

# Zack A. Clement, PLLC

FINANCIAL RESTRUCTURE FOR BUSINESSES AND GOVERNMENTS

## *Using Stern v. Marshall*

### **1. Holding in Stern v. Marshall**

In *Stern v. Marshall*, 564 U.S. 462 (2011) the Supreme Court declared for the third time that a bankruptcy court does not have authority under the Constitution to issue a final judgment in a lawsuit arising solely under state common law seeking to bring assets into a debtor's bankruptcy estate. The Court held that the bankruptcy court lacked constitutional authority to enter a final judgment on a counterclaim filed by Vickie Lynn Marshall, more commonly known as Anna Nicole Smith, alleging interference with expected inheritance against her late husband's son, Pierce Marshall, after he had filed a proof of claim in her Chapter 11 case alleging damages for defamation.

Previously, the Supreme Court had held that a bankruptcy court lacks the power to enter a final judgment on a debtor's state law contract claim against a non-debtor third party, *Northern Pipeline Const. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), and that a bankruptcy court lacks such power concerning a debtor's fraudulent conveyance claim against a non-debtor party who had not filed a proof of claim, *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989).

In *Stern*, the Supreme Court ultimately held that, even though Congress had provided in 28 U.S.C. §157(b)(2)(C) that a counterclaim against a party that has filed a proof of claim is a matter of "core" bankruptcy jurisdiction,<sup>1</sup> the bankruptcy court in Vickie Marshall's case

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<sup>1</sup> 28 U.S.C. §157(b)(1) provides that "bankruptcy judges may hear and determine [enter a final judgment on] all [main bankruptcy] cases arising under title 11 [the Bankruptcy Code] and all core proceedings [lawsuits] arising under title 11 [the Bankruptcy Code] or arising in a [bankruptcy] case under title 11." As to "proceedings" (lawsuits) that are merely related to a bankruptcy case because they might affect the size of the bankruptcy estate, the bankruptcy court can only issue proposed findings subject to de novo review

“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.” *Stern*, at 27.

The Supreme Court’s decision turned on its assessment of the facts concerning three factors: (1) is the right being adjudicated part of a federal regulatory scheme, (2) is adjudication of the right essential to the regulatory scheme and objective and (3), if not, is adjudication of the right intertwined with adjudications that are essential to the regulatory scheme and objective?

The Supreme Court held that a “public right” that can be assigned to a non Article III bankruptcy court must “derive . . . from a federal regulatory scheme” and “resolution of the claim by an expert governmental agency [such as a bankruptcy court] . . . must be essential to a limited regulatory objective,” neither of which the Court found present in the *Stern* case. The Court concluded that resolution the counterclaim at issue in *Stern* was not so intertwined with a core bankruptcy function (such as allowing a claim) as to bring it within the bankruptcy court’s power to decide (“there was never any reason to believe that the process of adjudicating Pierce’s proof of claim [for defamation] would necessarily resolve Vickie’s counterclaim [for interference with expected inheritance].”).

## 2. What *Stern* Means

**The Supreme Court’s decision in *Stern* is thus the third time it has said that it would not permit bankruptcy courts to enter final orders on trial of what it referred to in *Katchen v Landy*, 382 U.S. 323 (1966) as plenary matters under the old Bankruptcy Act - - matters that seek to bring assets into the custody of the bankruptcy court to be distributed to creditors through the bankruptcy process. Each of *Marathon*, *Granfinanciera* and *Stern* essentially held that a bankruptcy court could not enter a final order in a plenary matter.**

***Marathon*, *Granfinanciera* and *Stern* actually support the concept that bankruptcy courts can try and enter final judgments on matters falling into what the Court referred to in *Katchen* as the summary jurisdiction of the bankruptcy court - - that is jurisdiction over property of the estate in the custody of the court, allowing and**

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by the district court. 28 U.S.C. §157(c). 28 U.S.C. §157(b)(2) provides that core matters include, but are not limited to a list of sixteen items, including “counter-claims by the estate against persons filing claims against the estate.” 28 U.S.C. §157(b)(2)(C).

prioritizing of claims against those assets, and approval of plans for their distribution. *See e.g. Katchen*, 382 U.S. at 327, 329. In *Stern*, the Supreme Court gave substantial deference to *Katchen*, going to great lengths to distinguish it so as not to overrule it.

### 3. More Detailed Analysis of *Stern*

#### (a) Public Right Versus Common Law

*Stern* held that Vickie Marshall’s counterclaim did not meet the “public right” exception to the general rule that an Article III court (*i.e.*, a district court) must adjudicate a “matter which, from its nature, is the subject of a suit at the common law, or in equity or admiralty.” *Id.* at 2. When Congress creates a right that did not exist as a private right among citizens under the common law, it can assign that public right to a non-Article III court. According to *Stern*, the Supreme Court “has continued, however, to limit the [public right] exception 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,” neither of which it found to be present in the *Stern* case. *Id.* at 3 (emphasis added).

*Stern* noted that the Supreme Court had held in *Granfinanciera* that the bankruptcy court lacked power to enter judgment on a debtor’s fraudulent conveyance claim against a party that had not filed a creditor claim because “if a statutory right is not closely intertwined with a federal regulatory program Congress has power to enact, and if that right neither belongs to nor exists against the Federal Government, then it must be adjudicated by an Article III court.” *Id.* at 19. In *Granfinanciera*, the court held that “fraudulent conveyance suits were ‘quintessentially suits at common law that more nearly resemble state law contract claims brought by a bankrupt corporation to augment the bankruptcy estate than they do creditors’ hierarchically ordered claims to a pro rata share of the bankruptcy res.’” *Id.*

*Stern* found Vickie Marshall’s counterclaim to be similar to the fraudulent conveyance claims in *Granfinanciera*. It was not a claim created by Congress but “is instead one under state common law between two private parties. It does not depend on the will of Congress.” *Id.* at 19.

(b) **Filing a Proof of Claim Does Not Necessarily Equal Submission to Bankruptcy Court Jurisdiction**

*Stern* held that Pierce Marshall’s filing of a proof of claim in the bankruptcy case alleging defamation did not, by itself, give the bankruptcy court jurisdiction over Vickie Marshall’s counterclaim for tortious interference. According to the Court, “Pierce did not truly consent to resolution of Vickie’s claim in the bankruptcy court proceedings. He had nowhere else to go if he wished to recover from Vickie’s estate.” *Id.* at 20.

*Stern* thus appears on the surface to have overruled *Katchen v Landy*, 382 U.S. 323 (1966) which had held that a creditor who filed a proof of claim had submitted to the summary jurisdiction of the bankruptcy court over a counterclaim against it. *Stern*, however, distinguished *Katchen* because (1) the central bankruptcy function of allowing and paying the creditor’s claim could not be completed in *Katchen* until the preference counterclaim was resolved and (2) the preference cause of action was contained in the federal bankruptcy statute. Moreover, *Stern* ruled that, even though the courts below had concluded that Vickie Marshall’s counterclaim was compulsory, “there was never any reason to believe that the process of adjudicating Pierce’s proof of claim would necessarily resolve Vickie’s counterclaim.” *Id.* at 23.

(c) **Relatedness of a Counterclaim to a Core Matter**

*Stern* affirmed the circuit court’s holding that a counterclaim under §157(b)(2)(C) is properly a “core” proceeding “arising in a case under the [Bankruptcy] Code only if the counterclaim is so closely related to [a creditor’s] proof of claim that the resolution of the counterclaim is necessary to resolve the allowance or disallowance of the claim itself.” *Stern*, at 8. *Stern* held that Vickie Marshall’s counterclaim did not meet that standard.

Here Vickie’s Claim is a state law action independent of the federal bankruptcy law and not necessarily resolvable by a ruling on the creditor’s proof of claim in bankruptcy. *Northern Pipeline* and our subsequent decision in *Granfinanciera*, 492 U.S. 33 . . . rejected application of the ‘public rights’ exception in such cases.

*Id.* at 16.

(d) **The New Rule From *Stern***

Ultimately, *Stern* distinguished *Katchen* and extended *Granfinanciera* to Vickie Marshall's case in which (1) the creditor had filed a proof of claim and (2) the lower courts had found her counterclaim to be compulsory. In essence, *Stern* held that the "public law" exception would be extended to counterclaims based on state law where the resolution of the counterclaim (1) involves the essence of the bankruptcy process or (2) is so intertwined with claims allowance that it will necessarily be decided in connection with it.

*Granfinanciera's* distinction between actions that seek 'to augment the bankruptcy estate' and those that seek 'a pro rata share of the bankruptcy res' . . . reaffirms that 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 [1] stems from the bankruptcy itself or [2] would necessarily be resolved in the claims allowance process.

*Id.* at 24 (emphasis added).

2. **How *Stern* Can Be Used**

***Stern* is precedent for a bankruptcy court deciding state law issues that are necessarily involved in decision of core bankruptcy issues such as allowing claims, assuming, assigning or rejecting executory contracts, and finding that a plan of reorganization is feasible, fair and equitable and in the best interests of creditors.**

**These are the kind of issues that *Katchen* held could be decided in the summary jurisdiction of the bankruptcy courts. Thus many state law issues will be decided in plan confirmation hearings that are conducted as contested matters pursuant to Federal Rules of Bankruptcy Procedure 9014. For example, determinations of feasibility will often adjudicate underlying state law issues,**

**Recently, some creditors have tried to avoid having their state law based issues decided in a plan confirmation hearing by putting into an adversary proceeding complaint the same issues that they have raised**

**opposing confirmation of the plan. However, FRBP 7001 contains a very short list of issues that must be determined in an adversary proceeding instead of a contested matter. *Stern* and *Katchen* support summary adjudication of these necessarily related state law claims in a plan confirmation hearing conducted as a contested matter under FRBP 9014. After such an adjudication, an adversary proceeding raising the same issues should be dismissed on grounds res judicata. This raises an interesting question about when a motion to dismiss such an adversary proceeding should be scheduled.**

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