

Clients & Friends Alert

Detroit Bankruptcy Court Refuses Stay of Chapter 9 Eligibility Hearing Under *Stern v. Marshall*

September 30, 2013

On September 26, 2013, Judge Steven W. Rhodes of the U.S. Bankruptcy Court for the Eastern District of Michigan denied the Official Committee of Retirees' (the "**Committee**") motion to stay all eligibility proceedings pending its motion to withdraw the reference. *In re City of Detroit, Michigan*, Case No. 13-53846, ECF No. 1039 (Bankr. E.D. Mich. Sept. 26, 2013).¹ Notably, the Court refused to accept the Committee's broad interpretation of *Stern v. Marshall*, properly applied a traditional injunction test to the Committee's stay motion, and confirmed that a bankruptcy court has the power to decide issues of state law.

In considering a motion for a stay under Rule 5011(c) of the Federal Rules of Bankruptcy Procedure, courts consider traditional injunctive relief factors, including whether (i) the party is likely to prevail on the merits of the withdrawal motion; (ii) the party is likely to suffer irreparable harm if the motion is denied; (iii) the debtor will not be harmed by a stay; and (iv) the public interest will be served by granting a stay. *FDIC v. Imperial Capital Bancorp, Inc.*, 2011 WL 5600542, at *1 (S.D. Cal. Nov. 7, 2011).

Background

On September 11, 2013, the Committee filed a motion to withdraw reference on its objection to the City's eligibility to seek chapter 9 protection. The Committee's motion to withdraw the reference asserted three grounds: (i) *Stern v. Marshall* required withdrawal of reference of the eligibility objection, (ii) withdrawal of the reference is mandatory under 28 U.S.C. § 157(d), and (iii) withdrawal for cause is warranted. Separately, on September 13, 2013, the Committee filed a motion pursuant to Rule 5011(c) to stay the Bankruptcy Court's deadlines and hearings concerning the determination of eligibility, pending the district court's decision on the motion to withdraw the reference.

¹ Cadwalader represents Merrill Lynch Capital Services in the City's chapter 9 case.

In its stay motion, the Committee contended that, under the Supreme Court's decision in *Stern v. Marshall*, a bankruptcy court lacked the authority to enter a final order on state and non-bankruptcy law issues raised by the Committee that sought to adjudicate the private rights of City pensioners. Among other things, the Committee argued that the Bankruptcy Court did not have jurisdiction to address the Committee's arguments under the Michigan State Constitution and the Tenth Amendment of the U.S. Constitution.

Decision

The Bankruptcy Court denied the Committee's motion to stay all eligibility proceedings pending their motion to withdraw the reference to the District Court. In analyzing Rule 5011(c), the Bankruptcy Court concluded that a proponent of a stay motion must show probability of success and irreparable harm, which is the traditional injunction test.

The Bankruptcy Court first examined whether the Committee was likely to succeed on its motion to withdraw the reference. The Bankruptcy Court rejected the Committee's broad interpretation of *Stern*, where the Supreme Court admitted that the issue before it was "narrow." The Bankruptcy Court concluded that it may finally determine matters that arise under the Bankruptcy Code, but may not determine certain non-bankruptcy matters. Here, the Committee's motion concerned the City's eligibility to seek chapter 9 protection, which is a core matter that arises under the Bankruptcy Code. According to the Court, a bankruptcy court can constitutionally determine certain issues in connection with a core matter, "even those involving state law."

Furthermore, the Bankruptcy Court was not persuaded by the Committee's arguments concerning the Court's authority to decide issues under the Michigan and U.S. Constitutions. The Bankruptcy Court noted that since *Stern* was decided, bankruptcy courts have considered constitutional issues, including in two recent chapter 9 cases (*Harrisburg* and *Stockton*). The Bankruptcy Court found that "*Stern* does not change this status quo" and cautioned that the Committee's expansive interpretation of *Stern* would "significantly change the division of labor between the bankruptcy courts and the district courts."

The Bankruptcy Court also found that its ability to decide state law issues would not run afoul of principles of federalism because bankruptcy courts have historically decided issues of state law. Consequently, the Bankruptcy Court concluded that the "mere fact that state law must be applied does not by itself mean that *Stern* prohibits a non-Article III court from determining the matter." Nothing in *Stern*, according to the Bankruptcy Court, addressed the issue of federalism. Rather, *Stern* addressed the "public rights" doctrine, which concerns matters that can be delegated to a non-Article III court.

The Bankruptcy Court also concluded that the Committee would not suffer irreparable injury if the stay is not granted. The Bankruptcy Court stated that the “mere argument that a constitutional right might be impaired is not sufficient for a finding of irreparable injury.” Furthermore, the Bankruptcy Court was also not persuaded by the Committee’s arguments that its constituency would suffer a loss of constitutional rights if the stay is not granted because their pensions will be diminished. The Bankruptcy Court noted that the retirees had not suffered any loss of retirement benefits, and that there was no evidence that denying the Committee’s stay motion would itself create any risk to their retirement benefits.

In contrast, the Bankruptcy Court found that the City and its citizens would suffer significant harm if the Committee’s stay motion is granted. The Bankruptcy Court stated that the record in the chapter 9 case established the necessity to promptly decide the City’s eligibility for chapter 9 relief. The Bankruptcy Court noted that the eligibility objections created substantial uncertainty regarding the City’s ability to achieve its goal of adjusting its debts through chapter 9. According to the Bankruptcy Court, a delay in the City’s chapter 9 case would significantly harm the citizens of Detroit because the City’s ability to improve its municipal services and its financial condition would be “slowed, if not stalled entirely.”

Conclusion

The Bankruptcy Court’s rejection of the Committee’s broad interpretation of *Stern* is significant and establishes that *Stern*’s application is not unlimited. The Bankruptcy Court’s ruling ultimately confirms the well-established principle that a bankruptcy court has the power to decide state law issues involved in core matters, such as the approval of an executory contract or post-petition financing. Given that the eligibility proceedings will not be stayed, the City’s eligibility dispute should now be resolved in an expeditious manner.

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