Notes on the Removal Exception of 28 U.S.C. § 1452(a) for Local Government Counsel

by Kelly M. Rabalais

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Except for primarily civil rights claims, local governments rarely find themselves in federal court. The day-to-day practice of local government counsel lies in applying or enforcing their local laws or ordinances. Powers of state and local governments are referred to as "police powers." The Tenth Amendment to the U.S. Constitution grants states and, in turn, local governments, the authority to adopt laws for the protection of the health, safety, and welfare subject to the limitations of the federal and state constitutions. Often local governments engage in litigation to enforce their laws—and when they do, they might have to defend that enforcement action against removal to federal court or an automatic stay in bankruptcy court. When an enforcement action is removed to federal court, local government counsel must navigate removal or automatic stay statutes, which are often unchartered territory. As courts of limited jurisdiction, careful review of jurisdiction is critical to preserving the validity of the judicial review. Further, preserving state and local government independence, particularly when they seek to enforce their own laws, is considered sacred ground both by Congress in enacting exceptions to federal court jurisdiction and by federal courts in upholding the exceptions.

Deference to Local Governments

Removal based on bankruptcy jurisdiction is limited and does not extend to "a civil action by a governmental unit to enforce such governmental unit's police or regulatory power."[1] In my experience as a local government attorney, federal courts are extremely mindful of local jurisdiction efforts to self-govern and actually take great steps to avoid interference. The importance of judicial scrutiny is, "at its zenith where, as here, the suit was brought by a state itself, as 'the claim of sovereign protection from removal' in such circumstances 'arises in its most powerful form.'"[2] "In fact, '[i]n light of the congressional intent to restrict federal court jurisdiction, as well as the importance of preserving the independence of state governments, federal courts construe the removal statute narrowly, resolving any doubts against removability.'"[3] Courts routinely defer to the local government's enforcement efforts where the matter "relate[s] primarily to matters of public health and welfare, and the money damages sought will not inure, strictly speaking, to the economic benefit of the states," but rather, are brought to further "significant area[s] of state policy."[4]

This sentiment has been clearly expressed by one court in *In re General Motors LLC Ignition Switch Litigation.*[5] The district attorney of Orange County, Calif., filed an action against New GM (the entity that purchased the assets of reorganized debtor General Motors Corp.) alleging false and deceptive practices in selling vehicles while concealing known ignition switch defects. The claims were brought under the California Unfair Competition Law and the California False Advertising Law. New GM filed a notice of removal to the U.S. District Court for the Central District of California, asserting that the claims made by the Orange County district attorney arose under the Bankruptcy Code's 28 U.S.C. §§ 157(b) and 1334(b). New GM also pled federal question jurisdiction under 28 U.S.C. § 1331. The district attorney filed a motion to remand on the basis of the police and regulatory power exception of 28 U.S.C. § 1452(a).

Police and Regulatory Power Exception

Judicial interpretation of the enforcement exception has evolved over time. Prior decisions focused on the local government's intent and "courts concluded that whether the police-power exception applied turned on the merits of the individual exercise of police power and whether the lawsuit was truly intended to deter ongoing harmful conduct rather than benefit a state's coffers."[6]

However, that analysis was later rejected in favor of an objective purpose-driven review of the local government's enforcement. One can see that asking federal courts to engage in making a determination as to the validity of a state or local government's decision in enforcing its laws is problematic. Courts could only speculate as to the "intent" of state and local governments, and such a concept does not jive with the limited jurisdiction of bankruptcy courts. "As the

Fourth Circuit has put it, '[t]he inquiry is objective: We examine the purpose of the law that the state seeks to enforce rather than the state's intent in enforcing the law in a particular case.'"[7]

Abandoning an analysis that required federal courts to delve into the minds of state or local legislators seems consistent with the deference due to the legislative branch and, even more so, to independent local governance. This deference, however, does not equate to an automatic application of the police and regulatory powers exception to removal. The analysis simply shifted to an objective one where the purpose of local enforcement is the primary focus. Local government attorneys usually assist their legislators in crafting local laws, and we can best serve those legislative bodies by paying particular attention to the stated purpose of those laws. Passing the necessary purpose test to meet the police and regulatory powers exception would then be more likely.

After a subjective analysis as to the "intent" of the local entity in enforcing local laws was abandoned and courts were directed to look to the "purpose" behind enforcement, two tests were developed to determine whether a governmental action is actually an exercise of its police and regulatory power and, therefore, subject to the exception. The first is the "public purpose" test wherein courts ask if the government is primarily trying to implement public policy for the good of the citizenry or pointedly adjudicating private rights.[8] The second test is the "pecuniary purpose" test, which requires that the government's pecuniary interest not be the primary motivation for its action. Satisfaction of either test will qualify the action as one of enforcement.

The district court judge in *General Motors* ultimately concluded that the state's enforcement action of California's Unfair Competition Law and the California False Advertising Law passed both the public purpose and pecuniary purpose tests. Those specific laws were meant to protect the citizens from unfair or deceptive acts of businesses and the action only served to protect the public at large and not private parties. Secondly, the pecuniary purpose test was met because there was no showing that the enforcement of the California laws intended to financially benefit the state. New GM argued that since the state sought civil penalties in its enforcement action, the pecuniary interest test failed, but the court saw it differently.

Not only do state and local governments seek to stop bad actors, but they also seek to impose punitive aspects such as penalties, fines, attorney's fees, and costs. Most defendants argue that the local government's primary purpose in seeking enforcement of those punitive measures is pecuniary or that the local governments are actually advancing consumer's private rights and attempting to obtain restitution. Courts routinely reject those arguments. Looking at the purpose of the laws, courts uphold local enforcement as a means to stop the unlawful practices and deter such behavior in the future. Yes, restitution can make victims whole, but punishment is the primary goal and serves to deter future bad acts.[9]

Another aspect of the removal exception analysis is to ensure that the party seeking to enforce the laws is actually a governmental unit. Although it may seem obvious on its face, local governments have many different roles. For example, insurance commissioners can bring actions as a liquidator. Courts have noticed the slight difference of an insurance commissioner bringing suit as liquidator versus the state, department, or agency bringing suit.[10] The court noted in *In re Reliance Group Holdings Inc.* that the action was filed by the commissioner of insurance specifically in her role as liquidator and not for the commonwealth of Pennsylvania. The goal of the action was to ensure proper handling of the insurance company's creditors, members, policyholders, and shareholders, and the outcome did not affect the state treasury. Based on those factors, the insurance commissioner in her role as liquidator did not qualify as a "governmental unit" for purposes of the police and regulatory powers removal exception of 28 U.S.C. § 1452(a) and removal was proper to federal court.

Is the Removal Exception Truly an Exception?

Not willing to accept the police and regulatory power exception, defendants have claimed that federal question jurisdiction *can* exist generally. It has been argued that the police and regulatory power exception notwithstanding, removal may still be properly achieved pursuant to 28 U.S.C. § 1441, the general removal statute. However, the court in *In re Pacific Gas & Electric Co.* disagreed and stated the obvious. Section 1441 provides for removal of an action over which federal district courts have original jurisdiction, "except as otherwise expressly provided by act of Congress." Section 1452(a) is such an exception and such actions are not removable.[11]

New GM tried a similar, but slightly different argument in *General Motors*. Taken to the extreme, New GM argued that the police and regulatory power removal exception essentially swallows the § 1441 rule if courts were to allow "any" action by a governmental unit to fit the exception. The court quickly brought New GM back to the narrow focus of the § 1452(a) removal exception. Using the purpose of the local government enforcement, the court made clear that the exception applied to actions where the primary purpose was to enforce the local government's police power and not to further the state's pecuniary interest. Moreover, the court declined New GM's invitation to engage in a policy discussion of whether enforcement actions initiated by local governments should provide a removal exception and, instead, referred New GM to Congress. Thus, the courts will not opine as to whether the removal exception is good policy but will endeavor to only decide if a certain case meets the exception as stated in 28 U.S.C. § 1452(a).

Automatic Stay or Removal Exception or Both?

An exercise of police or regulatory power can come in many other forms such as actions related to a license issued by a local government or criminal actions. Defendants seek to enjoin this enforcement by arguing they are subject to effects of an automatic stay. In general, the "automatic stay" serves to prevent the initiation or continuation of actions against a debtor or property of the bankruptcy estate immediately upon filing for bankruptcy.[12] Among the types of proceedings that are stayed are administrative proceedings that began or could have begun prior to the commencement of a bankruptcy case.[13] There are a series of exceptions to the automatic stay, most notably criminal actions, regulatory actions related to certain types of licenses, and the enforcement of a government's police or regulatory power (except for enforcement of a money judgment).[14]

Courts have also determined that the issue of whether an automatic stay prevents enforcement is not determinative of whether removal is proper. Even though the two statutes are similarly written and jurisprudence interpreting each can be useful in deciding whether a matter is considered a police or regulatory action, the analysis of whether an automatic stay is proper and whether the removal exception is applicable are two separate determinations.

"Where the government acts like a creditor, it is stayed just like other creditors. When it is enforcing law, dealing with regulatory and law enforcement matters, the automatic stay does not stand in the way. But whether the automatic stay does or does not apply has little to do with whether actions—stayed or not—may be removed to the bankruptcy court. Nothing suggests that automatic stay considerations should inform the court's decision under § 1452."[15] However, the Bankruptcy Court enjoys extremely broad equitable powers under 11 U.S.C. § 105 and can enjoin state courts from proceeding in an action that might otherwise not be subject to the automatic stay.

In re Neuman presents just this sort of unique circumstance involving an injunction related to a state court action directed at the Chapter 11 trustee who had gained operational control of a debtor's nursing home due, in part, to the New York State Department of Health finding the trustee essentially had the powers of a receiver.[16] The bankruptcy court enjoined the debtor and a business affiliate from continuing to prosecute their state court case against the Chapter 11 trustee.[17] In consideration of the provisions of the Bankruptcy Code (title 11 of the U.S. Code) and the Anti-Injunction Act, 28 U.S.C. § 2283, the bankruptcy court found it had the authority to enjoin further prosecution of the state court proceeding due to the effect on the bankruptcy estate.[18]

The Bankruptcy Appellate Panel of the Ninth Circuit addressed the denial of a stay of proceedings against a debtor by the California Board of Medical Quality Assurance in *In re Thomassen*.[19] In *Thomassen*, the debtor was accused of gross negligence for care related to a cancer patient, and the state agency subsequently began its investigation before the debtor filed for bankruptcy in anticipation of its license being revoked.[20] After filing, the debtor attempted to stay the state agency's proceedings but was rejected by the bankruptcy court.[21] On appeal, the appellate panel reasoned that the state agency's proceeding against the debtor was not a proceeding stayed by § 362(a)(1), but rather a proceeding under the state's regulatory or police powers not "meant to frustrate the purposes or processes of the Bankruptcy Code."[22] The appellate panel again noted that the bankruptcy court was within its rights to issue an injunction, but the bankruptcy court's refusal to do so was not an abuse of discretion.[23]

The U.S. Court of Appeals for the First Circuit addressed disciplinary action against a debtor related to its position as a real estate agent and found it was excepted from the automatic stay.[24] Similarly, the bankruptcy court in *In re Gandy* found that the state of Texas did not violate the automatic stay when the Texas Commission on Environmental Quality, as well as its county counterpart, sought injunctive action against a debtor to prevent alleged continuing violations of Texas environmental law.[25]

In light of the foregoing cases, as well as 11 U.S.C. § 362 itself, the line in the proverbial sand is whether the proceeding is one that will frustrate the Bankruptcy Code and its purposes or processes.

Broadening the scope of practice for local government counsel with stints in federal court is useful, and bringing examples of local laws and enforcement of them to federal court provides a unique opportunity for collaboration. The removal exception of 28 U.S.C. § 1452(a) that gives deference to the enforcement of police and regulatory powers was enacted by Congress as a means to limit the jurisdiction of federal courts and the jurisprudence is consistent with that intent. Further, the interplay with the automatic stay exception of 11 U.S.C. § 362 can assist with the interpretation of whether an action qualifies as a police and regulatory action, but beware that analysis of the automatic stay exception must be made independently and can be a hurdle to local government enforcement of its laws. ⊙

Endnotes

[1]28 U.S.C. § 1452(a).
[2]*In re General Motors LLC Ignition Switch Litig.*, 69 F. Supp. 3d 404, 409 (S.D.N.Y. 2014); *In re Standard & Poor's Rating Agency Litig.,* 23 F. Supp. 3d 378 (quotation omitted), 392 (S.D.N.Y. 2014) (quoting *Nevada v. Bank of Am. Corp.,* 672 F.3d 661, 676 (9th Cir. 2012)).
[3]*General Motors*, 69 F. Supp. 3d at 409 (quotation omitted); *Purdue Pharma L.P. v. Kentucky,* 704 F.3d 208, 213 (2d Cir. 2013) (quoting *Lupo v. Human Affairs Int'l Inc.,* 28 F.3d 269, 274 (2d Cir. 1994)) (alteration in original); *accord Veneruso v. Mount Vernon Neighborhood Health Ctr.,* 933 F. Supp. 2d 613, 618 (S.D.N.Y. 2013).
[4]*General Motors*, 69 F. Supp. 3d at 410 (quoting *In re MTBE Prods. Liab. Litig.,* 488 F.3d 112, 133 (2d Cir. 2007)).
[5]*General Motors*, 69 F. Supp. 3d 404 (S.D.N.Y. 2014).
[6]*Id.* at 411.
[7]*Id*. at 412 (quoting *Safety-Kleen Inc. (Pinewood) v. Wyche,* 274 F.3d 846, 865 (4th Cir. 2001)).
[8]*Massachusetts v. New England Pellet LLC*, 409 B.R. 255, 259 (D. Mass. 2009).
[9]*Id*.
[10]*In re Reliance Grp. Holdings Inc*., 273 B.R. 374, 387 (Bankr. Ed. Pa. 2002).
[11]*In re Pac. Gas & Elec. Co*., 281 B.R. 1, 11 (Bankr. N.D. Cal. 2002).
[12]11 U.S.C. §§ 362(a) & 541.
[13]11 U.S.C. § 362(a)(1).
[14]*See generally* § 362(b).
[15]*Pac. Gas*, 11 U.S.C. 281 B.R. at 11.
[16]*See Garrity v. Leffer (In re Neuman),* 71 B.R. 567, 569-70 (Bankr. S.D.N.Y. 1987).
[17]*Id.* at 570-71.
[18]*Id.* at 572 ("The effect of an exemption under § 362(b) is 'not to make the action immune from injunction.'").
[19]*Thomassen v. Div. of Med. Quality Assurance (In re Thomassen),* 15 B.R. 907 (B.A.P. 9th Cir. 1981).
[20]*Id.* at 907-08.
[21]*Id.*
[22]*Id.* at 909-09.
[23]*Id.* at 910.
[24]*In re McMullen*, 386 F.3d 320, 330 (1st Cir. 2004).
[25]*Diaz v. State of Texas* (*In re Gandy)*, 327 B.R. 796 (Bankr. S.D. Tex. 2005) (Isgur, J.).