

# Clients & Friends Alert

## Court Approves Extension of the Automatic Stay in Detroit's Chapter 9 Case to State Officials

July 26, 2013

On July 24, 2013, Judge Steven W. Rhodes of the Bankruptcy Court for the Eastern District of Michigan approved the City of Detroit's motion to extend the automatic stay to various non-debtor parties, including certain state officials. The Court's ruling effectively stays all pending litigation against the City, allows the City to continue to move forward with its chapter 9 case, and paves the way for a dispute over the City's eligibility to file for chapter 9.

### The Chapter 9 Filing and the State Court Litigation

The City of Detroit filed for chapter 9 on July 18, 2013, and, with a population of 685,000, is the largest municipality to seek protection under chapter 9. Prior to the commencement of the City's chapter 9 case, certain unions, retirees and current employees of the City (collectively, the "Litigants") commenced multiple lawsuits against the Emergency Manager, the Governor, and the State Treasurer in state court regarding the constitutionality of the City's chapter 9 petition. The Litigants sought orders from the Ingham County Circuit Court (the "State Court") temporarily or preliminarily enjoining the Governor, State Treasurer, and certain other officials from authorizing a chapter 9 filing and "taking any further action with respect to any filing which has already occurred." The Litigants also sought to enjoin the defendants from authorizing any actions that might impair vested pension benefits. Moreover, certain of these Litigants sought a declaratory judgment that Michigan Public Act 436 ("PA 436") violated the state constitution to the extent that it purported to authorize chapter 9 cases in which vested pension benefits could be modified or impaired.<sup>1</sup>

On the same day that the City filed its chapter 9 petition, the State Court entered the temporary restraining orders sought by the Litigants in each of the prepetition lawsuits. Further, on July 19, 2013 (a day after the City filed its petition), the State Court amended the injunction orders to include "the agents and representatives" of the Emergency Manager, the Governor, and the City. The State Court also amended the order to enjoin the defendants from filing a "plan of adjustment

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<sup>1</sup> Article IX, Section 24 of the Michigan Constitution provides that accrued pension benefits of a state or municipal retirement system "shall not be diminished or impaired" by the state and its political subdivisions.

or any other filing” that might adversely affect pension benefits in a chapter 9 case. Finally, the State Court also entered a declaratory judgment finding that (i) PA 436 is unconstitutional to the extent that it permitted the Governor to proceed under chapter 9 in a manner that impairs pension benefits, and (ii) ordering the Governor to direct the Emergency Manager to “immediately withdraw the chapter 9 petition...[and] not authorize any further chapter 9 filing” which threatens to diminish accrued pension benefits.

### **The Stay Motions and Objections**

In response to the State Court orders, the City filed a motion in the Bankruptcy Court seeking confirmation of the protections of the automatic stay and a motion seeking to extend the automatic stay to certain non-debtor parties, including state officials (the “**Stay Motions**”). In its motion, the City requested that the Court confirm the application of the automatic stays to the Emergency Manager and other City officers, among other things. Further, the City requested that, pursuant to section 105(a) of the Bankruptcy Code, the Court extend the automatic stay to state officials (including the Governor, State Treasurer, and Loan Board), certain non-officer employees, and the representatives and agents of the City and Emergency Manager. The City contended that the extension of the stay was necessary due to the state officials’ close affiliation with the City, and the adverse effects that certain lawsuits against those non-debtor parties would have on the City’s ability to reorganize.

Various parties, including the Litigants and the AFSCME, objected to the City’s Stay Motions arguing that (i) the Bankruptcy Court could not decide the stay motions until a state court determined that the City was authorized to file under Michigan law, (ii) any determination by the Bankruptcy Court on the constitutionality of the City’s petition would violate the Tenth Amendment, (iii) the stay motions were procedurally deficient because the City did not commence an adversary proceeding, and (iv) the City could not use section 105(a) to create rights that did not otherwise exist under the Bankruptcy Code. The AFSCME also argued that the City was not eligible to file for chapter 9 because the State Court held that PA 436 was unconstitutional, and also raised various arguments pertaining to the feasibility of the City’s plan of adjustment.

### **The Court’s Decision**

Judge Rhodes granted the Stay Motions, and held that the extension of the automatic stay to the state officials was warranted in this case. The Court also stated that the issue before the Court was not whether the City was eligible to file, but rather, whether it should extend the protections of the automatic stay to various non-debtor parties, including the state officials.

**The Stay Confirmation Motion**

First, the Court approved the City's motion to confirm the protections of the automatic stay, and expressly overruled the Tenth Amendment objections raised by the Litigants and certain unions. At the hearing, the Litigants argued that the City's authorization to file under state law is a threshold issue that must be determined prior to the issuance of any orders in this case. Further, the Litigants maintained that the bankruptcy court did not have subject matter jurisdiction to address whether the City is duly authorized under state law to file for chapter 9. The Court disagreed and held that the issue of eligibility to file for chapter 9 is within the exclusive jurisdiction of the Bankruptcy Court, including whether the City was duly authorized to file for chapter 9 under Michigan law. The Court found that nothing in the Tenth Amendment or the principles of state sovereignty suggests that it would be unconstitutional for the Court to have exclusive jurisdiction over these issues. Indeed, the Court saw no evidence to suggest that Congress intended for state courts to have concurrent jurisdiction over eligibility issues.

In addition, the Court concluded that the Emergency Manager was an "officer" that was protected by the stay under section 922(a) of the Bankruptcy Code. According to the Court, PA 436 clearly provides the Emergency Manager with the powers of the officers of the City, including the mayor and city council. Therefore, the Court concluded that the Emergency Manager is an "officer" protected by the 922(a) stay.

**The Stay Extension Motion**

The Court also granted the City's motion to extend the stay, finding that the circumstances of this chapter 9 case warranted the extension of the stay to non-debtor entities. The Court noted that the standard for approving section 105(a) injunctions is ambiguous: some courts employ an "unusual circumstances" test, whereas other courts use a multi-factor test for preliminary injunctions. The Court determined that it was ultimately unnecessary to determine which standard applied because the City satisfied both standards. First, the Court concluded that "unusual circumstances" exist in this case because the litigation against the state entities and certain other non-debtor parties could have a significant and adverse impact on the City's ability to reorganize. Second, the Court held that the traditional preliminary injunction test was also satisfied because (i) the City would suffer prejudice if the stay extension is denied; (ii) the unions and other creditors would not be harmed if the stay extension motion is granted, as such creditors could still seek to lift the stay or seek abstention; and (iii) the injunction would be in the public interest because such stay extension would permit these issues to be adjudicated in one forum.

The Court overruled the Litigants' objections to the purported procedural infirmities of the City's stay extension motion and held that the commencement of an adversary proceeding was not warranted in this instance. The Court concluded that there was significant merit to the City's argument that it would be impossible and expensive to start an adversary proceeding against all parties affected by the stay extension. Here, the stay extension would potentially apply to future litigation against the state officials and the City could not possibly ascertain the identity of those future litigants.

Further, the Court rejected the unions' argument that section 105(a) cannot serve as a basis for the stay extension because that extension would create rights that do not exist under the Bankruptcy Code. Citing section 105(a)'s equitable powers and applicable case law, the Court found that it clearly had the authority to issue a stay extension if it deemed it necessary to carry out the provisions of the Bankruptcy Code. Here, the Court concluded that the stay extension was necessary because it would assist the Court in making the bankruptcy process more efficient and would give the Court control over the bankruptcy process. Thus, the Court was not convinced that "new rights" would be created by extending the stay in this case, as such extension was necessary.

The Court approved the City's motion to extend the stay to certain non-debtor entities, but explicitly preserved the right for creditors to move to lift the automatic stay. The Court made clear that its ruling did not relate to the City's eligibility to file under chapter 9, the feasibility of the City's plan of adjustment, or the impairment of the pensions under section 365. In particular, the Court stated that its ruling did not address whether the state constitution prohibited the Emergency Manager's appointment or the Governor's authorization of the chapter 9 filing. Further, the Court noted that its ruling did not address whether the state court orders (including the declaratory judgment) would have a preclusive effect under collateral estoppel. All of these issues, according to the Court, will be fully preserved and addressed later in the case.

### **Conclusion**

The Court's ruling allows the City to move forward with its case and prohibits the Litigants (or other creditors) from seeking to end run the City's chapter 9 case by pursuing actions outside of the bankruptcy court. Ultimately, the Court's ruling confirms the supremacy of the federal Bankruptcy Code, and clarifies that the issues of the City's eligibility will be determined by the bankruptcy court, not a state court. The Court will determine eligibility at a later date, and a dispute over the City's eligibility may take a substantial amount of time to resolve.

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