

LECTURE NOTES: [*In re INOFIN, 455 B.R. 19 \(Bkrcty. D. Mass. 2011\)*](#); TEXT Chap 12, p. 888 and ff.

THE ROLE OF THE AUTOMATIC STAY: WHY THE CREDITOR SOUGHT RELIEF IN IN RE INOFIN

In re Inofin key fact: the creditor conducted foreclosure sales of motor vehicle retail installment contracts prior to the bankruptcy filing by the debtor. The creditor “bid in” a portion of its debt to acquire these assets at the foreclosure sales—in effect taking title (or purporting to take title) to these assets in exchange for debt cancellation.

The creditor, Raymond C. Green, filed a motion for relief from the automatic stay following commencement of the case. The bankruptcy court suggested that this was the wrong procedural posture to consider the issue of the creditor’s security interest in motor vehicle retail installment contracts—indicating that the issue should have been addressed in an adversary proceeding. As the foreclosure sales at issue took place in January 2011, and the bankruptcy case commenced on February 9, 2011, it is not readily apparent why the creditor needed relief from the automatic stay—Raymond C. Green had already taken its action against the debtor’s property by conducting the foreclosure sales pre-petition in January.

In these Lecture Notes, we review how these purported foreclosure sales interact with the Bankruptcy Code and the automatic stay. Keep in mind that the creditor acquired these debtor assets prior to the commencement of the bankruptcy case. Among other questions, the court must decide whether the debtor should return this property to the estate or may retain the property pending a determination of its entitlement. In this case, that determination of entitlement should have taken place in an adversary proceeding but the posture of this case is confused [a matter which we will try to sort out!]

Federal courts disagree about whether inaction can violate the automatic stay. This issue arises when a creditor refuses to turn over property that it “properly” repossessed or otherwise acquired before the petition date.

Hypothesis (of instructor): The reason that the creditor, Raymond C. Green, sought relief from the automatic stay in *In re Inofin* was (probably) to play it safe. No creditor wants to risk violation of a court order—of which the automatic stay is one flavor—even though it is “automatic” upon the commencement of the case.

The debtor, Inofin Incorporated, is located in the First Circuit (and the bankruptcy petition was filed in a Massachusetts bankruptcy court in that Circuit). I say “play it safe” because there is an unresolved issue in the First Circuit related to the automatic stay. In the Eleventh Circuit, which includes Florida (and four other Circuits), a creditor who fails to turn over property after a demand by the bankruptcy trustee violates the automatic stay. This is true even though the creditor acquired its interest in the property pre-petition. In essence “inaction” by failure to return property is seen as an automatic stay violation. In a minority of jurisdictions, such “inaction” does not result in a stay violation. ***This issue has been accepted for review by the U.S. Supreme Court based upon the split among the federal Circuits.***

One option open to the creditor would have been to do nothing following the bankruptcy filing—other than retain the motor vehicle retail installment contracts (and, presumably continue to collect payments made on them) until such time as the bankruptcy trustee sought a return of those contracts (and their proceeds). To do this, the instructor’s assessment is that the bankruptcy trustee should have commenced an adversary proceeding against the creditor to seek a return of these assets. However, the creditor did not wait for the trustee to take this action. Rather, the creditor filed a motion to seek relief from the automatic stay. It is a bit of a puzzle—but there is a logical explanation for why it occurred this way (and why the bankruptcy court noted that an adversary proceeding was proper).

Background of the “inaction” results in stay violation Circuit Split

[NB: The following description of the US Courts of Appeals Circuit “split” is summarized from the Westlaw “maintained”¹ compilation: Automatic Stay: Overview by Practical Law Bankruptcy & Restructuring and Practical Law Finance] [\[begin paraphrase\]](#)

Under the majority view held in the US Courts of Appeals for the Second, Seventh, Eighth, Ninth, and Eleventh Circuits, a creditor's refusal to return property after a turnover demand is an act to exercise control over the property that violates the stay (see *In re Fulton*, 926 F.3d 916, 923-27 (7th Cir. 2019), cert granted sub nom. *Chicago v. Fulton*, 140 S. Ct. 680 (2019); *Weber v. SEFCU (In re Weber)*, 719 F.3d 72, 79-81 (2d Cir. 2013); *California Emp't Dev. Dep't v. Taxel (In re Del Mission Ltd.)*, 98 F.3d 1147, 1151-52 (9th Cir. 1996); *Motors Acceptance Corp. v. Rozier (In re Rozier)*, 376 F.3d 1323, 1324 (11th Cir. 2004); *Knaus v. Concordia Lumber Co., Inc. (In re Knaus)*, 889 F.2d 773, 774-75 (8th Cir. 1989)).

The US Courts of Appeals for the Third and Tenth Circuits and the District of Columbia have adopted the minority position that mere inaction cannot violate the stay when a creditor passively retains property that it obtained prepetition (see *In re Denby-Peterson*, 941 F.3d 115, 126 (3d Cir. 2019) (holding that a secured creditor is not required to turn over property of the debtor until the debtor obtains a court order requiring turnover); *WD Equip., LLC*

¹ In Westlaw “speak” a “maintained” resource is a subject matter area which Westlaw staff or contract attorneys continually monitor and revise for any necessary changes due to legal, market, or practice developments. For current issues like this Circuit split, it is a handy resource for you as law students and future practicing lawyers to learn about—though for an actual engagement as a practicing attorney, you would supplement with your own research. But, for historical matters, like the granting of cert it is handy.

v. Cowen (In re Cowen), 849 F.3d 943 (10th Cir. 2017); United States v. Inslaw, Inc., 932 F.2d 1467, 1474 (D.C. Cir. 1991)).

For example, a court applied the ruling in *In re Cowen* to hold that an automatic lien created by the Kansas workers' compensation statute to enforce subrogation rights given to an employer to allow reimbursement from the employee's recoveries against third parties for amounts paid by the employer as workers' compensation benefits did not violate the automatic stay (see *Davis v. Tyson Prepared Foods, Inc. (In re Garcia)*, 2017 WL 2951439, at *5-6 (Bankr. D. Kan. July 7, 2017), *aff'd*, 740 F. App'x 163 (10th Cir. 2018)). In contrast, another court applied *In re Fulton* to hold that a creditor violated the automatic stay by continuing to exercise control over garnished funds postpetition (see *In re Nimitz*, 2019 WL 7580141, at *3-5 (Bankr. E.D. Va. Dec. 16, 2019)).

On December 18, 2019, the US Supreme Court granted certiorari in *City of Chicago v. Fulton* to resolve the circuit split concerning this issue (see 140 S. Ct. 680). [end paraphrase]

The bankruptcy court in *In re Inofin* did not view the motion seeking relief from the stay as the proper procedure to raise the issue because the First Circuit within which it sat had not yet decided that “inaction” might result in a violation of the automatic stay. Yet, extant case law suggested that retention of the motor vehicle retail installment contracts (and their proceeds) might violate the automatic stay. Thus, the creditor sought relief from the stay—and the parties briefed the relevant issues and did not object.

While this “action” versus “inaction” distinction is tricky, there are many basic actions which the Bankruptcy Code clearly prohibits a creditor from taking against a debtor. These include the “self-help” remedies which the existence of a security interest allows a creditor to take without judicial or other state action. The following is a summary of those basic prohibited acts.

Prohibited Acts

The automatic stay expressly prohibits certain creditor actions (§ 362(a), Bankruptcy Code). Most creditor collection activities are subject to the automatic stay. Consider eight categories of stayed actions which a creditor may not take following the commencement of a bankruptcy case (whether voluntary or involuntary):

1. Filing or continuing to litigate a previously filed judicial, administrative, or other proceeding against the debtor to collect a prepetition claim (§ 362(a)(1), Bankruptcy Code), subject to the following limitations:
 - (a) the prosecution of causes of action that arise after the bankruptcy is filed are not stayed, such as an action for failure to pay postpetition rent; and
 - (b) only proceedings against the debtor are stayed. For example, an appeal where the debtor was the plaintiff would not be stayed.
2. Enforcing a prepetition judgment against the debtor or property of the estate (§ 362(a)(2), Bankruptcy Code).
3. Obtaining possession or control over estate property, regardless of whether the underlying claim arose before or after the filing of the bankruptcy petition (§ 362(a)(3), Bankruptcy Code). This includes both tangible property (such as land, buildings, and machinery) and intangible property rights (such as rights acquired under a license agreement or chattel paper).
4. Creating, perfecting, or enforcing a lien against property of the estate (§ 362(a)(4), Bankruptcy Code). See below for limited exceptions to this prohibition under the stay.
5. Creating, perfecting, or enforcing a lien against property of the debtor to the extent that the lien secures a prepetition claim (§ 362(a)(5), Bankruptcy Code). Property of the debtor is broader than property of the estate (for example, property of the debtor includes abandoned property, exempt property, and property acquired postpetition).

6. Any act to collect, recover, or assess a claim against the debtor that arose prepetition (§ 362(a)(6), Bankruptcy Code).
7. The setoff of mutual prepetition debts arising from different transactions (§ 362(a)(7), Bankruptcy Code). This means a prepetition debt owing to the debtor cannot be netted against a claim asserted against the debtor if they arise from different transactions. In contrast, recoupment, or netting mutual debts arising out of the same transaction, is not stayed.
8. US Tax Court proceedings concerning the debtor's tax liability for a taxable period determined by the bankruptcy court (§ 362(a)(8), Bankruptcy Code). These proceedings are stayed because the bankruptcy court has the power to adjudicate relevant tax liability issues.

To take any of the above actions, the creditor must ask the court for relief from the stay.

Exceptions to the “automatic stay”

As a general matter, following the commencement of a bankruptcy proceeding against a debtor, the creditors can do nothing—as is shown by the eight points outlined above. However, there are some exceptions, particularly related to perfection of security interests as indicated in point 4 above. (As a point of information, Wall Street negotiated the ability to “net” certain financial and derivatives contracts and sell collateral in specified circumstances in which a delay to wait for a court proceeding might result in large losses. The ability to perfect a security interest within grace periods (such as a PMSI in equipment) and to file continuation statements had a longer and more neutral genesis as a matter of legislative history. As a junior attorney I worked on the early efforts to amend the Bankruptcy Code to allow for contract “netting” and anti “cherry picking” of derivatives and swap contracts as counsel for ISDA—the International Swap Dealers Association, now known as: the International Swaps and Derivatives Association).

For our purposes, the items of most interest to us are related to continuation of perfection and similar matters.

Perfection of Security Interests

From a secured creditor's perspective, the most relevant exception concerns perfection of security interests under relation-back statutes (§ 362(b)(3), Bankruptcy Code). Acts to perfect, or to maintain or continue the perfection of a security interest, to the extent permitted in the Bankruptcy Code, are excepted from the automatic stay. They are permitted by the Bankruptcy Code in two situations:

1. Perfection, maintenance, or continuation of perfection of an interest in property is not prohibited by the stay if applicable non-bankruptcy law recognizes the effectiveness of retroactive perfection (§ 546(b), Bankruptcy Code).

For example, the UCC provides for the retroactive perfection of a purchase-money security interest (PMSI) (UCC § 9-324(a)). This means that under state law, the general rule is that an unperfected purchase-money security interest is effective against an entity that acquires rights in this property before the interest is perfected, if perfection occurs within the grace period fixed by the statute (20 days) (§ 546(b)(1)(A), Bankruptcy Code).

The filing of a UCC-3 continuation statement is also excepted from the automatic stay (if it occurs within the time fixed by applicable non-bankruptcy law) (§ 546(b)(1)(B), Bankruptcy Code).

2. The Bankruptcy Code contains a similar concept (§ 547(e)(2)(A), Bankruptcy Code). It provides that perfection of an interest in property (and perfection of purchase-money security interests under section 547(c)(3)(B) of the Bankruptcy Code) is not prohibited by the automatic stay if it occurs within a 30-day grace period.

However, if the statute does not allow the lien to relate back to a prepetition period, then the exception does not apply (see *In re Linear Elec. Co., Inc.*, 852 F.3d 313 (3d Cir. 2017)).

You might take a look at these sections of the Bankruptcy Code and you will see how the prohibitions and exceptions work. After doing so, then review TEXT Chap 12, p. 888 and ff.