



3rd Circuit Narrowly Construes Police Power Exception to Automatic Stay

L. Katherine Good

Special to the Delaware Business Court Insider | January 18, 2012

In a recent decision in *In re Nortel Networks Inc.*, the 3rd U.S. Circuit Court of Appeals held that Bankruptcy Code Section 362(b)(4)'s "police power exception" to the automatic stay should be narrowly construed. Thus, it upheld the Delaware Bankruptcy Court's order prohibiting two United Kingdom entities from bringing or continuing proceedings in the U.K. to assess and quantify the liability of the U.S. debtors with respect to pensions of their U.K. affiliates. In addition to establishing that the police power exception will be construed narrowly, *Nortel* illustrates how application of the exception requires a highly fact-intensive inquiry.

BACKGROUND

Nortel and its affiliates were global suppliers of telecommunication and computer networking services. Nortel and its affiliates commenced Chapter 11 cases in the United States and insolvency proceedings in Canada and were placed into administration under the Insolvency Act in the United Kingdom.

The appellants, the trustee of Nortel Networks U.K. Pension Plan and the U.K. Board of the Pension Protection Fund (PPF), filed claims in the U.S. bankruptcy case for potential contributions that may be required from the U.S. and Canadian Nortel entities with respect to the underfunding of a U.K. Nortel entity's pension plan by an estimated \$3.1 billion.

The U.K. Pensions Act 2004 provides the mechanism for regulation of pension plans in the U.K. The act establishes the U.K. Pensions Regulator (TPR) as the U.K. governmental agency in charge of regulating pension schemes in the U.K. The TPR may take regulatory actions such as determining if a pension is underfunded, quantifying the deficit, holding an employer or related party responsible for the deficit, and requiring payments from the responsible party to the TPR. The PPF is a government-created, privately funded entity that provides an insurance function under the act by providing payments to members of defined benefit pension plans when the employer cannot fund its pension obligations. Finally, the trustee is a private party responsible for administering the pension plan and ensuring that members receive benefits.

The commencement of administration proceedings in the United Kingdom triggered an assessment period during which the PPF was tasked with assessing its obligations to pay pension benefits and working to ensure that the U.K. Nortel pension plan recovers debts due to it.

Prior to commencement of any bankruptcy or insolvency proceedings by the Nortel entities, the TPR determined that the U.K. Nortel pension plan was "insufficiently resourced." Following the commencement of the Chapter 11 cases in the United States, the TPR issued a warning notice to several Nortel entities, including those that had commenced Chapter 11 and insolvency proceedings in the United States and Canada. The warning notice required the entities to make submissions to the TPR so that the TPR could determine whether to hold those entities financially responsible for the underfunding of the U.K. Nortel pension plan.

The U.S. debtors filed a motion to enforce the automatic stay to prevent the trustee and the PPF from participating in the proceedings being conducted by the TPR following the issuance of the warning notice. The Delaware Bankruptcy Court approved the motion and enforced the stay as to the trustee and the PPF, and declared the U.K. pension proceedings null and void with respect to the U.S. debtors. The Delaware District Court affirmed the Bankruptcy Court's ruling, and the trustee and the PPF appealed to the 3rd Circuit.

3RD CIRCUIT'S RULING

The 3rd Circuit affirmed and held that the appellants did not fall within the police power exception to the automatic stay. Section 362(b)(4) provides an exception, commonly known as the police power exception, to the automatic stay, which allows for "the commencement or continuation of an action or proceeding by a governmental unit ... to enforce such governmental unit's or organization's police and regulatory power,

including the enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit's or organization's police or regulatory power."

First, the 3rd Circuit determined that neither the trustee nor the PPF was a governmental unit. The 3rd Circuit held that the trustee was not a governmental unit because it was a "private party responsible for administering the plan and ensuring members receive their benefits." In addition, the PPF was not a governmental unit despite being a government-created entity. The 3rd Circuit looked at the legislative history of Bankruptcy Code Section 101(27)'s definition of "governmental unit," which instructed that governmental unit did not include "entities that owe their existence to state action such as the granting of a charter or a license but that have no other connection with a state or local government or the federal government." Moreover, the legislative history provided that the relationship between a government-created entity and the creating government must be an "active" one in which the entity "is actually carrying out some governmental function." Even though the PPF was government-created, the 3rd Circuit found that the relationship was not "active" because during the assessment period, the PPF was standing in the shoes of a private-party insurer.

In contrast, the 3rd Circuit found that the TPR was a governmental unit because it was executing its statutory objectives to protect members of pension plans and reduce the risk of situations requiring the PPF to fund pension obligations. However, the 3rd Circuit held that the TPR could not assert the police power exception because it was not a party to and did not file a claim in the U.S. bankruptcy proceedings.

Second, the 3rd Circuit held that the police power exception was not applicable to the PPF or the trustee because they were not seeking to exercise police or regulatory power. To determine whether a governmental unit is exercising police or regulatory power, courts have applied two similar and somewhat related tests, the pecuniary purpose test and the public policy test. The pecuniary purpose test looks at whether the governmental unit primarily seeks to protect a pecuniary interest of the government rather than to protect public safety and health. The public policy test assesses whether the government is seeking to promote public policy or public safety and welfare or to protect a pecuniary interest or private rights of the government. While the appellants argued that the U.K. pension proceedings were "advanc[ing] a public policy because they encourage the proper funding and administration of pension schemes and also serve to deter the 'moral hazard' created when employers and their affiliates evade pension obligations and pass off the burden of pension liabilities to PPF," the 3rd Circuit concluded that the U.K. pension proceedings were not predicated on alleged wrongdoing of the debtors. Instead, the primary purpose of the U.K. proceedings was to determine the liability for shortfalls in the U.K. pension plan, a pecuniary interest.

SIGNIFICANCE OF *NORTEL*

Nortel establishes that the police power exception will be construed narrowly, both with respect to what entities are governmental units and whether such governmental units are exercising police and regulatory power. In holding that the police power exception should be interpreted narrowly, the 3rd Circuit distinguished its 1984 decision in *Penn Terra Ltd. v. Department of Environmental Resources*. In *Penn Terra*, the 3rd Circuit stated that "the exception to the automatic stay provision contained in Subsections 362(b)(4)-(5) should itself be construed broadly, and no unnatural efforts be made to limit its scope." The court in *Nortel* explained that this statement from *Penn Terra* was specifically related to circumstances involving federal-state pre-emption questions related to environmental hazards. Moreover, the 3rd Circuit noted in *Nortel* that, as it also recognized in *Penn Terra*, the legislative history of Section 362(b)(4) supports a narrow construction of the police power exception in stating: "This section is intended to be given a narrow construction in order to permit governmental units to pursue actions to protect the public health and safety and not to apply to actions by a governmental unit to protect a pecuniary interest in property of the debtor or property of the estate."

In addition, *Nortel* also illustrates that the application of the police power exception will be a detailed and fact-intensive inquiry. For example, *Nortel* shows that determining if an entity created by state action is a "governmental unit" requires an examination of the relationship between that entity and the state and the functions carried out by such entity. Additionally, the application of the pecuniary purpose and public policy tests also requires careful examination of the particular facts. The 3rd Circuit stated that the application of the pecuniary purpose and public policy tests to the U.K. proceedings in *Nortel* was a "close question," revealing the fact-intensive nature of the tests. Moreover, the 3rd Circuit rejected arguments that the U.K. proceedings are similar to actions taken by the Pension Benefit Guaranty Corp. that have been held to fall within the police power exception, distinguishing the roles of the PBGC in the U.S. regulatory framework and

each of the TPR, the PPF and the trustee in the U.K. framework and noting that in certain instances even PBGC's actions are subject to the automatic stay, demonstrating the careful factual inquiry necessary when applying the police power exception.

The 3rd Circuit's decision in *Nortel* is also significant as the first instance of a court of appeals examining the application of the police power exception to the automatic stay with respect to a foreign proceeding. The court held that the plain language of the Bankruptcy Code does not provide any justification for distinguishing between domestic and foreign governmental units in the application of the police power exception to the automatic stay. In doing so, the court of appeals specifically rejected arguments on either side, i.e., that police powers should be more broadly or more narrowly construed in foreign proceedings. It ruled that principles of comity do not require a broader application of the police power exception to foreign proceedings, but also rejected the Delaware magistrate judge's assertion that "the police powers exception should be interpreted narrowly with regard to foreign entities."

L. Katherine Good (good@rlf.com), an associate at *Richards Layton & Finger*, focuses on business reorganizations and liquidations, debtor and creditors' rights, and other bankruptcy and insolvency related matters. The views expressed in this article are those of the author and not necessarily those of her firm or clients.

Reprinted with permission from the January 18, 2012 issue of Delaware Business Court Insider. © 2012 ALM Media Properties, LLC. Further duplication without permission is prohibited. All rights reserved.