision, the Supreme Court held that although the Bankruptcy Court had statutory authority under 28 U. S. C. §157(b)(2)(C) to enter a final judgment on the Debtor's counterclaim, it lacked authority under Article III of the United States Constitution to render a final judgment. The Debtor's counterclaim was not sufficiently factually or legally interrelated to the Petitioner's claim nor did it fall within the "public rights" exception because it was a matter of private right not completely dependent upon adjudication of a claim created by federal law.

### Authority Under Article III of the United States Constitution

The Supreme Court first held that the Bankruptcy Court's entry of a final order on the Debtor's counterclaim complied with Congress's jurisdictional grant set forth in 28 U.S.C. §157(b)(2)(C). That is, the Debtor's counterclaim was a core proceeding and the Bankruptcy Court had jurisdiction under the statute to enter a final order. Notwithstanding Congress's jurisdictional grant, however, the Supreme Court agreed with the Claimant that Article III of the United States Constitution did not permit Congress to provide the Bankruptcy Court with authority to enter a final judgment on the counterclaim.

The Supreme Court reaffirmed the distinction between Article I judges, such as bankruptcy court judges, and Article III judges, such as district court judges. For Article I judges, there is a category of cases involving "public rights" that Congress may constitutionally assign for resolution. The "public rights" exception extends only 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."<sup>2</sup> Claims subject to the public rights exception include those created by Congress or those that flow from a federal statutory scheme.

As it relates to the Debtor's counterclaim for tortious interference, the Supreme Court determined that the public rights exception did not apply because the claim was for a state law action independent of federal bankruptcy law and not necessarily resolvable by a ruling on the creditor's proof of claim in the bankruptcy. Moreover, the bankruptcy court did not have authority to adjudicate with finality the counterclaim based solely on the fact that the Claimant filed a proof of claim in the Debtor's bankruptcy proceeding.

### Future Implications

*Stern v. Marshall* will have ramifications for bankruptcy court administration. In circumstances in which a debtor files a counterclaim that is unrelated to the underlying claim filed by the creditor, a bankruptcy court may hear the counterclaim but will be limited to submitting proposed findings of fact and conclusions of law to the district court, with the district court entering a final order on the counterclaim after *de novo* review. It remains to be seen whether district courts will "withdraw" such counterclaims from bankruptcy courts.

*Stern v. Marshall* will likely have broader implications as well. In certain disputes it may not be entirely clear that a counterclaim is sufficiently related to an underlying claim to meet constitutional scrutiny, thereby creating the possibility of litigation over the legal and factual connections between a claim and counterclaim. This jurisdictional litigation may be time and resource consuming, and may also delay the orderly reorganization or liquidation of a debtor. As Justice Breyer points out in his dissent, a

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<sup>2</sup> *Id.*, 2011 U.S. LEXIS 4791 at \* 52.

consequence of this decision is that the orderly adjudication of claims and counterclaims in one bankruptcy proceeding may be hampered.<sup>3</sup>

Beyond possible litigation over the connections between a claim and counterclaim, the decision leaves open the possibility that creative lawyers will challenge the authority of bankruptcy courts to enter final orders in other “core” matters under 28 U.S.C. §157(b)(2). For example, will defendants in fraudulent transfer actions under state law seek to prevent bankruptcy courts from entering final orders because such actions may not be founded in substantive bankruptcy law and may not be subject to the public rights exception? Will unsecured creditors seek district court review of bankruptcy court orders determining the validity of secured creditors’ liens under state law? Such litigation is not unforeseeable.

The majority opinion in *Stern v. Marshall* asserts that the decision “does not change all that much.”<sup>4</sup> That said, the questions left unanswered by the opinion belie the fact that future litigation will be needed to determine the extent to which the decision chips away at traditional norms of bankruptcy court jurisdiction.

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<sup>3</sup> *Id.*, 2011 U.S. LEXIS 4891 at \*103 (dissent).

<sup>4</sup> *Id.*, 2011 U.S. LEXIS 4791 at \* 73.