

Insolvency and Restructuring Update

Stern v. Marshall – Supreme Court Limits the Power of Bankruptcy Courts to Hear Certain State Law Claims Brought by Debtors Against Creditors

Late last week, the United States Supreme Court affirmed a 2010 ruling of the Ninth Circuit Court of Appeals 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 against a creditor, even though the matter was part of the “core” statutory jurisdiction of the bankruptcy court. This significant decision limits the power of bankruptcy courts and may have wide-ranging implications, requiring certain types of claims to be decided in a non-bankruptcy forum, even where they are central to a debtor’s bankruptcy case.

Background

In the years since the death of J. Howard Marshall II, the estates of Vickie Lynn Marshall (J. Howard’s wife) and of E. Pierce Marshall (his son)¹ have engaged in a drawn-out battle over J. Howard’s estate, with two courts—a Texas state court and a federal bankruptcy court—reaching opposite conclusions on entitlement to J. Howard’s assets.

Just prior to J. Howard’s death, Vickie filed suit in Texas state probate court, asserting that Pierce fraudulently induced J. Howard to sign a living trust that did not include her. The Texas state court rejected Vickie’s claim and ruled in Pierce’s favor. While the Texas state court proceeding was pending, Vickie filed for bankruptcy, and Pierce filed a complaint and a proof of claim in the bankruptcy court, alleging that Vickie had defamed him. In response, Vickie filed a counterclaim seeking damages based on Pierce’s alleged tortious interference with J. Howard’s gift to Vickie. The bankruptcy court entered a final judgment in Vickie’s favor.

On appeal, the Ninth Circuit held that the bankruptcy court lacked authority to enter judgment on Vickie’s counterclaim, which was based solely on state law, because it was not a “core” proceeding. Therefore, the court ruled in Pierce’s favor, holding that the decision of the Texas state court, which was first-in-time, controlled.

Analysis

The Supreme Court affirmed the Ninth Circuit’s ruling, albeit on different grounds. While the Court unanimously concluded that the bankruptcy court had statutory authority under 28 U.S.C. § 157(b) to issue a final judgment on Vickie’s counterclaim because it was a “core” proceeding, the Court held, in a five-to-four ruling, that the bankruptcy court lacked the constitutional authority to decide the state law counterclaim to the extent that it was not resolved in the process of ruling on Pierce’s proof of claim.

In discussing the constitutional question, the Court stressed that the goal of Article III judges, protected by life tenure and salary guarantees, is to ensure that the judiciary is independent from the other two branches of government. The Court relied heavily on its previous decision in *Northern Pipeline Constr.*

¹ Vickie Lynn Marshall (more commonly known as Anna Nicole Smith) and E. Pierce Marshall have now each passed away. Although the dispute is now between their respective estates, for simplicity, the parties will be referred to as “Vickie” and “Pierce.”

Co. v. Marathon Pipe Line Co.,² which held that bankruptcy courts, as non-Article III courts, were not constitutionally permitted to decide a state law contract claim against an entity that was not otherwise part of the bankruptcy proceedings.

In rejecting Vickie’s argument that Pierce’s participation in the bankruptcy constituted his consent to the bankruptcy court’s jurisdiction over all related disputes, the Court noted that “it is hard to see why Pierce’s decision to file a claim should make any difference with respect to the characterization of Vickie’s counterclaim.”³ To determine Vickie’s claim, “the bankruptcy court was required to and did make several factual and legal determinations that were not ‘disposed of in passing on objections’ to Pierce’s claim.”⁴ Because Vickie was required to prove additional elements beyond those involved in Pierce’s claim, “there was never any reason to believe that the process of adjudicating Pierce’s proof of claim would necessarily resolve Vickie’s counterclaim.”⁵

Concluding that Vickie’s counterclaim was simply a state law action “independent of the federal bankruptcy law,”⁶ the Court held that the bankruptcy court lacked the jurisdiction to decide the counterclaim. Accordingly, the Court affirmed the Ninth Circuit decision holding that the decision of the Texas state court was controlling.

Future Implications

The Supreme Court’s ruling means that many state law causes of action 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 for the purposes of filing a proof of claim in the case.

In reaching its decision, the Court recognized the potential for significant practical impact on the bankruptcy process. But it concluded that any additional delays or costs would not be significant, noting that the bankruptcy framework already contemplates that certain state law matters will be resolved by non-bankruptcy judges, such as non-core claims under § 1334(c)(2) and matters that are rightly left to state courts under § 1334(c)(1).

The dissent disagreed, arguing that for a bankruptcy court to be effective, it “must have broad authority to restructure [debtor-creditor] relations.”⁷ To highlight the practical effect of the Court’s decision, the dissent discussed the following fact pattern:

A tenant files for bankruptcy. The landlord files a claim for unpaid rent. The tenant asserts a counterclaim for damages suffered by the landlord’s (1) failing to fulfill his obligations as lessor, and (2) improperly recovering possession of the premises by misrepresenting the facts in housing court.

In the view of the dissent, this state law counterclaim does not “stem from the bankruptcy itself” and would not “necessarily be resolved in the claims allowance process.”⁸ For example, it would require the debtor to prove damages suffered by the lessor’s failures and recovery attempts. Therefore, according to

² 450 U.S. 50 (1982).

³ Op. at 30.

⁴ Op. at 32 (citing *Katchen v. Landy*, 382 U.S. 323, 332 n.9 (1966)).

⁵ Op. at 32.

⁶ Op. at 21.

⁷ Ds. at 14, 15 (Breyer, J. dissenting).

⁸ Ds. at 16 (Breyer, J. dissenting).

the dissent, “under the majority’s holding, the federal district judge, not the bankruptcy judge, would have to hear and resolve [this type of] counterclaim.”⁹

The dissent argued that the Court’s ruling will result in a “game of jurisdictional ping-pong between courts [that will] lead to inefficiency, increased cost, delay, and needless additional suffering among those faced with bankruptcy.”¹⁰

The full effect of this potentially significant decision will not be known until lower courts have had the opportunity to consider and decide additional disputes.

- ▶ [See a copy of the Supreme Court's decision in *Stern v. Marshall*](#)

⁹ Ds. at 16 (Breyer, J. dissenting).

¹⁰ Ds. at 17 (Breyer, J. dissenting).

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