

Theodore entered into an installment contract with a corporate creditor for the purchase of a new automobile. A few years later, he defaulted on his installment payments, and the creditor repossessed the vehicle. Not long after that, Theodore filed for bankruptcy in federal bankruptcy court.

Needing his car to commute to work, he requested that the creditor return the vehicle to his bankruptcy estate. When the creditor refused to return the vehicle, absent what it deemed “adequate protection” of its interests, Theodore moved for sanctions under a Bankruptcy Code provision, claiming that the creditor had willfully violated the automatic “stay” provision in the Bankruptcy Code. The stay provision forbids a creditor from committing any act to obtain possession of property from the bankruptcy estate, or to “exercise control” over the property of the estate, once the debtor has filed for bankruptcy.

In Theodore’s case, the creditor could not be said to have acted to obtain possession of the vehicle after the bankruptcy filing, because it already possessed the car at that point. Thus, one issue was whether it could be said to have “exercised control” over the vehicle by simply keeping it and refusing to return it to the debtor, as opposed to selling or doing something else with it.

A federal appellate court answered this question in the affirmative. It held that, upon the request of a debtor that has filed for bankruptcy, a creditor must first return an asset in which the debtor has an interest to his or her bankruptcy estate and then, if necessary, seek adequate protection of its interests in the bankruptcy court. To hold that “exercising control” over an asset refers only to selling or otherwise destroying the asset would not be logical, given the central goal of reorganization bankruptcy. That goal is to gather together all of the debtor’s property in the bankruptcy estate, so that the debtor may rehabilitate his or her credit and pay off his or her debts. This applies to all property, even property (such as Theodore’s car) that is lawfully seized before the filing of a bankruptcy petition.

The court essentially ruled that the creditor’s position had put things in the wrong order. Instead of being permitted to hang on to the vehicle until it felt satisfied that its interests would be protected, the creditor had to first return the asset to the bankruptcy estate. Then, if the debtor failed to show that he could adequately protect the creditor’s interests, the bankruptcy court was empowered to condition the right of the estate to keep possession of the asset on the provision of certain specified adequate protections to the creditor.

Some other considerations also weighed in favor of placing the onus on the creditor, rather than on Theodore, to seek relief from the court if it believed that its interests were not adequately protected. First, the whole purpose of reorganization bankruptcy, be it corporate or personal, and of the stay in particular, is to allow the debtor to regain his financial foothold and repay his or her creditors. Properly implemented, a stay allows a debtor free use of his or her assets while the court works with both the debtor and the creditors to establish a rehabilitation and repayment plan. In theory at least, these assets generate money that could contribute to paying down the debtor’s obligations. In Theodore’s case, if his car remained in the hands of the creditor, it could hamper him from going to work (or, in other cases, from finding work), which is crucial for getting the funds necessary to pay off his debts.

Second, allowing a creditor to maintain possession of an asset until it decides on its own that adequate protection is in place, or until the debtor moves for the asset's return, gives the creditor an unfair bargaining advantage over other secured creditors.

Finally, requiring the debtor, rather than the creditor, to bear the costs of seeking court relief hurts not only the debtor but all of the debtor's other creditors by draining the value of the bankruptcy estate. The court reasoned that it makes more sense for all creditors to move before the court in a consolidated proceeding to have their assets adequately protected than for a debtor to file multiple motions piecemeal in an attempt to recover assets that may be scattered among many creditors.