ALERTS

Third Circuit Allows Repossessing Secured Lender to Hold Collateral Pending Bankruptcy Stay

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"[A] secured creditor [has no] affirmative obligation under the automatic stay to return a debtor's [repossessed] collateral to the bankruptcy estate immediately upon notice of the debtor's bankruptcy," held the U.S. Court of Appeals for the Third Circuit on Oct. 28, 2019. *In re Denby-Peterson*, 2019 WL 5538570, *1 (3d Cir. Oct. 28, 2019). Affirming the lower courts, the Third Circuit joined "the minority of our sister courts – the Tenth and D.C. Circuits" with its holding. According to the court, it was "[g]uided by the plain language of the Bankruptcy Code's automatic stay and turnover provisions, the legislative purpose and policy goals of the automatic stay, and the reasoning of the Supreme Court and our two sister circuits...." *Id.* at *13. In sum, because "a secured creditor [need not] return the [repossessed] collateral to the debtor until the debtor obtains a [bankruptcy] court order... requiring the creditor to do so," it does "not violate the automatic stay" of Bankruptcy Code ("Code") § 362(a)(3) (creditors stayed from "any act to obtain possession of property of the debtor... or to exercise control over property of the estate."). *Id.* at *5 – *6.

Relevance

The Third Circuit followed the holdings of the Tenth and D.C. Circuits "that a creditor does not violate the stay in regard to property of the estate if it merely maintains the status quo." *Id.* at *3, citing *In re Cowen*, 849 F.3d 943 (10th Cir. 2017); *United States v. Inslaw, Inc.*, 932 F.2d 1467 (D.C. Cir. 1991). In contrast, the "Second, Seventh, Eighth, and Ninth Circuits... have

held that the Bankruptcy Code's turnover provision requires immediate turnover of estate property that was seized [prior to bankruptcy] and that failure to do so violates the automatic stay." *Id.*, citing *In re Fulton*, 926 F.3d 916 (7th Cir. 2019); *In re Weber*, 719 F.3d 72 (2d Cir. 2013); *In re Del Mission Ltd.*, 98 F.3d 1147 (9th Cir. 1996); *In re Knaus*, 889 F.2d 773 (8th Cir. 1989); also see *In re Rozier*, 376 F.3d 1323, 1324 (11th Cir. 2004) (creditor held "in willful contempt of the automatic stay… by refusing to return the vehicle)."

The Supreme Court should resolve this circuit split. It did so 24 years ago in *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995), when it "considered the interplay between the automatic stay and the turnover provision in [Code §] 542(b)." 2019 WL 5538570, at *12. In *Strumpf*, the court held "that a bank's temporary withholding of funds in a debtor's bank account, pending resolution of the bank's setoff right… did not violate the automatic stay," reasoning "among other things, that [to] interpret… [§] 542(b)'s turnover provision as self-executing would 'eviscerate' the provision's exceptions to the duty to pay." *Id.* at *12.

Facts

The individual debtor bought a used Chevrolet Corvette in July 2016. After making several installment payments on her financing agreement, the secured lenders repossessed the car when the debtor later defaulted on her car payments. The debtor then filed a Chapter 13 petition notifying the secured lenders of the bankruptcy filing and demanding that they return the car to her.

The lenders rejected the debtor's demand. She then moved for a turnover order in the bankruptcy court under Code § 542(a) (creditor "shall deliver" debtor's property to debtor), seeking not only the return of the car, but also sanctions under Code § 363(k) for the lenders' alleged "willful violation" of the Code's automatic stay.

The Lower Courts

The bankruptcy court ordered the turnover of the car but denied the debtor's request for sanctions, reasoning that the lenders had not violated the stay by failing to return the car after receiving notice of the bankruptcy filing. The district court affirmed.

The Third Circuit

The Third Circuit noted the "twofold" purpose of the automatic stay in Code § 362(a). Not only does it protect the debtor "by stopping all collection efforts, harassment, and foreclosure actions," but it also protects creditors by "preventing particular creditors from acting unilaterally in self-interest to obtain payment from a debtor to the detriment of other creditors." *Id.* at *5. The stay thus "prevent[s] dismemberment of the estate," enabling an "orderly" distribution of the debtor's assets. *Id.*, citing *Taggart v. Lorenzen*, 139 S.Ct. 1795, 1804 (2019) (automatic stay "aims to prevent damaging disruptions to the administration of a bankruptcy case in the short run.").

An "individual injured by any willful violation" of the automatic stay may seek "actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages." *Id.* at *5, quoting Code § 362(k). Here, the debtor sought sanctions because of the lenders' refusal to turn over the debtor's car.

Plain Language of Code. The court rejected the debtor's assertion that the lenders violated the stay by failing to return her car. "... § 362(a)(3) prohibits creditors from taking any affirmative act to exercise control over property of the estate." *Id.* at *7. Because the statutory language "is prospective in nature ... the *exercise* of control is not stayed, but the *act* to exercise control is stayed." *Id.* In short, the language "requires a post petition affirmative act to exercise control over property of the estate." *Id.*

No Affirmative Act. The lenders here had "possession and control of the" car, but "merely passively retained that same possession and control." *Id.* at *8. They never violated the automatic stay because they never did anything "to exercise control over" the car. *Id.* When learning of the debtor's bankruptcy filing, they merely "preserved the pre-petition status quo." *Id.* Congress never intended "passive retention to qualify as 'an act to exercise control over property of the estate.'" *Id.*, quoting Code § 362(a)(3).

No Need to Resort to Unhelpful Legislative History. The court rejected the debtor's reliance on the legislative history because of the "unambiguous text" of § 362(a)(3). *Id.* at *8. In any event, as the court noted, "Congress ... 'gave no explanation of its intent'" when it amended § 362(a)(3) by adding "to exercise control over property of the estate." *Id.* Indeed, said the court, "Congress did not express any intent, much less an intent to include creditors' passive retention of property that was seized pre-petition." *Id.* *9.

Code § 542(a) Turnover Provision Not Self Effectuating. Rejecting the debtor's argument that Code § 542(a) is "self-executing," the court found that "a creditor's obligation to turn over estate property to the debtor is not automatic." *Id.* *10. Instead, the debtor or trustee must sue in the bankruptcy court to give that court a chance to determine whether the property is subject to turnover. Both the Federal Rules of Bankruptcy Procedure and § 542(a) itself govern.

The debtor or trustee, after a bankruptcy filing, "must . . . initiate a turnover proceeding by (1) filing a complaint in Bankruptcy Court, and (2) serving a creditor with a copy of the complaint" under Bankruptcy Rule 7001(1). *Id.* *10. Also, Code § 542(a) "explicitly limits the right to turnover [of] estate property that (1) is in the possession, custody or control of a creditor, and (2) is not 'of inconsequential value or benefit to the estate.'" *Id.* *11. Thus, "explicit conditions . . . must be satisfied before property is subject to turnover." *Id.* There is no "automatic duty on creditors to turn over collateral to the debtor upon learning of a bankruptcy petition" and Code § 542(a) is not "self-effectuating." *Id.* The bankruptcy court, after a debtor or trustee sues, "must ultimately decide whether certain property must be turned over to the debtor." *Id.* Although Code § 542(a) contains the phrase "shall deliver to the [debtor]," it only happens when the bankruptcy court "says so in the context of an adversary proceeding brought under Rule 7001(1)." *Id.* at *12.

Supreme Court Guidelines. The Supreme Court's *Strumpf* decision supports the holding in *Denby-Peterson*: "interpreting § 542(b)'s turnover provision as self-executing would 'eviscerate' the provision's exceptions to the duty to pay." *Id.*, citing *Strumpf*, 516 U.S. at 20. Neither the "automatic stay provision [nor] the turnover provision … refer to each other." *Id.* Accordingly, "they should not be read together, [meaning that] violation of the turnover provision would not warrant sanctions for violation of the automatic stay provision." *Id.*

Comments

1. The Third Circuit reached a sensible, practical result in *Denby-Peterson*. The well-reasoned opinion maintained the right balance between debtors' and creditors' rights. By preserving the status quo and the debtor's right to reclaim its property, it also relieves secured lenders from the threat of sanctions.

2. The turnover remedy was also never viewed as self-effectuating under pre-Code practice. A secured lender who repossessed collateral prior to bankruptcy was able to retain possession pending the bankruptcy court's entry of a turnover. Ralph Brubaker, "Turnover, Adequate Protection and the Automatic Stay (Part I): Origins and Evolution of the Turnover Power," 33 Bnkr. L. Letter No. 8, at 4 — 7 (Aug. 2013). According to the Supreme Court, moreover, when a debtor sought a turnover order, "[n]othing in the legislative history evinces a congressional intent to depart from that [pre-Code] practice." *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 208 (1983).

Authored by Michael L. Cook.

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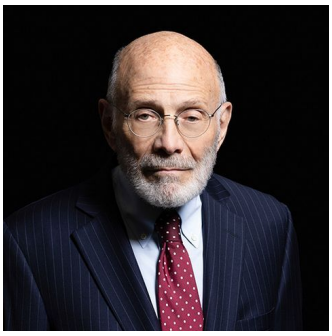

Michael Cook

Of Counsel

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