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Stern v. Marshall: What the United States Supreme Court Has to Say About Bankruptcy Court Jurisdiction

On June 23, 2011, the Supreme Court of the United States handed down what may prove to be the most significant case on bankruptcy court jurisdiction in almost 30 years. In *Stern v. Marshall*,¹ the Supreme Court held that bankruptcy court judges, as non-Article III judges, lack constitutional authority to enter final judgments on counterclaims asserted by a debtor where the counterclaims involve issues not essential to the allowance or disallowance of the underlying claims or are otherwise not subject to the "public rights" exception. While the opinion addresses the narrow legal question of bankruptcy court authority to enter trial judgments on counterclaims, in the wake of *Stern v. Marshall*, bankruptcy courts are acting quite carefully and conservatively in asserting authority and jurisdiction, and that debtors and creditors are spending time and resources litigating these issues.

STERN V. MARSHALL DECISION

The *Stern v. Marshall* 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 for the Central District of California granted the Debtor summary judgment on the defamation claim and eventually awarded her hundreds of millions of dollars in damages on her counterclaim. On appeal, the Claimant asserted 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 further 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."

In a 5-4 decision authored by Chief Justice Roberts, 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 Claimant'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.

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."² Claims subject to the public rights exception include those created by Congress or those that flow from a federal statutory scheme.

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With respect 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 capable of resolution by a ruling on the creditor's proof of claim in the bankruptcy case. 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 case.

IMMEDIATE IMPACT OF THE DECISION

Courts are grappling with issues of bankruptcy court authority and jurisdiction in the wake of *Stern v. Marshall*. In one recent case, *In re BearingPoint, Inc.*, a confirmed chapter 11 plan provided that certain claims against former officers and directors of the debtor could be brought only in the Bankruptcy Court for the Southern District of New York or in the District Court for the Southern District of New York.³ Out

of concern that Bankruptcy Court would “be bogged down in procedural complications, aggravated by the Supreme Court’s recent decision in *Stern v. Marshall*,” the Bankruptcy Court modified the confirmation order so that the suits at issue could be filed in state court in the state where the debtor was previously located.⁴ The Bankruptcy Court emphasized that without modifying the plan, potential jurisdictional litigation would cause the confirmation order to “be tied in procedural knots by motion practice, here and in the District Court, exploiting asserted or actual disabilities on my part, as an Article I bankruptcy judge, to issue findings and orders.”⁵ In dicta, the Bankruptcy Court predicted that the consent of parties to bankruptcy court jurisdiction would not be a valid basis for bankruptcy courts to issue final judgments, thereby creating “huge uncertainty . . . with the potential to tie up this case, and countless others, in knots.”⁶

In *Walker, Truesdell, Roth & Assocs. v. The Blackstone Group, L.P. (In re Extended Stay, Inc.)*, Adv. Proc. Nos. 11-2255 and 11-2256 (JMP), the trustee for the litigation trust created by the Debtors’ bankruptcy plan filed a motion to withdraw the reference to the Bankruptcy Court for the Southern District of New York with respect to complaints filed by the litigation trustee against certain banks, advisors and other third parties for alleged fraudulent transfers relating to the Debtors’ prepetition leveraged buy-out.⁷ Under the Debtors’ plan, the Bankruptcy Court had authority to enter final judgments on lawsuits initiated by the litigation trustee against third parties “to the fullest extent that is legally permissible.”⁸ Despite the fact that the claims for avoidance and recovery of fraudulent transfers under the Bankruptcy Code are “arguably core,” the litigation trustee determined that in light of *Stern v. Marshall* the Bankruptcy Court’s authority “to enter final judgments on lawsuits initiated against third parties, post-confirmation” “is at the very least a litigable issue.”⁹ Accordingly, the litigation trustee sought to withdraw the reference in order to “avoid unnecessary litigation” and a “constitutional challenge to the proceeding.”¹⁰ The litigation trustee’s motion is currently extant.

Stern v. Marshall is also having an impact on multi-billion dollar litigation in the Lehman Brothers bankruptcy case. In the context of an adversary proceeding filed by debtor Lehman Brothers Holdings, Inc. (“LBHI”) against claimant JPMorgan Chase Bank, N.A. (“JPMorgan”), Adv. Proc. No. 10-03266 (JMP), Judge Peck requested briefing from the parties regarding the ability of the Bankruptcy Court for the Southern District of New York to issue a final judgment on the common law causes of action in the adversary proceeding.¹¹ In its complaint, LBHI pleaded 49 counts (18 of which were predicated on common law) seeking to invalidate certain security and guarantee agreements entered into with JPMorgan as well as JPMorgan’s taking or withholding of collateral in connection with those agreements. The LBHI brief on the issue argues, among other things, that *Stern v. Marshall* stands for the proposition that “if the claims reconciliation process will necessarily resolve the estate’s affirmative claims, then the bankruptcy court has the authority to enter a final judgment on those claims.”¹² Pursuant to this reading of the Supreme Court decision, the Bankruptcy Court has authority to adjudicate with finality LBHI’s claims because those claims “directly attack the validity and enforceability of the very agreements and pledges of collateral which serve as the basis for JPMorgan’s Proof of Claim.”¹³ On the other hand, JPMorgan argues that *Stern v. Marshall* stands for the proposition that “a bankruptcy court is not constitutionally permitted to determine claims by a bankruptcy estate against a

creditor that are ‘not necessarily resolvable’ in the context of ruling on the creditor’s proof of claim . . . , and that seek to augment the bankruptcy estate.”¹⁴ Pursuant to JPMorgan’s reading of *Stern v. Marshall*, LBHI’s claims are “constitutionally required to be determined by an Article III court” because those claims are “replete with legal and factual issues” beyond those addressed in JPMorgan’s proof of claim.¹⁵

The Bankruptcy Appellate Panel for the 8th Circuit recently weighed in on *Stern v. Marshall* in a case concerning jurisdiction over claims against non-debtor entities. In *Schmidt v. Klein Bank (In re Schmidt)*, Klein Bank filed state court replevin actions against certain corporate entities and corresponding guarantee actions against the corporations’ shareholders.¹⁶ Just prior to the replevin actions being heard, the corporation’s shareholders filed chapter 11 petitions in the Bankruptcy Court for the District of Minnesota. The corporate entities did not file petitions. The debtors removed the replevin actions to the Bankruptcy Court because, as the debtors asserted, they had a legal interest in the property being replevined. Klein Bank filed motions to remand the actions to state court, but the Bankruptcy Court held that the replevin actions were core proceedings and mandatory abstention did not apply. On appeal, the Bankruptcy Appellate Panel for the 8th Circuit determined that both the claims against the non-debtors and the causes of action against the debtors on the guarantee were non-core because “those causes of action existed under state law, regardless of the bankruptcy filing.”¹⁷ The Bankruptcy Appellate Panel made clear that “absent extraordinary circumstances,” *Stern v. Marshall* does not allow a principal of a corporation to use a bankruptcy filing to protect against causes of action against the corporation.¹⁸

In another recent case, *White Eagle, Inc. v. Borichich (In re Borichich)*, the Bankruptcy Court for the Northern District of Illinois temporarily abstained from entering a final money judgment on a state law claim in a nondischargeability action.¹⁹ Prior to *Stern v. Marshall*, Seventh Circuit precedent permitted bankruptcy court judges to determine the amount of nondischargeable debt and enter a dollar judgment on that finding.²⁰ In the wake of *Stern v. Marshall*, the Bankruptcy Court concluded that, at the present time, it could only determine, but not enter a judgment, regarding the amount of debt found to be nondischargeable. The Bankruptcy Court then asked for briefing from the parties as to whether the Bankruptcy Court could enter a dollar judgment in light of *Stern v. Marshall*.

Even in cases where state law claims are seemingly not implicated, litigants may feel compelled to brief, and courts may feel compelled to consider, the implications of *Stern v. Marshall*. In *Turner v. First Community Credit Union (In re Turner)*, the Bankruptcy Court for the Southern District of Texas considered whether or not it had jurisdiction to hear the debtors’ adversary proceeding against a depository bank, a claimant, for alleged violations of the automatic stay resulting from the bank setting off funds held in a deposit account against amounts owed on the debtors’ auto loans.²¹ Unlike the state law counterclaim in *Stern v. Marshall*, the counterclaim in *Turner* was based on alleged violations of the automatic stay under section 362 of the Bankruptcy Code. According to the Bankruptcy Court, the alleged automatic stay violation claims were “purely a creature of the Bankruptcy Code.”²² In reaching its conclusion that the Bankruptcy Court did not have jurisdiction, the Bankruptcy Court wrote a seven

paragraph jurisdictional analysis, including an analysis of the “public rights” exception, to justify its authority.

CONCLUSION AND FUTURE IMPLICATIONS

Although it has only been a short time since *Stern v. Marshall* was decided, it appears that the decision is being used by practitioners and bankruptcy court judges alike to raise questions about bankruptcy court authority and jurisdiction in matters beyond state law counterclaims. Until such time as there is binding precedent at the circuit court level to clarify these issues, it is likely that bankruptcy courts will act cautiously and that parties will be compelled to spend time and money litigating these issues.

¹ *Stern v. Marshall*, No. 10-179, 564 U.S. ___, 131 S. Ct. 63, 177 L. Ed. 2d 1152, 2011 U.S. LEXIS 4791 (June 23, 2011).

² *Id.*, 2011 U.S. LEXIS 4791 at * 52.

³ 2011 WL 2709295 (Bankr. S.D.N.Y. July 11, 2011).

⁴ *Id.*, 2011 WL 2709295 at * 1.

⁵ *Id.*, 2011 WL 2709295 at * 1.

⁶ *Id.*, 2011 WL 2709295 at * 7.

⁷ See Plaintiff’s Memorandum of Law in Support of Motion to Withdraw the Reference [Doc. No. 19], filed on July 29, 2011. Certain related complaints were also filed with Supreme Court of the State of New York, Count of New York.

⁸ *Id.* at 5.

⁹ *Id.* at 5, 10.

¹⁰ *Id.* at 6.

¹¹ See Plaintiff’s Memorandum Asserting the Effect of the Supreme Court’s Decision in *Stern v. Marshall* on the Bankruptcy Court’s Ability to Render Final Judgment on the Common Law Claims Asserted in this Adversary Proceeding [Doc. No. 89], filed on August 5, 2011.

¹² *Id.* at 8.

¹³ *Id.* at 13.

¹⁴ See Supplemental Memorandum of Law in Support of Motion to Dismiss of JPMorgan Chase Bank, N.A. [Doc. No. 90] (emphasis in original), filed on August 5, 2011.

15 *Id.* at 14-15.

16 2011 WL 3300693 (8th Cir. B.A.P. Aug. 3, 2011).

17 *Id.*, 2011 WL 3300693 at *4.

18 *Id.*, 2011 WL 3300693 at *4.

19 2011 WL 2600692 (Bankr. N.D. Ill. June 29, 2011).

20 *Id.*, 2011 WL 2600692 at *9. *See In re Hallahan*, 936 F.2d 1496, 1508 (7th Cir. 1991)

21 2011 WL 2708907 (Bankr. S.D. Tex. July 11, 2011).

22 *Id.*, 2011 WL 2708907 at * 4.