Alert

Supreme Court Limits Power of Bankruptcy Courts to Rule on State Law Claims by Trustees and Debtors

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The Supreme Court held on June 23, 2011 that bankruptcy "judges should not be in the business of entering final judgments" on a debtor's state law counterclaim in response to a claim filed by a creditor. *Stern v. Marshall*, ___ U.S. ___, 2011 WL 2472792, *25, *27 (2011) (5-4) ("The Bankruptcy Court below lacked the constitutional authority to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim."). In effect, the Court limited the ability of bankruptcy courts to rule on a trustee's non-bankruptcy-related claims against third parties. The decision appears to be narrow, but, as shown below, will have a much broader effect on the ability of trustees and debtors to sue creditors in the "home" bankruptcy court.

Factual Overview
The 15-year litigation in *Stern* turned on a multi-state conflict between a widow and her stepson. She claimed that the stepson had fraudulently prevented his father, a wealthy Texan, from including his wife, the soon-to-be widow, in a living trust prior to his death, although the decedent had "meant to give her half his property." *Id.* at *6.

The widow first asserted her claim in a Texas probate court, before her husband's death in April 1995. The stepson disputed the claim in Texas, but the widow, after being forced into a California Chapter 11 case, then reasserted her claim as a counterclaim in response to the stepson's defamation claim in the bankruptcy court. The stepson also filed a defamation complaint against the widow in the bankruptcy court, asserting that his claim was not dischargeable. The California district court agreed with the bankruptcy court that the stepson was liable on the widow's counterclaim but did not enter a judgment until *after* the Texas court had first rejected her claim.

The Ninth Circuit, in 2010, on remand from a 2006 Supreme Court ruling, held that "the Texas probate court's judgment [was] the earliest final judgment . . . on matters relevant to" the parties' claims. *Id.* at *8. Thus, in its view, the California district court should have "afford[ed] preclusive effect" to the Texas "court's determination of relevant legal and factual issues." *Id.* The Supreme Court affirmed on constitutional grounds.

The Invalidated Statute
The Judiciary Code, 28 U.S.C. § 157(b)(2)(C), authorizes bankruptcy judges to "hear and determine all core proceedings arising under [the Bankruptcy Code] 11, or arising in a case under [the Bankruptcy Code] 11 . . ., and may enter appropriate orders and judgments, subject to [appellate] review . . .," including "*counterclaims by the estate against persons filing claims against the estate*." (Emphasis added.) Nevertheless, the majority of the Court in *Stern* (five Justices) found this specific provision of the Judiciary Code to be unconstitutional because of Article III of the U.S. Constitution, which requires "[t]he judicial Power of the United States" to "be vested in" only those independent judges who have life tenure and whose salaries Congress may not

diminish — *i.e.*, U.S. district judges, *not* bankruptcy judges. Article III judges (Supreme Court Courts of Appeals and district courts) are appointed by the President (Art. II, § 2) with the "advice and consent of the Senate." Congress has failed, however, to give bankruptcy judges Article III status, choosing instead to provide for their appointment as Article I, § 8 judges under Congress's legislative power. As the Supreme Court noted, "bankruptcy judges . . . have been appointed to 14-year terms by the courts of appeals . . .," *Id.* at *9, pursuant to federal legislation, 28 U.S.C. § 152(a)(1).

Majority Rationale
Justice Scalia, in a concurring opinion, summarized the principal "reasons given in the Court's opinion for concluding that an Article III judge [*i.e.*, a district judge] was required to adjudicate this lawsuit [a debtor's nonbankrutpcy law counterclaim]":

1. it "was one 'under state common law'";
2. it "was 'not "completely dependent upon' adjudication of a claim created by federal law";
3. "[the creditor here] did not truly consent to resolution of [the debtor's] claim in the bankruptcy court proceedings";
4. "the asserted authority to decide [the debtor's] claim is not limited to a particularized area of the law";
5. "there was never any reason to believe that the process of adjudicating [the creditor's] proof of claim would necessarily resolve [the debtor's] counterclaim";
6. "[the debtor] was not 'asserting a right of recovery created by federal bankruptcy law'"; and
7. the Bankruptcy Judge "ha[d] the power to enter appropriate orders and judgments" — including final judgments — subject to review only if a party chooses to appeal."

Id. at *27. In sum, *Stern* will have far-reaching consequences in bankruptcy litigation, only some of which can be predicted here. Indeed, the dissent predicted "a constitutionally required game of ping-pong between courts [that will] lead to inefficiency, increased cost, delay, and needless additional suffering . . . ." *Id.* at *37.

Likely Consequences
First, a trustee's counterclaim based on state law (*e.g.*, contract, tort) must now be determined by a district judge despite the creditor's filing of a proof of claim in the bankruptcy court. A preference counterclaim, but *not a* fraudulent transfer counterclaim, can still be heard and determined by the bankruptcy judge. *Id.* at *21-22, citing *Katchen v. Landy*, 382 U.S. 323 (1966) and *Langenkamp v. Culp*, 498 U.S. 42 (1990). Other routine matters will still be handled by bankruptcy judges (*e.g.*, allowance of claims; contract rejection and contract assumption; fee issues; automatic stay disputes). In doubt and subject to litigation will be any non-bankruptcy claims asserted by the debtor's estate against third parties, including fraudulent transfers, lender liability claims and fraud claims.

District judges are not looking for more work. They will probably construe *Stern* narrowly and reallocate pre-trial matters in non-core bankruptcy litigation to the bankruptcy courts. This kind of reallocation occurred after the Second Circuit held that a bankruptcy judge could not determine a breach-of-contract claim when the non-debtor was entitled to a jury trial. *In re Orion Pictures Corp.*, 21 F.3d 24 (2d Cir. 1994). The district courts later allowed bankruptcy judges to preside over all pre-trial matters until the dispute was ready for trial. *See*, *In re Loral Space & Communications*, 2004 U.S. Dist. LEXIS 13230 (S.D.N.Y. 2004) ("While the issue is always case specific, often courts in this District have found it appropriate to defer withdrawing the reference [to the bankruptcy court] until a case is trial ready.")(citing cases).

Comment
Supreme Court precedent had led litigators to assume that a creditor's filing of a claim in the bankruptcy court constituted a submission to the bankruptcy's jurisdiction for all purposes. In order to distinguish this precedent, which was limited to preference counterclaims that are part of the claims allowance process, *Katchen*, *Langenkamp*, supra, the majority in *Stern* held that 28 U.S.C. § 157(b)(2)(C) was unconstitutional by

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going beyond the basic bankruptcy scheme. Although *Stern* is ostensibly a narrow ruling, the majority essentially held that Congress had given too much power to bankruptcy judges, who are not Article III hearing officers.

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