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Questioning Willful Violations of the Automatic Stay: Third Circuit Gives University the Third Degree

October 6, 2021

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A recent decision by the Court of Appeals for the Third Circuit affirming the decisions of both the bankruptcy and district courts, provides an interesting analysis of "willful" violations of the automatic stay under Section 362 of the Bankruptcy Code. *See California Coast Univ. v. Aleckna (In re Aleckna)*, No. 20-1309 (3d Cir. 2021). Although the context of this case involved a university's conduct relating to an outstanding tuition debt and how that may be a violation of the Section 362 stay, the issues included interpreting the term "willfulness" in a way that would have a much broader reach.

In *Aleckna*, the court revisited the term willfulness in view of an earlier Third Circuit decision construing the use of that word in the Code to, in effect, create an exception to a violation when a creditor acts in a good faith belief that the stay does not apply to the conduct and there is "persuasive authority" supporting the creditor's belief, even if the authority turns out to be wrong.

The Code provides for an automatic stay which arises upon the filing of a bankruptcy petition. The stay prevents, among other things, creditors from taking actions against the debtor and its property or acts to collect debts. Section 362(k) of the Code offers an injured debtor a source of relief against creditors who violate the stay, permitting a recovery of actual damages, including legal fees, and punitive damages.[1]

Aleckna was a former college student with an outstanding balance of approximately $6,300 on her tuition when she filed her Chapter 13 petition. After filing, she requested a copy of her transcript from the university. The university provided her a copy of her transcript but without indicating any graduation date, considering her to have not technically graduated if there was an outstanding balance for tuition.

Because certain types of student loans may be nondischargeable in bankruptcy, the university commenced an adversary proceeding to declare the tuition debt nondischargeable (which it subsequently withdrew presumably because the debt was not a student loan or the type of student loan that fit within the exception to discharge). The debtor filed a counterclaim arguing the university's refusal to provide a completed transcript violated the stay and was "an unlawful attempt to collect on pre-petition debt."

It is worth noting that the university had not invoked any legal process to collect the debt or, apparently, engaged in any affirmative collection efforts against the debtor to recover the past-due tuition balances. Instead, it withheld the graduation date from her transcript because of the overdue balance. The university argued that, although it may have been required to provide a transcript to the debtor, it was not required to provide a transcript which acknowledged a graduation date.

The bankruptcy court, affirmed by the district court, found the university willfully violated the automatic stay and awarded the debtor damages and attorneys' fees. [2] The university appealed to the Third Circuit.

On appeal, the university did not dispute that it had violated the automatic stay but contested the award of damages and attorneys' fees as being unjustified because the stay violation had not been "willful."

The university relied on the 1992 Third Circuit decision, *In re Univ. Med. Ctr.*, 973 F.2d 1065, 1085, 1088 (3d Cir. 1992), in which it ruled a defendant did not "willfully" violate the automatic stay if the defendant had a good faith belief that it was not violating the automatic stay and the law governing the alleged violation was "sufficiently uncertain" with the defendant's position supported by "persuasive authority."[3]

The Third Circuit in *University Medical* found the defendant had not willfully violated the automatic stay and, thus, did not award the plaintiff any damages. 973 F.2d at 1085. The *University Medical* court held that, while "good faith alone" was insufficient, if the defendant had a good faith (*i.e.*, honest) belief that it was not violating the automatic stay, coupled with the "uncertain" nature of the underlying issues of law supported by persuasive case authority, it would negate any finding of willfulness. *Id.**[4]***

In *Aleckna*, the university tried to rely on the absence of case law addressing whether refusal to give a student-debtor his or her transcript with a graduation date violates the automatic stay. The Third Circuit rejected the university's position, noting that it had not pointed to any persuasive authority supporting its position and determined that the mere absence of case law that a college does not violate the stay by refusing to provide a transcript that includes a graduation date does not render the law sufficiently unsettled.

The Third Circuit distinguished two cases relied upon by the university that found no stay violations for withholding of an entire transcript. The court observed that unlike in the case before it, the debts in those cases appeared to be non-dischargeable.

Creditors of debtors in cases in the Third Circuit (*i.e.*, New Jersey, Pennsylvania, and Delaware) and anywhere else for that matter should be aware of the potential for substantial liability from stay violations, and how willfulness can be found merely when one is aware of the automatic stay *(i.e.*, there is a bankruptcy filing) and intentionally takes the actions that violate the stay, regardless of whether the creditor intended or even knew it was violating

the automatic stay. The *Aleckna* court made it clear that its judicial exception if you will to a finding of willfulness is quite limited (*i.e.*, good faith belief the actions do not violate the stay and persuasive authority to back up that belief). [5]

Creditors finding themselves in the position of the university, where there may be some argument that the stay does not apply to the contemplated conduct, should consider temporarily withholding a transcript but only while expeditiously seeking a court determination that the action is not prohibited by the automatic stay.[6] It should also consider asserting as part of such motion (or in defense of a debtor's 363(k) claim) the following argument not raised in *Aleckna*.

While the United States Supreme Court issued a narrow opinion in *City of Chicago v. Fulton*, 141 S. Ct. 585 (2021), holding that the City of Chicago had not violated Section 362(a)(3) of the Code by failing to return a vehicle it had seized pre-petition, the basis of that ruling may be applicable in a context like *Aleckna*.

On appeal from the Seventh Circuit, the Court in *Fulton* decided whether an entity that passively retains possession of the debtor's property, which it had seized pre-petition, violates the automatic stay by failing to return such property after the bankruptcy filing. In *Fulton*, the debtors' vehicles were impounded pre-petition due to unpaid fines. The city in *Fulton* refused to return the vehicles to each debtor after the Chapter 13 petitions were filed. The Court held that "mere retention of estate property after the filing of a bankruptcy petition does not violate" the automatic stay. The Court indicated a stay violation requires "something more than merely retaining property." The Court observed that, "taken together, the most natural reading of these terms—"stay," "act," and "exercise control"—is that §362(a)(3) prohibits affirmative acts that would disturb the status quo of estate property as of the time when the bankruptcy petition was filed." 141 S. Ct. at 587.

When considering the application of *Fulton* to facts like those presented in *Aleckna*, one could argue that simply withholding a debtor's completed transcript due to outstanding tuition balances is akin to merely retaining possession of a vehicle, which was not found to be a stay violation in *Fulton* under Section 362(a)(3). Bear in mind, however, that *Fulton* addressed only Section 362(a)(3) which speaks in terms of a creditor taking an act to obtain possession or control of property of the estate. But another subsection, (a)(6), which was the one applicable in *Aleckna*, also speaks in terms of only an act to collect a debt. Query whether the wording of (a)(3) is similar enough to the wording of (a)(6) that *Fulton* could support an argument that the mere withholding of information, particularly without any demand or other affirmative actions to collect the tuition, does not violate the automatic stay and that *Aleckna* was wrongly decided.[7]

Please note that this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient. If you have questions regarding these provisions, or any other aspect of bankruptcy law, please contact Michael H. Traison at 312.860.4230, Thomas R. Slome at 516.296.9165 and/or Amanda A. Tersigni at 516.357.3738.

Footnotes

[1] We have previously issued a number of legal alerts on the topic of the automatic stay: Beware of the Automatic Stay! Bankruptcy Court Sanctions Law Firm and Client for "Willful" Violation of the Automatic Stay - Cullen and Dykman LLP (cullenllp.com); Supreme Court to Decide Whether Creditor's Inaction Violates the Automatic Stay - Cullen and Dykman LLP (cullenllp.com); Automatic Stay Violators and Prepetition Seizures - Cullen and Dykman LLP (cullenllp.com); Yet Another Court Addresses Violation of the Automatic Stay - Cullen and Dykman LLP (cullenllp.com); The Automatic Stay: Even Pre-Petition Seizures May Be Covered - Cullen and Dykman LLP (cullenllp.com); Bank Freezes and the Automatic Stay - Cullen and Dykman LLP (cullenllp.com).

[2] The actual damages awarded amounted to $230.16, based upon time the debtor had to take off work to attend trial, and by 2016 approximately $100,000 was spent in attorneys' fees and $3,927.12 in expenses.

[3] In *Aleckna*, the Third Circuit first considered if its *University Medical* decision was legislatively overruled by a 2005 amendment to the Code that included a good faith defense in narrow circumstances not applicable here. The court ruled that *University Medical* was not legislatively overruled, but as explained below that determination did not help the university in light of *University Medical*'s additional "persuasive authority" requirement.

[4] The *Aleckna* court noted that "decisions from within the Third Circuit demonstrate that courts did not read [*University Medical*] so broadly to establish a general defense of good faith." In fact, shortly after the *University Medical* decision, the Third Circuit found a creditor's "good faith" belief that it had not violated the automatic stay provision 'is not determinative of willfulness under § 362,'" quoting *In re Lansdale Family Rests., Inc.*, 977 F.2d 826, 829 (3d Cir. 1992).

[5] Notably, a Petition for Rehearing or Rehearing En Banc has been filed by the California Coast University in connection with this Third Circuit decision in *Aleckna*.

[6] *Cf. Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 19-20 (1995) (finding that a bank's temporary placement of an administrative freeze on debtor's bank account while the bank sought relief from the stay to exercise setoff rights was not a stay violation).

[7] A university faced with a situation like *Aleckna* might also consider a somewhat novel approach of filing a motion for a court order pursuant to Section 365 of the Code compelling the student-debtor to assume or reject what arguably may be deemed an executory contract between the student and the university, one under which the university agreed to provide services, including a graduation, in exchange for payment of tuition. Such a motion could relieve the university of any obligation to process graduation credentials to a student with a past-due tuition balance unless and until the student cures all defaults and assumes the contract.

Practices

- Bankruptcy and Creditors' Rights

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