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Tenth Circuit Strengthens Circuit Split—Supporting the Minority Position That Passive Retention of Property Does Not Violate the Automatic Stay in Bankruptcy

A common issue that arises in many bankruptcy cases is whether a creditor who refuses to return collateral that he repossessed prior to the petition date violates the automatic stay. In February, the Tenth Circuit widened a circuit split by adopting the minority position that to violate the automatic stay in bankruptcy a creditor must take action, not merely retain the property of the estate. The Bankruptcy Code's automatic stay provision, 11 U.S.C. § 362, prohibits any post-petition "act to obtain possession of property of the estate or … to exercise control over property of the estate."[1] Several circuit courts, including the Second, Seventh, Eighth and Ninth Circuits, have held that a creditor's refusal to return property after a demand for turnover violates the automatic stay.[2] However, with its opinion in *In re Cowen*, 849 F.3d 943 (10th Cir. 2017), the Tenth Circuit joined the DC Circuit in determining that the passive retention of property, seized pre-petition, does not violate the automatic stay.[3]

Background

The filing of a bankruptcy petition operates as an automatic stay, prohibiting creditors from committing "any act to obtain possession of property of the estate or … to exercise control over property of the estate."[4] The second clause, preventing any act to exercise control over property of the estate, was added by a 1984 amendment[5] and is the crux of the current circuit split.

The Tenth and DC Circuits have both adopted the minority rule that "only affirmative acts to gain possession of, or to exercise control over, property of the estate violate § 362(a)(3)."[6] In contrast, the majority of circuits that have addressed the issue hold that refusal to return property after a demand for turnover is an act to exercise control over the property that violates the automatic stay. The significance of the majority interpretation for creditors is twofold. First, it may require a creditor to turn over property before seeking "adequate protection" from the court.[7] Second, under this interpretation a creditor who passively retains property of the estate after a demand for turnover is in violation of the automatic stay and may be liable for actual damages, including costs, attorneys' fees and, where appropriate, punitive damages.[8]

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[1] 11 U.S.C. § 362(a)(3).
[2] *See* e.g., *In re Weber*, 719 F.3d 72 (2nd Cir. 2013); *Thompson v. GMAC, LLC*, 566 F.3d 699 (7th Cir. 2009); *In re Del Mission*, 98 F.3d 1147, 1996 (9th Cir. 1996); *In re Knaus*, 889 F.2d 773 (8th Cir. 1989).
[3] *See also United States v. Inslaw*, 932 F.2d 1467 (D.C. Cir. 1991).
[4] *Id.*
[5] *See* Bankruptcy Amendments and Federal Judgeships Act of 1984, 130 CONG. REC. H7471 (daily ed. June 29, 1984).
[6] *In re Cowen*, 849 F.3d 943 (10th Cir. 2017). *See also United States v. Inslaw*, 932 F.2d 1467, 1474 (D.C. Cir. 1991).
[7] *See Thompson v. GMAC, LLC*, 566 F.3d 699 (7th Cir. 2009) (finding that a creditor must first return the property to the bankruptcy estate and then seek certain adequate protection).
[8] 11 U.S.C. § 362(k)(1).

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i. The Majority Rule

The majority of circuit courts have determined that passively retaining an asset is "exercising control" over the asset within the meaning of Section 362(a).[9] The four circuits forming the split's majority have held that the turnover of seized property is compulsory under Section 542, that passive retention of property after a demand for turnover is a violation of the automatic stay and that a lack of adequate protection does not exempt a creditor from turning over the property at issue. The Seventh Circuit's decision in *Thompson v. GMAC* is illustrative of this majority position.

In *Thompson*, the court held that a creditor who refused to return a vehicle that had been lawfully repossessed one month before the bankruptcy petition's filing was "exercising control over the asset" in violation of the automatic stay, despite the creditor's lack of adequate protection.[10] The court found that the plain meaning of "control" includes a "restraining or directing influence over" the property.[11] The court also recognized that the 1984 amendment to Section 362 "prohibit[ing] conduct above and beyond obtaining possession of an asset suggests that [Congress] intended to include conduct by creditors who seized an asset pre-petition."[12]

The majority view is that the practical effect and primary policy goal of bankruptcy is to "group all of the debtor's property together in his estate such that he may rehabilitate his credit and pay off his debts."[13] The majority acknowledges that Section 541 provides that the bankruptcy estate is composed of property "wherever located and by whomever held," including equitable interests, rights to redeem and other rights.[14] As this includes property seized pre-petition, the majority courts hold that the passive retention of property in the bankruptcy estate is a violation of the automatic stay.[15]

The *Thompson* court also determined that a creditor may not "unilaterally condition the return of the property on its own determination of adequate protection."[16] While a creditor is entitled to adequate protection for its interests in the property, it must first turn over the property and subsequently seek adequate protection by requesting the court, pursuant to Section 363(e), to prohibit or condition the use or lease of the property, as necessary to provide adequate protection of the creditor's interest. The majority view places the burden on the creditor, and not the debtor, to seek relief from the bankruptcy court for statutory and policy reasons. First, the court interpreted Section 363 to place the burden on the creditor to request adequate protection after turning over the assets.[17] Second, the court noted that allowing creditors to retain possession of the property for lack of adequate protection contravenes the primary policy objectives of bankruptcy—to allow the debtor "to regain his financial foothold and repay his creditors."[18] The court reasoned that without the property, in this instance a vehicle, the debtor may be without transportation to work. Thus, the debtor is less likely to be able to repay his creditors and the creditor in possession may unfairly gain uneven bargaining power.[19]

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[9] *See In re Weber*, 719 F.3d 72, 81 (2nd Cir. 2013); *Thompson v. GMAC, LLC*, 566 F.3d 699, 703 (7th Cir. 2009); *In re Del Mission*, 98 F.3d 1147, 1151 (9th Cir. 1996); *In re Knaus*, 889 F.2d 773, 775 (8th Cir. 1989).
[10] *Thompson*, 566 F.3d at 702.
[11] *Id.* (citing Webster's Dictionary).
[12] *Id.* at 703.
[13] *Id.* at 702.
[14] *In re Weber*, 719 F.3d at 79.
[15] *Id.*
[16] *Thompson*, 566 F.3d at 703 (quoting *In re Colortran*, 210 B.R. 823, 827-28 (BAP 9th Cir. 1997)).
[17] *Id.* at 703.
[18] *Id.* at 706.
[19] *Id.*

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ii. In re Cowen: The Tenth Circuit Adopts the Minority Rule

The Tenth Circuit's *In re Cowen* decision involved two creditors who repossessed two commercial trucks from the debtor prior to the filing of the bankruptcy petition.[20] The debtor filed Chapter 13 bankruptcy on the day of his final deadline to pay off his first truck and within the 10-day cure period for the second truck.[21] He notified his creditors of the filing and requested the immediate return of the trucks.[22] When the creditors refused, the debtor moved the court to hold them in contempt for a willful violation of the automatic stay.[23] The bankruptcy court applied the majority rule: "the act of passively holding onto an asset constitutes 'exercising control' over it, and such action violates section 362(a)(3) of the Bankruptcy Code,"[24] and concluded that the creditors' failure to return the trucks constituted a continuing violation of the automatic stay.[25]

Relying on the plain language of Section 362, the Tenth Circuit reversed the bankruptcy court and joined the minority position. The court held that the automatic stay prevents "entities from doing something to obtain possession of or to exercise control over the estate's property," but does not extend to "the act of passively holding onto an asset."[26] Through a plain reading of the statute, the court determined that the phrase "any act" requires an affirmative action, thus the "automatic stay, as its name suggests, serves as a restraint only on acts to *gain* possession or control over property of the estate."[27]

Further, the Tenth Circuit disagreed with the practical and policy considerations endorsed by the split's majority. Specifically, the court rejected the sweeping interpretation of the 1984 amendment to Section 362 that " 'the mere fact that Congress expanded the provision to prohibit conduct above and beyond obtaining possession of an asset' [demonstrates] that Congress 'intended to prevent creditors from retaining property of the debtor.' "[28] Rather, the Tenth Circuit adopted a narrower interpretation of the amendment as expanding violations of the automatic stay to include " 'acts' that 'exercise control' over, but do not 'obtain possession of,' the estate's property," such as "a creditor in possession who improperly sells property belonging to the estate."[29]

Notably, *In re Cowen* confirmed that a court may still enforce the turnover of property to the bankruptcy estate, without the need of finding a violation of the automatic stay.[30] The bankruptcy courts have broad equitable power under Section 105(a) to enforce Section 542, which requires that "an entity … in possession … of property that the trustee may use, sell, or lease … shall deliver to the trustee, and account for, such property or the value of such property."[31] Section 105(a) "grants bankruptcy courts the power to sanction conduct abusive of the judicial process" and enter civil contempt orders, including monetary damages.[32]

Creditor Implications

First, the Tenth Circuit strengthened the circuit split by joining the minority, which states that creditors that retain possession of assets that were properly seized pre-petition do not violate the automatic stay. The impact of this decision is that in the Tenth Circuit—and in other courts following the minority rule—the

[20] *In re Cowen*, 849 F.3d 943, 944 (10th Cir. 2017).
[21] *Id.* at 946.
[22] *Id.*
[23] *Id.*
[24] *Id.* at 948 (citing *Thompson v. GMAC, LLC*, 566 F.3d 699 (7th Cir. 2009)).
[25] *Id.*
[26] *Id.* at 949.
[27] *Id.* (citing *United States v. Inslaw*, 932 F.2d 1467, 1474 (D.C. Cir. 1991)) (emphasis added).
[28] *Id.* (quoting *In re Weber*, 719 F.3d 72, 81 (2d Cir. 2013)).
[29] *Id.* at 950.
[30] *Id.*
[31] 11 U.S.C. § 542(a).
[32] *In re Cowen*, 849 F.3d at 950.

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debtor may be obligated to initiate proceedings for turnover of the property, and the creditor may be able to wait for entry of a turnover order before relinquishing the property.[33]

Second, *In re Cowen* confirmed that there may still be creditor liability in those courts applying the minority rule for failure to return property to the bankruptcy estate after a demand for turnover. Specifically, the Tenth Circuit found that courts can utilize the broad equitable powers under Section 105, which grants bankruptcy courts the power to sanction conduct abusive of the judicial process, to enforce the turnover requirements of Section 542.

Finally, the decision in *In re Cowen* has already manifested itself in a favorable outcome for creditors. A recent bankruptcy court decision in the District of Kansas, following the precedent set by *In re Cowen,* held that the creation of a worker's compensation subrogation lien did not violate the automatic stay because the lien arose without the creditor's "committing any affirmative post-petition act that breached § 362(a)(4)."[34] The *Garcia* decision could provide an opportunity for appeal to the Tenth Circuit and a request for review of the *In re Cowen* holding. Ultimately, such an appeal could lead to a petition for certiorari to the US Supreme Court to resolve the circuit split.

Conclusion

While the *In re Cowen* decision has positive implications for creditors, the decision still leaves the potential for liability for passive retention of assets seized pre-petition. Even in jurisdictions that have adopted the minority rule, creditors should be cautious in retaining property seized pre-petition—as a well-plead complaint that seeks enforcement of Section 542 through the equitable powers of Section 105(a) may still state a viable claim under *In re Cowen*. Thus, in addition to defending the turnover action, creditors should still consider proactively seeking relief from the automatic stay before taking any further action with the collateral and to request adequate protection for the creditor's interest in its collateral.

The development of this circuit split will impact future interpretations of automatic stay violations and what creditor actions are permissible. Currently, the *In re Cowen* decision provides some protection for creditors. Long term, the Tenth Circuit's reinforcement of the circuit split regarding automatic stay violations may provide an avenue for Supreme Court review.

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[33] *See* e.g., *Thompson v. GMAC, LLC*, 566 F.3d 699, 700 (7th Cir. 2009) (discussing the procedure in district courts applying the minority rule).
[34] *In re Garcia*, 2017 WL 2951439, *6 (Bankr. D. Kan. July 7, 2017).