Testimony of

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on behalf of the

NATIONAL BANKRUPTCY CONFERENCE

before the

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The Supreme Court's Decision in *Stern v. Marshall:* Its Effects on Bankruptcy Administration and Possible Congressional Responses

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Good morning. My name is Patrick Vance and I am appearing here today on behalf of the National Bankruptcy Conference. By way of background, I am a partner in the New Orleans, Louisiana office of Jones, Walker, Waechter, Poitevent, Carrère and Denègre, where I head the firm's bankruptcy practice and I am the practice group leader for the Commercial Litigation practice group. I have been at Jones Walker for my entire 37 year career as a lawyer.

The National Bankruptcy Conference is grateful for the opportunity to participate in this hearing and to present its comments on the impact and effect on the bankruptcy system arising from the Supreme Court's *Stern v. Marshall* decision handed down last year.

The Supreme Court's decision – *Stern v. Marshall*, 131 S. Ct. 2594 (2011) – has created considerable consternation in the bankruptcy world. In a 5 – 4 decision, the Court found that the statutory grant of power to bankruptcy judges in 28 U.S.C. §157(b)(2)(C) to hear and determine core proceedings constituting "counterclaims by the estate against persons filing claims against the estate" exceeds the limits of Article III of the Constitution.

Although Chief Justice Roberts insisted that the holding is narrow, the near universal reaction among the bar and many courts is one of disbelief. The Court's rationale for its decision permits a reading that calls into question the constitutional validity of the bankruptcy court's authority over a wider range of core proceedings than the type of counterclaim that gave rise to the issue in *Stern*. For instance, *Stern* arguably affects avoidable preferences and fraudulent conveyances which constitute fertile areas for bankruptcy litigation.

Indeed, there are in excess of 500 reported decisions that cite *Stern*. Those lower court decisions indicate that some courts and parties are rushing to raise broader constitutional issues as they do not believe that *Stern* can be confined to an isolated, narrow issue. Some even argue that the effect of the *Stern* case is to return bankruptcy decision-making back to the bad old days

before the enactment of our modern bankruptcy code in 1978. Students of bankruptcy history worry that the bankruptcy system will return to those days when there was a lot of wasteful and expensive litigation sorting out whether the bankruptcy judge or referee was exercising summary or plenary jurisdiction.

If the Supreme Court's decisions on the contours of Article III and bankruptcy court powers were subject to easy synthesis, perhaps the post-*Stern* issues would not be so thorny and would provoke less litigation. The simplest solution is obvious, but has encountered stubborn resistance over the years. If bankruptcy courts were presided over by Article III judges, bankruptcy lawyers and judges could do their work efficiently without concern over the limitations that might affect the court's power to render final judgments.

The National Bankruptcy Conference has consistently recommended Article III status for bankruptcy courts. And incidentally, this was the view of the House of Representatives before enactment of the 1978 Bankruptcy Code. But, the history is known well. The Senate's view was to the contrary, and that view prevailed.

I have attached to my opening statement two reports written by the Court System and Bankruptcy Administration Committee of the National Bankruptcy Conference. The reports cover a lot of ground. The October 26, 2011 report is entitled The Scope and Implications of Stern v. Marshall. It reviews the tortured history of the decision, analyzes its scope and attempts to reconcile the decision with the Supreme Court's other Article III cases.

The report also addresses the validity of "consent" so as to permit a bankruptcy court to hear, determine, and enter a final judgment on a *Stern*- like claim – that is, one that is statutorily designated as "core" for which an Article III adjudication is otherwise required. A section of the report is a comparison of the bankruptcy court's powers to hear and decide disputes with the

Federal Magistrate Act (28 U.S.C. §636(c)(1)), the later having been upheld by virtually all of the courts of appeal. The comparison suggests that "consent" of litigants may well limit the effects of *Stern* on the regular work of the bankruptcy courts. If so, this would be in keeping with Chief Justice Roberts' observation that the effect of the *Stern* decision should not change the division of labor between the district courts and bankruptcy courts.

So, how have the players in the system gone about trying to maintain as much of the status quo as possible? The May 7, 2012 report attached to this statement attempts to summarize those efforts. While the NBC has not yet, and may never, attempted to summarize and/or categorize the some 500 decisions which cite *Stern*, it does appear that the courts are attempting to read *Stern* narrowly. The report highlights eight decisions rendered by various courts of appeal and bankruptcy appellate panels.

Two other efforts which are underway are noted in the report. First, several judicial districts have enacted local rules that require the parties to state explicitly early on whether they will consent or not to the bankruptcy court's rendition of a final judgment. Some of the referral orders attempt to avoid the head splitting *Stern* analysis and declare that if the district court in reviewing the work of the bankruptcy court concludes that an Article III court is necessary to render a final judgment, then the judgment of the bankruptcy court will be treated as "proposed" findings of fact and "proposed" conclusions of law.

And second, the Judicial Conference's Advisory Committee on Bankruptcy Rules approved for publication at its June meeting proposed amendments to several Rules of Bankruptcy Procedure (Rules 7008, 7012, 7016, 9027 and 9033). These amendments were presented to the Committee on Rules of Practice and Procedure and will be published in August for public comment. However, those rules will likely not go into effect until December, 2014.

In the meantime, there are some clean up actions that Congress might consider with respect to 28 U.S.C. §157(b) and (c). Section 157(b)(2)(c) which was the focus of the *Stern* case should be revised. It would also appear that §157(c)(1) should be amended to include "core" matters that require an Article III court. This would clarify that absent consent, the bankruptcy court could at least hear the dispute and send proposed findings to the district court. Section 157(c)(2) should also include *Stern*-like "core" matters.

Since the full impact of *Stern* remains unclear, time and judicial decisions may dictate other statutory revisions. The only sure way to prevent repeated and costly litigation over these matters is to create Article III bankruptcy courts. But until that can be accomplished, revisions to section 157 or perhaps new local rules, revised reference orders and the proposed bankruptcy rules amendments can be pursued to keep the bankruptcy system working as efficiently as possible.

Once again, I would like to thank the Chair and the rest of the Subcommittee for inviting the National Bankruptcy Conference to testify in this important hearing. The Conference would be pleased to formulate drafting proposals and assist in technical matters if the Subcommittee would find that helpful.

NATIONAL BANKRUPTCY CONFERENCE

COMMITTEE ON COURT SYSTEM AND BANKRUPTCY ADMINISTRATION[1]

"THE SCOPE AND IMPLICATIONS OF *STERN v. MARSHALL, 131 S. CT. 2594 (2011)*"

OCTOBER 26, 2011[2]

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[1] Authored by Chair, Prof. S. Elizabeth Gibson, Michael St. Patrick Baxter, Prof. Randal C. Picker and R. Patrick Vance.

[2] The contents of this Report were presented at the 2011 Annual Meeting of the National Bankruptcy Conference, together with the recommendations of the Committee. This Report has neither been approved nor disapproved by the Conference.

In *Stern v. Marshall*, 131 S.Ct. 2594 (2011), the Supreme Court returned to the question of the scope of authority that bankruptcy courts can exercise consistent with the constraints of Article III of the U.S. Constitution. Article III vests the judicial power of the United States in courts where the judges enjoy certain constitutional protections designed to preserve their independence from the political branches and from democratic forces. Bankruptcy judges do not enjoy those protections. In *Stern*, in a 5-4 decision, the Court found that the statutory grant of power to bankruptcy judges in 28 USC § 157(b)(2)(C) to hear and determine core proceedings constituting "counterclaims by the estate against persons filing claims against the estate" exceeds the limits of Article III of the Constitution.

I. The Decision

Anna Nicole Smith (referred to the in Supreme Court opinion by her actual first name, "Vickie") married J. Howard Marshall II roughly one year before his death. But even before her husband's death, a fight broke out between Vickie and Marshall's son, Pierce Marshall, over what would happen to the husband's assets on his death. After his death, Vickie filed a bankruptcy petition, and Pierce Marshall in turn filed a complaint in the bankruptcy proceeding. Pierce believed that Vickie had defamed him in the fight over his father's assets, and Pierce sought to have the defamation claim declared non-dischargeable. Pierce eventually filed a proof of claim in Vickie's bankruptcy case relating to the alleged defamation. Vickie responded to that claim by filing a counterclaim for tortious interference in connection with her now-deceased husband's assets.

The bankruptcy court resolved both Pierce's original claim against Vickie and her counterclaim against him. Vickie won a summary judgment motion on the defamation claim and was awarded $400 million in compensatory damages and $25 million in punitive damages on her tortious interference claim. There were many other proceedings—including state proceedings and a prior trip to the U.S. Supreme Court—but eventually the outcome turned on Pierce's challenge to the power of the bankruptcy court to decide Vickie's counterclaim.

That was the question before the Supreme Court, and the initial question was statutory. The jurisdictional provision for bankruptcy cases and proceedings, 28 USC § 1334, distinguishes between bankruptcy cases and proceedings and then within proceedings, among proceedings "arising under title 11" or "arising in or related to cases under title 11." That provision assigns jurisdictional power to district courts, not bankruptcy courts, but 28 USC § 157 sets forth the procedures under which district courts can assign matters within their jurisdiction under § 1334 to bankruptcy courts. Those provisions draw a sharp line between (1) what the statute defines as core proceedings arising under title 11 or arising in a case under title 11 and (2) proceedings that are non-core but otherwise related to a bankruptcy case. Matters that fall within the first statutory standard may be heard and determined by bankruptcy judges. The statute then offers a nonexclusive list of core proceedings, including the provision regarding counterclaims in § 157(b)(2)(C).

Pierce argued that under the statute a core proceeding need not necessarily be an arising-in or arising-under proceeding. Under that scheme, bankruptcy courts could hear and determine core proceedings that arose under title 11 or in a title 11 case, but not core proceedings that were

merely related to cases under title 11, such as, in Pierce's view, the counterclaim asserted by Vickie. The Court majority rejected that argument. The Court understood the statute to provide that core proceedings necessarily arise under title 11 or in cases under title 11, and thus the statute assigned to the bankruptcy court the power to decide Vickie's counterclaim. Pierce also raised a question about the extent to which § 157(b)(5)'s special rules for personal injury or wrongful death claims should apply in this situation, but the Court treated that provision as not jurisdictional and therefore subject to waiver. It concluded that Pierce had waived his claim to a district court trial under that provision.

That took the Court to the constitutional issue. The Court majority understood Article III to be critical in enacting our scheme of separation of powers among the judiciary, the legislature, and the executive. That in turn imposed sharp limits on the power of Congress to withdraw matters from resolution by Article III judges. As the Court put it: "When a suit is made of 'the stuff of the traditional actions at common law tried by the courts at Westminster in 1789,' Northern Pipeline, 458 U.S., at 90 (Rehnquist, J., concurring in judgment), and is brought within the bounds of federal jurisdiction, the responsibility for deciding that suit rests with Article III judges in Article III courts."

But at the same time, at least since *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), the Court has recognized a set of conflicts that Congress has the power to assign outside of the Article III judiciary for resolution. This is usually captured in the ill-defined "public rights" concept, but the core of that idea is that Congress enjoys flexibility in how to design the administration of a scheme when it creates new rights, even rights that just establish relationships among private parties. Disputes in those circumstances need not be assigned to Article III courts, and Congress can assign administration of those disputes to administrative agencies or what might be labeled as "courts" even if they don't enjoy Article III protections. This is critical, as much of the administrative apparatus that we associate with the modern federal government matches exactly this framework.

After a discussion of the cases on the scope of the public rights concept, the Court concluded that Vickie's counterclaim for tortious interference simply did not fall within the public rights doctrine. The action instead was a traditional, common law claim between two private parties: "What is plain here is that this case involves the most prototypical exercise of judicial power: the entry of a final, binding judgment by a court with broad substantive jurisdiction, on a common law cause of action, when the action neither derives from nor depends upon any agency regulatory regime. If such an exercise of judicial power may nonetheless be taken from the Article III Judiciary simply by deeming it part of some amorphous 'public right,' then Article III would be transformed from the guardian of individual liberty and separation of powers we have long recognized into mere wishful thinking."

The Court majority then turned to the cleanup of remaining issues. Pierce had filed a proof of claim in Vickie's bankruptcy proceeding, and the question was whether that filing created a power in the bankruptcy court to adjudicate Vickie's counterclaim for tortious interference. Two of the Court's prior decisions, namely *Katchen v. Landy*, 382 U.S. 323 (1966), and *Langenkamp v. Culp*, 498 U.S. 42 (1990) (per curiam), might be read to suggest that Pierce's proof of claim had that result, but the Court saw those cases as distinguishable. They addressed the proper location for adjudicating a bankruptcy preference claim, a classic example of a

separately created federal right. The Court also noted that under § 502(d) of the Bankruptcy Code, a creditor's claim can be disallowed as a result of the receipt of a preference. The Court found those preference claims to be quite different from the state law-based counterclaim asserted by Vickie that raised issues entirely different from Pierce's defamation claim. Finally, the Court rejected the idea that bankruptcy courts resolving counterclaims under § 157(b)(2)(C) could properly be viewed as adjuncts to Article III courts. With the power to enter final judgments on the counterclaims, subject to normal appellate review, they were in the eyes of the majority no more adjuncts of the district court than districts courts are adjuncts of the court of appeals.

In a short opinion, Justice Scalia concurred to emphasize his understanding of the public rights doctrine. In his view, the public rights doctrine encompasses disputes between the government and a second party and not disputes between two private parties.

Justice Breyer, joined by three other justices, dissented. He agreed with the majority's analysis on the statutory claim but disagreed with its constitutional analysis. The core of his analysis turned on what he understood to be the implications of *Crowell v. Benson*, 285 U.S. 22 (1932). Justice Breyer understood *Crowell* to provide the underpinning for the modern administrative state. One way to characterize the counterclaim provision in § 157(b) is precisely that it assigns the resolution of a private dispute to an administrative agency, namely the bankruptcy court. The majority opinion sidestepped *Crowell* in a footnote, but Justice Breyer feared that the majority's analysis put at risk the adjudication authority for private disputes currently assigned to the National Labor Relations Board and other federal agencies. Instead, Justice Breyer believed that the Court's inquiry should have focused on whether the congressional assignment of a particular dispute to a non-Article III actor seemed to pose an actual threat to Article III authority or independence. Absent that fear—and he didn't see the basis for that here—Justice Breyer would have found the assignment of authority to the bankruptcy court constitutional.

II. Scope of the Court's Decision

In his opinion for the Court, Chief Justice Roberts stressed the narrowness of the Court's holding and the limited practical impact of the decision. In response to arguments that the decision would "create significant delays and impose additional costs on the bankruptcy process," the Chief Justice wrote that the Court did not believe that "removal of counterclaims such as Vickie's from core bankruptcy jurisdiction meaningfully changes the division of labor in the current statute; we agree with the United States that the question presented here is a 'narrow' one."[2] The opinion went on to explain why it was important to adhere strictly to Article III's requirements even if the decision in this case "does not change all that much."[3] And the concluding paragraph of the opinion stated the "one isolated respect" in which the Court concluded that the Bankruptcy Act of 1984 exceeded the limitations of Article III: "The

[2] 131 S. Ct. at 2619-20.

[3] *Id.* at 2620.

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."[4]

If the Court's statement of the import of the decision is accepted at face value, it causes some disruption of the core-proceedings scheme established by § 157, but it does not require a major overhaul of the bankruptcy courts' exercise of jurisdiction like the one caused by *Northern Pipeline*. It means that a bankruptcy court cannot enter a final judgment on some counterclaims asserted by the estate against a creditor who files a proof of claim—at least if the parties do not consent to that exercise of authority by the bankruptcy court. But § 157's authorization for the exercise of jurisdiction by the bankruptcy court is otherwise unaffected. Under that reading, the only issues requiring resolution after *Stern* are the validity of party consent to a bankruptcy court's determination of a state law counterclaim and the procedure that bankruptcy courts should follow when they are unable to enter a final judgment on such a claim.

The Court's rationale for its decision, however, permits a reading that calls into question the constitutional validity of the bankruptcy courts' authority over a wider range of core proceedings than the type of counterclaim that gave rise to the issue in *Stern*. The majority's return to the categorical approach to Article III that a plurality followed in *Northern Pipeline* and a majority followed in *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989), as opposed to the more fluid approach it adopted in two intervening Article III decisions, provides a basis for challenging the constitutionality of the bankruptcy courts' authority to enter final judgments in certain other types of core proceedings. At its broadest, *Stern* might even be read to raise questions about the validity of much of the bankruptcy courts' authority over core proceedings. Although these constitutional questions regarding the 1984 congressional response to *Northern Pipeline* were raised twenty-two years ago by the *Granfinanciera* decision, they have largely been ignored until now. Lower court decisions in the wake of *Stern*, however, indicate that some courts and parties are no longer refraining from raising these broader constitutional issues and that they do not believe that *Stern* can be confined to an isolated, narrow issue. The discussion that follows in this Part summarizes the Supreme Court's recent Article III decisions and sets forth arguments that might be made for broader applications of *Stern*.

A. The case law background

The Court's opinion in *Stern* relied heavily on *Northern Pipeline* and *Granfinanciera*. The reasoning and language of those decisions, particularly the latter, provide the basis for a more expansive application of *Stern* than the Chief Justice's opinion acknowledged.

In *Northern Pipeline* a majority of the Court held that the statutory grant of bankruptcy jurisdiction under the 1978 Act, codified at 28 U.S.C. § 1471, was unconstitutional to the extent that it authorized bankruptcy judges, who lacked the attributes of Article III judges, to hear and decide state law contract claims, subject to traditional appellate review by an Article III court. Four members of the Court, in an opinion written by Justice Brennan, addressed the question broadly and concluded that "the broad grant of jurisdiction to the bankruptcy courts contained in . . . § 1471 . . . is unconstitutional."[5] Two other members of the Court—Justices Rehnquist and

[4] *Id.*

[5] 458 U.S. 50, 87 (1982).

O'Connor—concurred in the judgment without attempting to synthesize the Court's Article III precedents or addressing exercises of jurisdiction by bankruptcy courts beyond the instance before them. Because they concluded that the grant of authority in question was not severable from the remainder of § 1471, those justices concurred in the judgment striking down the jurisdictional statute in its entirety.

The plurality opinion identified "three narrow situations" not subject to the constitutional command that the judicial power of the United States be vested in Article III courts: territorial courts, military courts, and legislative and administrative courts created to adjudicate cases involving public rights. Without definitively explaining the distinction between public and private rights, Justice Brennan wrote that "a matter of public rights must at a minimum arise 'between the government and others.'"[6] The liability of one individual to another, on the other hand, was said to be a matter of private rights. The first two exceptions were clearly inapplicable to the debtor in possession's adversary proceeding against Marathon, and the third was as well according to the plurality. The litigation was between individuals, and the plurality distinguished the "adjudication of state-created private rights, such as the right to recover contract damages that is at issue in this case" from "the restructuring of debtor-creditor relations, which is at the core of the federal bankruptcy power." The latter, it said, "may well be a 'public right.'" [7]

The Supreme Court issued two decisions a few years after *Northern Pipeline* that took a decidedly different approach to the Article III analysis. The majority opinion in both cases was written by Justice O'Connor. In *Thomas v. Union Carbide Agric. Prods. Co.*, 473 U.S. 568 (1985), the Court upheld the provision of a federal statute that authorized binding arbitration, subject to only limited judicial review, to resolve disputes among participants in a pesticide registration program. In contrast to Justice Brennan's *Northern Pipeline* opinion, Justice O'Connor wrote for the Court that "practical attention to substance rather than doctrinaire reliance on formal categories should inform application of Article III."[8] The Court then expanded its description of public rights from the one offered by the *Northern Pipeline* plurality. It rejected the argument that "the right to an Article III forum is absolute unless the Federal Government is a party of record."[9] Instead, the Court held, the Article III analysis must take into account "the origin of the right at issue [and] the concerns guiding the selection by Congress of a particular method for resolving disputes."[10]

The following year Justice O'Connor's opinion for the Court in *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833 (1986), again explicitly rejected a categorical Article III analysis. She wrote that when the Court determines whether Congress may authorize a non-Article III tribunal to exercise the judicial power of the United States, it "has declined to adopt formalistic and unbending rules."[11] She then set out a multi-factored test for reviewing Article III challenges, noting that none of the factors "has been deemed to be determinative." The Court,

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[6] *Id.* at 69.

[7] *Id.* at 71.

[8] 473 U.S. 568, 587 (1985).

[9] *Id.* at 586.

[10] *Id.* at 587.

[11] 478 U.S. 833, 851 (1986)

she wrote, weighs these factors "with an eye to the practical effect that the congressional action will have on the constitutionally assigned role of the federal judiciary."[12] The Court upheld the authority of an administrative agency to determine a counterclaim arising under state law. Although the Court concluded that the claim was a private right, that characterization did not end the analysis. Justice O'Connor explained that "this Court has rejected any attempt to make determinative for Article III purposes the distinction between public and private rights." She added that "there is no reason inherent in separation of powers principles to accord the state law character of a claim talismanic power in Article III inquiries."[13]

Because the strict, categorical approach articulated in *Northern Pipeline* was embraced by only four members of the Court and was later twice rejected by a majority of its members, the Court's discussion of Article III in the *Granfinanciera* opinion three years after *Schor* was especially surprising. The issue in *Granfinanciera* was whether there was a Seventh Amendment right to a jury trial of a fraudulent transfer action brought in a bankruptcy case. In answering that question in the affirmative, the Court—in an opinion written by Justice Brennan—addressed whether the claim involved public rights. It undertook that analysis because the Court had previously held that "[u]nless a legal cause of action involves 'public rights,' Congress may not deprive parties litigating over such a right of the Seventh Amendment's guarantee of a jury trial."[14]

In the public rights portion of the Court's opinion, Justice Brennan expressly linked that aspect of the Seventh Amendment analysis with the method of analysis under Article III:

> [O]ur decisions point to the conclusion that, if a statutory cause of action is legal in nature, 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. For if a statutory cause of action . . . 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 power."[15]

Justice Brennan, now writing for a majority of the Court, thus returned to the categorical view that a private right—at least one created by statute—must be litigated in an Article III tribunal. The Court then concluded that "a bankruptcy trustee's right to recover a fraudulent conveyance under 11 U.S.C. § 548(a)(2) seems to us more accurately described as a private rather than a public right as we have used those terms in our Article III decisions."[16] Thus, despite the classification of a fraudulent transfer action as a core proceeding under § 157(b)(2)(H), the Court stated, albeit in *dicta*, that non-Article III bankruptcy judges could not adjudicate such claims.

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[12] *Id.*

[13] *Id.* at 853.

[14] 492 U.S. 33, 53 (1989).

[15] *Id.*

[16] *Id.* at 55.