

## Bankruptcy, Restructuring and Creditors' Rights Client Service Group

To: Our Clients and Friends

June 27, 2011

### United States Supreme Court Defines Limits of Bankruptcy-Court Jurisdiction, Raises Additional Questions

The United States Supreme Court's recent decision in *Stern v. Marshall* (June 23, 2011) has significant implications for litigants, such as lenders, who often are forced to litigate non-bankruptcy issues in bankruptcy courts. The case involves the sixteen-year-old legal battle between model/actress Anna Nicole Smith ("Anna") and her late husband's son, Pierce Marshall ("Pierce"). The original parties have passed away, but the executors of their estates have continued to litigate over the fortune of Anna's late husband, J. Howard Marshall II.

As the tabloids have documented, Anna Nicole Smith married a very wealthy and much older man, who died a year after their marriage. His will left substantially all of his fortune to his son, Pierce. Anna challenged the will in Texas probate court by asserting that Pierce had tortiously interfered with the inheritance promised to Anna by her late husband. Anna subsequently filed a voluntary bankruptcy petition in the Central District of California. Pierce commenced a lawsuit and filed a claim in Anna's bankruptcy case, contending that Anna had defamed him. Anna defended and asserted a counterclaim for the alleged tortious interference with her expectancy of an inheritance. Pierce prevailed in Texas probate court, but Anna obtained a judgment of more than \$400 million against Pierce in bankruptcy court. The Supreme Court resolved another jurisdictional issue in favor of Anna in a 2006 decision. In the parties' second trip to the Supreme Court, Pierce argued that the bankruptcy court did not have the authority to enter a final judgment on Anna's counterclaim and, therefore, that the Texas probate court ruling should control.

Article III of the United States Constitution reserves the judicial power to federal courts whose judges enjoy life tenure during good behavior and no diminution of salary. Bankruptcy courts are not Article III courts; bankruptcy judges serve 14-year terms without salary protection. Nearly 30 years ago, in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), the U.S. Supreme Court ruled that the Constitution forbids bankruptcy courts from exercising judicial power over state-law matters not directly and necessarily involving a bankruptcy case's restructuring of debtor-creditor relations. In that decision, a plurality of the Court referred to debt restructuring as "the core of the federal bankruptcy power."

In the wake of the *Marathon* decision, Congress passed the Bankruptcy Amendments and Federal Judgeship Act of 1984. The 1984 legislation made sweeping changes to the federal bankruptcy laws by, among other things, clarifying a bankruptcy court's power to act in a variety of "core" proceedings and placing new limits on a bankruptcy court's authority to enter final judgments in "non-core" proceedings—*i.e.*, disputes not significantly related to a bankruptcy case. At the same time, however, this legislation continued to allow bankruptcy courts to adjudicate certain categories of disputes that do not directly involve bankruptcy law or the restructuring of a

debtor's obligations to creditors. At issue, in particular, in *Stern v. Marshall* was a provision authorizing a bankruptcy court to hear and determine "counterclaims by the [bankruptcy] estate against persons filing claims against the estate." 28 U.S.C. § 157(b)(1)(C). Pierce argued that, although Anna's counterclaim for tortious interference fell within the literal language of the statute, the Constitution does not permit a bankruptcy court to hear and decide any and all counterclaims that a debtor might assert against a creditor.

The Supreme Court agreed with Pierce "that designating all counterclaims as 'core' proceedings raises serious constitutional concerns." Because Anna's counterclaim was a common-law tort claim that existed without regard to her bankruptcy, it could not come within the narrow jurisdiction of the bankruptcy courts: "Congress may not bypass Article III simply because a proceeding may have *some* bearing on a bankruptcy case; the question is whether the action at issue stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process." The Supreme Court ruled that adjudicating Anna's counterclaim was an impermissible exercise of judicial power by the bankruptcy court. Because the bankruptcy court's judgment could not stand, the judgment of the Texas probate court in favor of Pierce controls, and Anna's heirs will not receive any of her late husband's fortune.

Beyond the immediate effect on the parties, the decision has potentially far-reaching consequences for litigants in bankruptcy cases and related proceedings. A bankruptcy judge will no longer be able to issue a final judgment on a debtor's common-law counterclaim that "is not resolved in the process of ruling on a creditor's proof of claim." Under current law, however, the parties may consent to allow a bankruptcy judge to issue a final judgment; the Supreme Court's decision does not appear to eliminate that possibility. Absent consent, the bankruptcy judge in such a dispute will be required to issue proposed findings of fact and conclusions of law, which will be subject to plenary review by the federal district court.

The decision is certain to spark further litigation challenging a bankruptcy court's authority to adjudicate various issues such as contract rights (as in the *Marathon* decision), fraudulent-transfer claims arising under state law and possibly those arising under bankruptcy law, lender-liability claims, and other torts and state-law causes of action. Because there is a degree of overlap between the Supreme Court's Article III cases and its jury-trial jurisprudence, the decision also may have implications for the rights of parties in bankruptcy disputes to demand trial by jury. Parties that are currently engaged in litigation with a debtor or bankruptcy trustee should consider whether *Stern v. Marshall* provides a basis for objecting to the final determination of the matter by a bankruptcy judge.

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