

*Stern v. Marshall: What Does It Really Mean?*

By Richard E. Mikels and Ella Shenhav

Mintz Levin Cohn Ferris Glovsky and Popeo, P.C.

Since it was decided in June 2011, countless scholars and courts have weighed in on the impact and implications of the Supreme Court’s seminal opinion in *Stern v. Marshall*.<sup>1/</sup> As many of these analyses recognize, *Stern* cannot be fully understood without a historical context. This article reviews the background essential to a proper reading and understanding of *Stern*, and then analyzes the decision itself in light of this historical context.

I. What Came Before Stern

Before the 1978 Bankruptcy Code (the “Code”) was enacted to replace the Bankruptcy Act of 1898 (as amended, the “Act”),<sup>2/</sup> bankruptcy courts were courts of limited jurisdiction. Bankruptcy proceedings were generally conducted before referees. In 1974, the referees became bankruptcy judges, although without any change in jurisdiction.<sup>3/</sup> The pre-Code bankruptcy judges had two types of jurisdiction: (1) they had “summary” jurisdiction over matters of administration in the bankruptcy case, such as petitions, the bankruptcy res, and the allowance of claims, and additional summary jurisdiction to decide controversies over property in the actual or constructive possession of the court; and (2) the bankruptcy court did not have jurisdiction to hear “plenary” actions, which dealt with recoveries other than disputes over assets which were in the actual or constructive possession of the court. However, the bankruptcy court could hear such actions, such as preferences, fraudulent conveyances and state law causes of action, with the consent of the parties.

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<sup>1/</sup> *Stern v. Marshall*, 131 S.Ct. 2594 (2011)

<sup>2/</sup> The Act was enacted in 1978, but only took effect in October of 1979.

<sup>3/</sup> Therefore this article will refer to them as bankruptcy judges.

It is important to note that absent consent, the pre-Code bankruptcy judge did not have the right to finally determine plenary state law causes of action, like the ones in *Marathon* or *Stern (infra)*. Further, the bankruptcy judge could not hear preferences or fraudulent conveyances. If the parties consented, the bankruptcy judge could hear all such matters, and a myriad of ways existed by which the non-debtor party could consent (often inadvertently). Of course, if a party filed a proof of claim, the bankruptcy court could determine the claim because that was part of the court's summary jurisdiction. In the important case of *Katchen v. Landy*,<sup>4/</sup> which was cited approvingly by both *Granfinanciera* and *Stern, infra*, the Supreme Court held that a bankruptcy court was empowered to hear preferences and fraudulent conveyances if the defendant had filed a proof of claim in the bankruptcy case. That holding stemmed from the fact that pursuant to Section 57(g) of the Act (which was the predecessor to Section 502(d) of the Code), a party that had received a preference was required to return the preference before its claim could be allowed. Therefore, according to *Katchen*, the resolution of the claim necessarily involved a determination of whether the preference or fraudulent conveyance had been received and paid back. Therefore, it was not the filing of the proof of claim itself that granted the bankruptcy court authority to hear the preference or fraudulent conveyance. It was the requirements of Section 57(g) that provided such authority.

Defendants in preference or fraudulent conveyance or other plenary actions had an ability to cause long delays by exercising their rights to complain about the case being heard in the bankruptcy court. This led to settlements which were more favorable to the defendants, increased cost to the estate, and delays in the administration of bankruptcy cases.

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<sup>4/</sup> *Katchen v. Landy*, 382 U.S. 323, 86 S.Ct. 467 (1996)

This jurisdiction issue was a major topic of concern that Congress attempted to resolve by the passage of the Code.<sup>5/</sup> Bankruptcy courts' jurisdiction after enactment of the Code was much broader than the jurisdiction exercised under the pre-Code system.<sup>6/</sup> The distinction between "summary" and "plenary" jurisdiction was eliminated, and it was replaced with a broad grant of jurisdiction over all "civil proceedings arising under title 11 or arising in or related to cases under title 11."<sup>7/</sup> Included under this jurisdictional grant were "suits to recover accounts, controversies involving exempt property, actions to avoid transfers and payments as preferences or fraudulent conveyances, and causes of action owned by the debtor at the time of the petition for bankruptcy."<sup>8/</sup> For the first time, Congress passed legislation which granted the bankruptcy courts jurisdiction over fraudulent transfers and preference actions, as well as civil actions dealing with state law issues that would have been plenary pre-Code.

The Code's jurisdictional regime enjoyed only a brief respite before it came under attack by the Supreme Court in *Northern Pipeline Construction Co. v. Marathon Pipe Line Company*.<sup>9/</sup> Drawing a line between matters involving public versus private rights, the Supreme Court held that "only controversies in the former category may be removed from Art. III courts and delegated to legislative courts or administrative agencies for their determination."<sup>10/</sup> In response to the Supreme Court's *Marathon* opinion, Congress passed several interim measures to keep the

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<sup>5/</sup> See 1 Collier on Bankruptcy ¶ 3.10 (16<sup>th</sup> ed. 2011)

<sup>6/</sup> *Marathon, infra*, at 54

<sup>7/</sup> 28 U.S.C. § 1471(b) (1976 ed., Supp. IV). "Arising under" means any matter involving a cause of action created by title 11. 1 Collier on Bankruptcy ¶ 3.01[3][e][i] (16<sup>th</sup> ed. 2011). "Arising in" "acts as the residual category of civil proceedings" and includes matters such as administrative matters that arise in a bankruptcy case but are not based on any express right created by title 11, such as orders to turn over property of the estate and determination of the validity, extent or priority of liens. *Id.* at ¶ 3.01[3][e][iv]. And a civil proceeding is "related to" a bankruptcy case when "the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy." *Id.* at ¶ 3.01[3][e][ii] (citing *Pacor, Inc. v. Higgins*, 743 F.2d 984 (3d Cir. 1985).

<sup>8/</sup> *Marathon, infra*, at 54

<sup>9/</sup> *Northern Pipeline Construction Co. v. Marathon Pipe Line Company*, 102 S.Ct. 2858, 458 U.S. 50 (1982)

<sup>10/</sup> *Marathon* at 70 (emphasis in original).

bankruptcy courts operational until it finally enacted the Bankruptcy Amendments and Federal Judgeship Act of 1984 (the “1984 Act”). The 1984 Act gave district courts authority to refer all cases under title 11, all proceedings arising under title 11, and all cases arising in or related to a case under title 11 to the bankruptcy courts. 28 U.S.C. § 157(a). In addition, the 1984 Act divided bankruptcy-related matters into “core” and “non-core” proceedings. 28 U.S.C. §§ 157(b)(1) and 157(c)(1). Pursuant to the 1984 Act, both core and non-core proceedings could be heard by bankruptcy courts, but those courts could only enter final judgments in core proceedings, unless the parties consented. In non-core cases otherwise related to a case under title 11, bankruptcy courts were authorized to “submit proposed findings of fact and conclusions of law to the district court,” which would then be reviewed by the district court on a *de novo* basis. 28 U.S.C. 157(c)(1).

But in 1989, the Supreme Court began chipping away at the constitutionality of the 1984 Act. In *Granfinanciera, S.A. v. Nordberg*,<sup>11/</sup> the Supreme Court held that fraudulent conveyance actions implicated private rights, and therefore the adjudication of such actions without affording the parties the opportunity to have a jury trial was violative of the Seventh Amendment. Significantly, the Court specifically held that “the question whether the Seventh Amendment permits Congress to assign its adjudication to a tribunal that does not employ juries as factfinders requires the same answer as the question whether Article III allows Congress to assign adjudication of that cause of action to a non-Article III tribunal.”<sup>12/</sup>

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<sup>11/</sup> *Granfinanciera, S.A. v. Nordberg*, 109 S.Ct. 2782, 492 U.S. 33 (1989)

<sup>12/</sup> *Id.* at 53.

Not long after *Granfinanciera* was handed down, the Supreme Court revisited the issue in its *per curiam* opinion in *Langenkamp v. Culp*.<sup>13/</sup> *Langenkamp* reaffirmed the *Granfinanciera* holding, this time in the preferential transfer context.

## II. *Stern – An Overview*

In *Stern v. Marshall*, the Supreme Court, once more attacking the 1984 Act and addressing the difference in bankruptcy courts' authority over matters of public versus private rights, held in a 5-4 ruling that a bankruptcy court lacked constitutional authority to finally adjudicate a debtor's state law counterclaim against a creditor, even if the creditor filed his or her own claim against the estate.

As though the legal analysis at the basis of the opinion was not sufficient to create one of the most talked-about – if not *the* most talked-about – bankruptcy opinions of the century thus far, the tabloid-appropriate facts only served to add more interest in the *Stern* opinion. At the heart of the case lies a dispute between Vickie Lynn Marshall, a/k/a Anna Nicole Smith (“Vickie”), and E. Pierce Marshall (“Pierce”)<sup>14/</sup> the son of Vickie's deceased husband, the much-older Texas multi-millionaire J. Howard Marshall, III (“J. Howard”). Before J. Howard's death, Vickie, upset over the fact that her husband had not included her in his will, sued Pierce in a Texas state court, alleging that he fraudulently induced J. Howard to sign a living trust that excluded Vickie. Vickie claimed that J. Howard had meant to give her half his property.

After J. Howard's death, Vickie filed a petition for bankruptcy. Pierce then filed a complaint in that bankruptcy proceeding, alleging that Vickie had defamed him by causing her lawyers to tell the press that Pierce had engaged in fraud in order to gain control of his father's assets, and seeking a declaration that his defamation claim was not dischargeable in the

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<sup>13/</sup> *Langenkamp v. Culp*, 498 U.S. 42, 111 S.Ct. 330 (1990) (*per curiam*)

<sup>14/</sup> Both Vickie and Pierce had passed away during the litigation, and were deceased when the Supreme Court made its decision. The parties in the case were their respective estates.

bankruptcy proceedings. Pierce subsequently filed a proof of claim in the bankruptcy action, seeking to recover damages for the alleged defamation from Vickie's bankruptcy estate. In response, Vickie, in addition to answering the complaint, filed a counterclaim for tortious interference with the gift she expected from J. Howard.

The bankruptcy court granted Vickie summary judgment on Pierce's claim for defamation and awarded Vickie more than \$400 million on her counterclaim, over Pierce's objection that the bankruptcy court lacked jurisdiction over Vickie's counterclaim because it was not a "core proceeding" under 28 U.S.C. § 157(b)(2)(C). While the bankruptcy court concluded Vickie's counterclaim was indeed a core proceeding, the district court disagreed, and determined it was required to treat the bankruptcy court's judgment as proposed findings, rather than a final judgment. The court of appeals concluded that the counterclaim was not a core proceeding because it was not sufficiently related to Pierce's proof of claim, and the Supreme Court granted certiorari.

In a decision that sent shockwaves throughout the bankruptcy world, the Supreme Court held that while Vickie's counterclaim was indeed a core proceeding pursuant to the plain text of 28 U.S.C. § 157(b)(2)(C), but that Congress exceeded its constitutional authority in passing this statute. Returning to the same themes outlined in *Marathon*, the Court noted that Article III requires that "judicial power" only be vested in judges that "shall hold their Offices during good behavior, and shall, at stated Times, receive for their Services, a Compensation, which shall not be diminished during their continuance in Office."<sup>15/</sup> The purpose of Article III, explained the Court, would be frustrated if other branches of the federal government were permitted to confer such judicial power on non-Article III tribunals.

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<sup>15/</sup> *Stern* at 2600 (citing Article III, § 1, of the Constitution)

After a brief review of the historical context, the Court concluded that, on core matters, the bankruptcy courts now “exercise the same powers they wielded under the 1978 Act. The authority exercised by the newly constituted [bankruptcy] courts over a counterclaim such as Vickie's exceeds the bounds of Article III.”<sup>16/</sup>

Rejecting Vickie’s argument that her claim involved a public right that could be decided by a non-Article III court, the Court characterized it squarely as “one under state common law between two private parties,” which does “not fall within any of the varied formulations of the public rights exception.”<sup>17/</sup> Therefore, held the Court, the bankruptcy court, as a non-Article III court, could not finally adjudicate Vickie’s counterclaim.

### III. What *Stern* Really Meant

As noted above, the *Stern* decision caused an uproar in the bankruptcy community and has been the source of much speculation as to its ultimate result – would bankruptcy courts lose control over matters they have long presided over, such as fraudulent transfers and preference actions, or would the decision be read narrowly, so as to only apply to the precise type of situation that existed in *Stern*? However, *Stern* must be read along with *Marathon*, *Granfinanciera* and *Langenkamp* in order to understand the full scope of the opinion.

As described above, *Granfinanciera* held that adjudication of fraudulent conveyance actions implicated private rights, and therefore required the opportunity to have a jury trial pursuant to the Seventh Amendment. The Court stated, notably, that “if a statutory cause of action, such as respondent’s right to recover a fraudulent conveyance under 11 U.S.C. § 548(a)(2), is not a “public right” for Article III purposes, then Congress may not assign its adjudication to a specialized non-Article III court lacking the essential attributes of the judicial

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<sup>16/</sup> *Stern* at 2597

<sup>17/</sup> *Id.* at 2614

power.”<sup>18/</sup> Not only that, but *Granfinanciera*, which clearly states that a private right matter cannot be finally adjudicated by a bankruptcy court absent consent, goes on to state that “a bankruptcy trustee’s right to recover a fraudulent conveyance under 11 U.S.C. § 548(a)(2) seems to us more accurately characterized as a private rather than a public right...”.<sup>19/</sup> The Court found the cause of action in question to be a private right based on the fact that it was brought to civil courts since time immemorial. The Court was specific in suggesting that the analysis utilized for determining whether a jury trial exists is the same analysis that must be used to determine whether Congress has the right to delegate the final determination of such matters to an Article I court.

Many commentators and courts have considered *Granfinanciera* to be limited to the narrow issue of whether a party is entitled to a jury trial, and its express comments regarding Article II courts to be merely dicta. Others believe that the *Granfinanciera* decision stands for the proposition that bankruptcy courts may not finally adjudicate matters that do not fall under the public rights exception to the exercise of judicial powers by non-Article III courts, including fraudulent transfers and preference actions, and therefore actually chipped away at the constitutionality of the Code’s jurisdiction provisions. The Supreme Court reaffirmed its *Granfinanciera* holding, and its underlying reasoning, in *Langenkamp*. Further, the *Stern* opinion described *Granfinanciera* as concluding that “Congress could not constitutionally assign resolution of the fraudulent conveyance action to a non-Article III court.”<sup>20/</sup>

The *Stern* opinion emphasized that, while the three branches of government are not “hermetically sealed from one another,” the interaction between them must be limited, therefore

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<sup>18/</sup> *Granfinanciera* at 53 (citation and internal quotation marks omitted)

<sup>19/</sup> *Id.* at 55

<sup>20/</sup> *Stern* at 2614 n.7

Congress’s power to give non-Article III courts authority is also limited.<sup>21/</sup> “The structural principles secured by the separation of powers protect the individual as well,”<sup>22/</sup> explained the Court.<sup>23/</sup>

As an initial matter, 28 U.S.C. § 1334 grants the district courts original jurisdiction over certain categories of bankruptcy proceedings. This section states, in pertinent part:

- (a) Except as provided in subsection (b) of this section, the district courts shall have original and exclusive jurisdiction of all cases under title 11.
- (b) Except as provided in subsection (e)(2), and notwithstanding any Act of Congress that confers exclusive jurisdiction on a court or courts other than the district courts, the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11.

Pursuant to this section, jurisdiction resides in the district court. The district court may (and, for the most part, they have) transfer a bankruptcy case and proceedings within it to the bankruptcy court pursuant to 28 U.S.C. 157(a), which states that “[e]ach district court may provide that any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11 shall be referred to the bankruptcy judges for the district.”

28 U.S.C. § 157(b)(2) pronounces as core proceedings, *inter alia*, counterclaims by the estate against person filing claims against the estate (§ 157(b)(2)(C)), proceedings to determine, avoid or recover preferences (§ 157(b)(2)(F)), proceedings to determine, avoid or recover fraudulent conveyances (§ 157(b)(2)(H)), and other proceedings under the catch-all §

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<sup>21/</sup> *Stern* at 2609

<sup>22/</sup> *Id.*

<sup>23/</sup> This raises the question: Does one have an individual right to have his or her case heard in an Article III court? If that is the case, that would explain a lot about the *Stern* decision because defendants with certain types of claims would have an absolute right to have their case decided by an Article III judge.

157(b)(2)(O).<sup>24/</sup> Whether a matter is a core proceeding or “otherwise related” is a determination to be made by the bankruptcy judge pursuant to 28 U.S.C. 157(b)(3). If it is a core matter, the bankruptcy court can issue a final order subject to appeal; if it is a non-core matter, then the bankruptcy court may issue proposed findings and conclusions to the district court.

At least two interpretations to section 157 were argued in *Stern*. One interpretation is that under a strict reading of 28 U.S.C 157(b)(1), a core proceeding must “arise in” or “arise under” a case under Title 11, but cannot be a related-to proceeding. Under that interpretation, core proceedings are limited to proceedings “arising in” or “arising under.” Even a category of “core proceeding” listed under Section 157(b)(2) cannot be core unless it is a proceeding that “arises in” or “arises under.” If that interpretation had been accepted in *Stern*, the end result of the analysis would have been the same because some actions listed under 157(b)(2) would be core and others would not. The constitutional issue could have been avoided altogether, and yet the same result could have been reached. Instead, the Court preferred to read 28 U.S.C 157(b)(2) as establishing that certain categories of matters were core proceedings, and therefore some of the Congressional grant of authority to issue final orders to non-Article III judges was unconstitutional. It should have been obvious from the beginning that 28 USC 157(b)(2)(C), (F) (H) and (O) might not pass muster under *Marathon*. However, Congress’s goal of simplifying and expediting bankruptcy proceedings by expanding jurisdiction was once again reflected in the 1984 amendments and controlled bankruptcy proceedings until *Granfinanciera*, *Langenkamp* and *Stern v. Marshall*. Those three cases can easily be construed as telling the bankruptcy community that the Supreme Court meant what it said in *Marathon*.

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<sup>24/</sup> 157(b)(2)(O) pronounces as core proceedings “other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims.”

It is important to note that *Stern* is not an analysis of a jurisdictional issue. Rather, the court explained:

Section 157 allocates the authority to enter final judgment between the bankruptcy court and the district court. That allocation does not implicate questions of subject matter jurisdiction.<sup>25/</sup>

Since it is not a jurisdictional issue, by consenting, parties may give the bankruptcy court authority to hear their cases. While the lower court found that Pierce's counterclaim was compulsory, the Supreme Court did not decide that issue one way or the other, but rather determined that there were issues necessary to determining Vickie's counterclaim against Pierce that would not necessarily be decided in determining Pierce's claim. Pierce consented to jurisdiction over his claim in a number of ways, but that doesn't mean he consented to the bankruptcy court's determination of Vickie's counterclaim. The *Stern* opinion seems to say that if the determination of the claim would have determined all issues in the counterclaim, then the bankruptcy court would be able to issue final orders over the counterclaim.

#### IV. Conclusion

Chief Justice Roberts wrote that the *Stern* decision is "narrow,"<sup>26/</sup> and that could mean that it only affects state law counterclaims. However, the Court could have also meant this decision does not have the effect of eviscerating the bankruptcy code's jurisdictional provisions as was accomplished by *Marathon*. Even in its broadest reading, *Stern* points out that there is at least one, and possibly more categories of cases that Congress delegated to bankruptcy courts in 1984 that were beyond Congress's power to delegate under the Constitution. However, the bulk of the jurisdictional scheme remains untouched. How *Stern* will be interpreted is hard to predict. For example, it must be nearly inconceivable for anyone who started their career after 1979 that

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<sup>25/</sup> *Stern* at 2607 (internal citations omitted)

<sup>26/</sup> *Id.* at 2620

bankruptcy courts would not have the ability to enter final orders in preference and fraudulent conveyance cases. However, this may be the case under *Stern*, *Granfinanciera* and *Langenkamp*. Usually when things are inconceivable and violate the best bankruptcy policies (creating less efficiency, added expense, and interminable delays), people interpret them in ways that may have been unintended by the Supreme Court. For example, after *Marathon*, where the Supreme Court essentially curtailed bankruptcy jurisdiction to a model closer to what existed pre-code, Congress responded with the 1984 amendments, which expanded the role of bankruptcy courts to as close as possible to what Congress intended in 1978, but with a passing nod to the very direct provisions of *Marathon*. Congress was successful in expanding bankruptcy courts' jurisdiction for 27 years, until the *Stern* decision was issued. Therefore, it would not be surprising to see some courts and commentators try to limit *Stern* as much as possible. On the other hand, reading *Marathon*, *Stern*, *Langenkamp* and *Granfinanciera* together could lead to a broader range of restraints on bankruptcy courts than even Chief Justice Roberts had intended.

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