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Deepening Circuit Split, Third Circuit Holds that Items Seized Pre-Petition Did Not Violate Automatic Stay

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The Third Circuit has recently held in *In re Denby-Peterson*, 941 F.3d 115 (3rd Cir. 2019) that creditors who refuse to relinquish an item that was seized pre-petition are not subject to sanctions because their refusal does not violate 11 U.S.C. § 362's automatic stay. The case further deepens a circuit split on the issue.

The Facts

As the Third Circuit explained, "the center of this bankruptcy appeal is "'America's first sports car': The Chevrolet Corvette." Joy Denby-Peterson purchased a 2008 Corvette in July 2016, and several months later the vehicle was repossessed when Denby Peterson failed to make all of the required loan payments. After repossession, Denby-Peterson filed an emergency Chapter 13 Bankruptcy petition in the Bankruptcy Court for the District of New Jersey. She then notified her creditors of the filing and demanded return of the Corvette. The creditor refused to do so, and Denby-Peterson filed a motion for turnover seeking an order (1) compelling the return of the Corvette, and (2) imposing sanctions for an alleged violation of the automatic stay. After a two-day hearing, the Bankruptcy Court ordered the creditor to return the Corvette as required by 11 U.S.C. § 542(a), but denied the request for sanctions. On the latter point, the bankruptcy court reasoned that the creditor's refusal to return the Corvette was not a violation of the automatic stay absent a court order requiring turnover. Denby-Peterson appealed to the district court (which affirmed on similar grounds) and again to the Third Circuit.

The Third Circuit's Ruling: Meaning of Section 362's Automatic Stay and the Interplay of Section 542's Turnover Provision

Noting a split in authority among the federal circuits, the Third Circuit sided with the minority of circuits by holding that a secured creditor does not violate § 362's automatic stay by maintaining possession of collateral that it lawfully repossessed pre-petition, even after notice of the debtor's bankruptcy. The Court began its analysis by considering the plain language of Section 362(a)(2), which provides (as relevant here) that the filing of a bankruptcy petition "operates as a stay . . . of . . . any act to . . . exercise control over

property of the estate." 11 U.S.C. § 362(a)(3). The court noted that the operative terms and phrases of the Section are "stay," "act," and "exercise control" and concluded, after a review of the ordinary meaning of those terms, that "Section 362(a)(3) prohibits creditors from taking any affirmative act to exercise control over property of the estate." The Court further held that this duty "is prospective in nature . . . the *exercise* of control is not stayed, but the *act to* exercise control is stayed." *Denby-Peterson*, 941 F.3d at 126 (emphasis in original). Based on this enunciation of the rule, the Court held that on the facts of this case, "a post-petition affirmative act to exercise control over the Corvette is not present," and thus there was no violation of the automatic stay. *Id.*

The Court also considered and rejected a related argument made by the debtor that Section 362 should be read *in pari materia* with 542(a)'s "allegedly self-effectuating" turnover provision. Section 542 provides that an entity in possession, custody, or control of property of the debtor "shall deliver" the property to the bankruptcy trustee. The Court acknowledged that Section 542 uses mandatory language – "shall deliver" – but explained that the question in this case "is when must a creditor deliver?" The Court analyzed Section 542's provisions and held that "it would be illogical for us to interpret the turnover provision as imposing an automatic duty on creditors to turn over collateral to the debtor upon learning of a bankruptcy petition." *Id.* at 130. Doing so would allow debtors to temporarily strip creditors of their rights to assert affirmative defenses such as laches, or to claim that the property is not property of the estate. While the Court agreed that creditors could still make these arguments in the course of the bankruptcy proceedings if the collateral was immediately turned over, it held that it did "not read the turnover provision as placing the onus on creditors to surrendering the collateral and then immediately file a motion in Bankruptcy Court asserting their rights." Therefore, the Court reasoned, the mandatory language in Section 542 does not lead to the conclusion that Section 362's automatic stay is self-effectuating.

The Court also rejected the notion that § 362 and § 542 must be read together, reasoning that "[e]ven assuming the turnover provision is self-executing . . . there is still no textual link between Section 542 and Section 362. The language of the automatic stay provision and the turnover provision do not refer to each other. The absence of an express textual link between the two provisions indicates that they should not be read together, so violation of the turnover provision would not warrant sanctions for violation of the automatic stay provision." *Id.* at 132.

Widening of a Circuit Split

As the Third Circuit noted, its decision in *Denby-Peterson* deepened a split among the circuits on the meaning of Section 362's automatic stay provision. The Third Circuit joined the Tenth and D.C. Circuits in holding that a secured creditor does not have an affirmative obligation to return a debtor's collateral immediately upon notice of the bankruptcy. On the other side of the split, the Second, Seventh, Eighth, and Ninth Circuits have held that Section 362 requires a creditor to immediately return collateral that was repossessed pre-petition as soon as the creditor knows of the bankruptcy filing.

This leads to a complicated state of the law, especially for nationwide creditors. In some circuits, a creditor is permitted to ignore a post-petition demand for the return of

collateral that was lawfully repossessed pre-petition. In other circuits, however, that same conduct could expose the creditor to sanctions for willful violation of Section 362's automatic stay. And still, in other circuits, the law is wholly unclear and the creditor must make a calculated risk of either returning the collateral thereby necessitating the expenditure of more resources to protect its rights, or possibly be subject to sanctions.

Due to the deep (and deepening) circuit split, the state of the law related to § 362 is obviously disuniform. In December 2019, the Supreme Court agreed to decide the issue presented by *Denby-Peterson* by granting certiorari in a Seventh Circuit case, *In re Fulton*, 926 F.3d 916 (7th Cir. 2019). The *Fulton* court held that the Bankruptcy Code's turnover provision requires immediate turnover of estate property that was seized pre-petition; look for the creditor's attorneys in that case to rely heavily on *Denby-Peterson*'s reasoning in seeking to obtain a creditor-friendly ruling at the Supreme Court.

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