

## Police or Regulatory Power Exception to Automatic Stay

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### Introduction

Under § 362(b)(4) of the Bankruptcy Code, a party may bring a claim against a debtor despite the automatic stay provision of § 362(a) if the claimant acts within a governmental unit or agency's police or regulatory powers. In some cases, however, it is unclear whether the claimant is in fact enforcing police or regulatory powers, or whether the claimant is attempting to adjudicate private rights. In making this determination, courts have advocated narrowing the scope of the § 362(b)(4) exception to the automatic stay, with the result that a claimant that appears at first blush to act within its police or regulatory powers may ultimately be held in violation of the stay.

Two cases illustrate how similar facts can result in divergent holdings once the court examines the connection between the claimant and the governmental unit. In both *In re Reyes*<sup>1</sup> and *McMullen v. Sevigny (In re McMullen)*,<sup>2</sup> a real estate client filed a complaint against a debtor real estate agent with the state real estate commission. The Bankruptcy Court for the Western District of Texas held in *Reyes* that because the state agency was compelled to bring an action against the agent after the client filed the complaint, that client—and not the state agency—was

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<sup>1</sup> No. 10-52366-C, 2011 WL 1522337 (Bankr. W.D. Tex. Apr. 20, 2011).

<sup>2</sup> 386 F.3d 320 (1st Cir. 2004).

the true claimant.<sup>3</sup> Thus, the *Reyes* court held that the action did not come within the police or regulatory power exception to the automatic stay. In contrast, the First District in *McMullen* held that the proceeding brought against the debtor was excepted from the automatic stay because the state agency’s power to revoke or suspend a debtor agent’s license “plainly implement[ed]” state policy, and the agency lacked the power to make the debtor agent pay damages to the client.<sup>4</sup> Accordingly, the *McMullen* court held that the proceeding “was designed to serve—and did in fact principally serve—to protect the public in the future, rather than to seek recompense for the alleged financial losses sustained by [the client].”<sup>5</sup>

Part I of this memorandum describes the police or regulatory power exception under § 362(b)(4) and the exception’s general application. Part IIA explores situations in which courts have held that the police or regulatory exception to the stay applied and highlights three factors the courts consider when making that determination: the purpose behind the government agency’s formation; the agency’s choice in bringing the action; and the agency’s inability to award monetary damages to specific claimants. Part IIB examines situations in which courts have held that the exception to the stay did not apply, and explains three factors those courts consider: the agency’s lack of choice in bringing the action; the agency’s ability to award monetary damages to individual claimants; and the agency’s decision not to intervene in the proceeding against the debtor. The memorandum concludes that the jurisprudence in this area demonstrates a consistently narrow interpretation of § 362(b)(4) because the courts have recognized the expansive nature of the automatic stay.

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<sup>3</sup> *Reyes*, 2011 WL 1522337, at \*6.

<sup>4</sup> *McMullen*, 386 F.3d at 326–27.

<sup>5</sup> *Id.* at 327.

## **I. Application of § 362(b)(4): The Pecuniary Purpose and Public Policy Tests**

Under § 362(b)(4), the filing of an involuntary or voluntary bankruptcy petition does not operate as a stay “of the commencement or continuation of an action or proceeding by a governmental unit . . . to enforce such governmental unit’s or organization’s police and regulatory power.”<sup>6</sup> Also known as the police or regulatory power exception, § 362(b)(4) has been construed to permit actions ranging from administrative proceedings against the debtor for violation of federal regulations<sup>7</sup> to reimbursement claims against the debtor for environmental clean-up costs.<sup>8</sup>

Whether a court will find § 362(b)(4) applicable generally depends on whether the action passes the pecuniary purpose and public policy tests.<sup>9</sup> Under the pecuniary purpose test, courts focus on whether the purportedly “governmental” proceeding “relates primarily to the protection of the government’s pecuniary interest in the debtor’s property, and not to matters of public safety.”<sup>10</sup> A proceeding that relates primarily to matters of public safety is excepted from the stay.<sup>11</sup> Additionally, a government action with a pecuniary component does not necessarily prevent the action from coming within the exception, since “most government actions which fall under this exemption have some pecuniary component, particularly those associated with fraud detection.”<sup>12</sup>

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<sup>6</sup> 11 U.S.C. § 362(b)(4) (West 2010).

<sup>7</sup> *E.g.*, *Bd. of Governors of the Fed. Reserve Sys. v. MCorp Fin., Inc.*, 502 U.S. 32 (1991).

<sup>8</sup> *E.g.*, *United States v. Nicolet, Inc.*, 857 F.2d 202 (3d Cir. 1988).

<sup>9</sup> *See Chao v. Hosp. Staffing Servs., Inc.*, 270 F.3d 374 (6th Cir. 2001).

<sup>10</sup> *Id.* at 385 (quoting *Word v. Commerce Oil Co. (In re Commerce Oil Co.)*, 847 F.2d 291, 295 (6th Cir. 1988)).

<sup>11</sup> *See id.*

<sup>12</sup> *Universal Life Church, Inc. v. United States (In re Universal Life Church, Inc.)*, 128 F.3d 1294, 1299 (9th Cir. 1997).

Under the “public policy test,” courts “distinguish between proceedings that adjudicate private rights and those that effectuate public policy.”<sup>13</sup> A proceeding that effectuates public policy is excepted from the stay.<sup>14</sup> The inquiry into the public policy test is “objective,” requiring the court to examine “the purpose of the law that the state seeks to enforce rather than the *state’s intent* in enforcing the law in a particular case.”<sup>15</sup>

Where the law has the dual purpose of promoting the public welfare and protecting the state’s pecuniary interest, the court may have to determine the *primary* purpose of the law.<sup>16</sup> If the primary purpose of the law is to promote the public welfare, the court will likely hold that the exception to the automatic stay applies. In *United States v. Nicolet, Inc.*, the Third Circuit held that the EPA action, in which the agency sought reimbursement for environmental clean-up costs, fell within the regulatory power exception because the action “interject[ed] a valuable deterrence element into the CERCLA scheme, ensuring that responsible parties will be held accountable for their environmental misdeeds.”<sup>17</sup> A court may also except an action from the stay despite the debtor’s argument that the government action mainly advances a state pecuniary interest. In *Thomassen v. Division of Medical Quality Assurance, Department of Consumer Affairs, State of California (In re Thomassen)*, the state initiated administrative proceedings to revoke the debtor physician’s license after allegations that he had committed gross negligence in patient care, refused to return a duplicate payment to his patient, and failed to pay his medical support employees.<sup>18</sup> The debtor had “couch[ed] the State’s actions in pecuniary terms,

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<sup>13</sup> *Chao*, 270 F.3d at 386 (quoting *In re Commerce Oil Co.*, 847 F.2d at 295).

<sup>14</sup> *See id.*

<sup>15</sup> *Safety-Kleen, Inc. (Pinewood) v. Wyche*, 274 F.3d 846, 865 (4th Cir. 2001) (emphasis added).

<sup>16</sup> *See id.*; *Yellow Cab Coop. Ass’n v. Metro Taxi, Inc.*, 132 F.3d 591 (10th Cir. 1997).

<sup>17</sup> 857 F.2d 202, 210 (3d Cir. 1988).

<sup>18</sup> 15 B.R. 907, 907–08 (B.A.P. 9th Cir. 1981).

asserting that the actions . . . were meant to . . . forc[e] the payment . . . of certain debts owed to persons whom he had allegedly defrauded.”<sup>19</sup> The Ninth Circuit Bankruptcy Appellate Panel was unconvinced. It concluded that the state’s actions “represent[ed] a direct application of the unit’s police or regulatory powers” and thus was excepted from the stay.<sup>20</sup> The Panel determined that the license revocation proceeding against the debtor physician was based solely on concerns for the “health or safety of the public”—specifically, in preventing malpractice and fraud.<sup>21</sup> Likewise, in *Universal Life Church, Inc. v. United States (In re Universal Life Church, Inc.)*, the Ninth Circuit rejected the debtor church’s position that the IRS “must have no pecuniary motive at all” to fall within the police or regulatory power exception.<sup>22</sup> In *Universal*, the IRS had revoked the debtor’s tax-exempt status after the debtor filed for bankruptcy, and the debtor argued that the revocation violated the automatic stay.<sup>23</sup> The bankruptcy court disagreed, holding that the revocation came within the police or regulatory power exception.<sup>24</sup> The district and circuit courts affirmed.<sup>25</sup> The Ninth Circuit pointed out that nothing in § 362(b)(4) required the IRS’s action to “serve only welfare purposes before it qualifie[d] for the exception.”<sup>26</sup> When the court examines the agency’s purposes and concludes that those purposes primarily serve to deter wrongdoing, the court may well hold that the agency’s action fits within the scope of the exception.

In determining whether a complaint falls within the police or regulatory power exception, courts need not examine whether the government unit or agency’s exercise of this power is

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<sup>19</sup> *Id.* at 909.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* at 909–10.

<sup>22</sup> 128 F.3d 1294, 1299 (9th Cir. 1997).

<sup>23</sup> *Id.* at 1296.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

legitimate. In *Board of Governors of the Federal Reserve System v. MCorp Financial, Inc.*, the Supreme Court held that the Board’s actions fell “squarely” within § 362(b)(4) in commencing two administrative proceedings against MCorp for violating both a Board regulation and a provision of the Federal Reserve Act.<sup>27</sup> MCorp had argued that for an action to come within the ambit of § 362(b)(4), the court “must first determine whether the proposed exercise of police or regulatory power is legitimate.”<sup>28</sup> The Court disagreed. It found that such a reading would require bankruptcy courts to “scrutinize the validity of every administrative or enforcement action brought against a bankrupt entity,” thus conflicting with the “limited authority Congress has vested in bankruptcy courts.”<sup>29</sup>

## **II. Factors Considered by Courts in Determining Whether the Exception Applies**

### **A. Actions Falling Within the Exception**

When the pecuniary purpose and public policy tests favor a finding that § 362(b)(4)’s police or regulatory power exception applies to the action, the court may find that one or more of three factors are present. First, the court may find that the agency was established to serve the public good. Second, the court may find that the government agency had the authority to decide whether or not to bring the action against the debtor. Finally, the court may find that the agency lacked the power to award monetary damages to specific claimants, but instead, had the express authority to punish the debtor in ways that vindicate the public interest.

If the government unit or agency was created in order to serve the public good, a court may find that a claim brought by that unit or agency falls within the exception to the stay. For

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<sup>27</sup> 502 U.S. 32, 34, 39–40 (1991).

<sup>28</sup> *Id.* at 40.

<sup>29</sup> *Id.*

example, the EEOC functions as a federal administrative agency “charged with the responsibility of investigating claims of employment discrimination and settling disputes.”<sup>30</sup> In *E.E.O.C. v. Rath Packing Co.*, the Eight Circuit held that the EEOC’s lawsuit was excepted from the stay because the lawsuit sought to enforce Title VII to “stop a harm to the public—invidious employment discrimination which is . . . detrimental to the welfare of the country.”<sup>31</sup> When the government agency’s very action aims to vindicate the public interest, the automatic stay may not apply to that action.<sup>32</sup>

Second, if the government unit may bring a claim at its own discretion, then the court will probably determine that the claim falls within the exception to the stay. For example, the International Trade Commission’s investigations for violations of § 337 of the Tariff Act do not automatically begin with the filing of a complaint. Rather, the filing prompts the ITC to “examine the complaint” and conduct an “informal” investigation.”<sup>33</sup> In *United States International Trade Commission v. Jaffe*, the court pointed out that a “formal” ITC investigation for such a violation “does not begin until the ITC determine[s] whether the complaint is properly filed and whether an investigation should be instituted on the basis of the complaint.”<sup>34</sup> Accordingly, the court held that the investigation of the debtor fit within the exception to the stay.<sup>35</sup> Likewise, under Massachusetts law, the state real estate commission is not compelled to

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<sup>30</sup> *E.E.O.C. v. Rath Packing Co.*, 787 F.2d 318, 326 (8th Cir. 1986) (quoting *Occidental Life Ins. Co. v. EEOC*, 432 U.S. 355, 368 (1977)).

<sup>31</sup> *Id.*

<sup>32</sup> *See id.* at 325 (“Thus, [w]hen the EEOC acts, albeit at the behest of and for the benefit of specific individuals, it acts also to vindicate the public interest in preventing employment discrimination.”) (quoting *Gen. Tel. Co. of the Nw. v. E.E.O.C.*, 446 U.S. 318, 318 (1980)) (internal quotation marks omitted).

<sup>33</sup> 19 C.F.R. § 210.9 (1994).

<sup>34</sup> 433 B.R. 538, 541 (E.D. Va. 2010) (internal quotation marks omitted).

<sup>35</sup> *Id.* at 543.

investigate an agent when a client files a complaint.<sup>36</sup> Rather, the complaint *permits* the commission to investigate the agent.<sup>37</sup> In its discussion of *McMullen*, the *Reyes* court reasoned that because Massachusetts law “did not compel the agency to commence an action without first satisfying itself that the pursuit [of] such an action was warranted,” the state agency was the actual party initiating the proceeding against the debtors.<sup>38</sup> Thus, the proceeding fell within the exception to the automatic stay.

Third, if the government unit or agency lacks the power to compel the debtor to pay damages, the court may be persuaded that the unit or agency has “no pecuniary interest” in the matter and thus acted to vindicate the public interest. For example, in *McMullen*, the Massachusetts real estate board “was neither empowered to compel McMullen to repay the deposit to the [clients], nor to award any other restitutionary remedy.”<sup>39</sup> Rather, the board’s only enumerated powers were to suspend, revoke, or refuse to renew a broker’s license.<sup>40</sup> Thus, the First Circuit held that the disciplinary proceeding served principally to protect the public, rather than serve to seek compensation for the losses sustained by the client.<sup>41</sup> Additionally, a government agency that awards a form of compensation may still be held to act to vindicate the public interest, if the primary purpose of the award is to protect the public. For example, the ITC has the power to require a debtor defendant to forfeit a posted bond to the complainant.<sup>42</sup> The

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<sup>36</sup> MASS. GEN. LAWS ANN. ch. 112, § 87AAA (West 2010).

<sup>37</sup> *Id.* (“The board *may* . . . investigate . . . .”) (emphasis added).

<sup>38</sup> *In re Reyes*, No. 10-52366-C, 2011 WL 1522337, at \*4–5 (Bankr. W.D. Tex. Apr. 20, 2011).

<sup>39</sup> 386 F.3d 320, 326–27 (1st Cir. 2004).

<sup>40</sup> MASS. GEN. LAWS ANN. ch. 112, § 87AAA.

<sup>41</sup> *McMullen*, 386 F.3d at 327.

<sup>42</sup> *See United States Int’l Trade Comm’n v. Jaffe*, 433 B.R. 538, 546 (E.D. Va. 2010).

*Jaffe* court found that this bond’s purpose was not to “compensate the complainant . . . [but rather] to protect the complainant . . . as well as the public interest.”<sup>43</sup>

#### B. Actions Not Falling Within the Exception

In finding that the pecuniary purpose and public policy tests do not favor application of § 362(b)(4) to the action, the court may find one or more of the following three factors present. First, the court may find that the government unit or agency did not have a choice in bringing the action against the debtor, a sign that the true claimant was not the agency itself, but an individual complainant. Second, the court may find that the agency was empowered to award monetary damages to individual claimants, suggesting that the agency was acting to vindicate private interests instead of the public good. Finally, the court may find that the agency or unit declined to participate in the proceeding at all, thus making it clear that the individual claimant—and not the government unit—brought the action.

When a private party’s complaint “necessitates”<sup>44</sup> government action, the court may hold that § 362(b)(4) does not cover the action. For example, Texas law requires the Texas Real Estate Commission (“TREC”) to investigate the actions and records of the real estate agent once a complaint is filed, if the complaint and evidence provide reasonable cause for an investigation.<sup>45</sup> The TREC “had no independent choice in the matter.”<sup>46</sup> Accordingly, the *Reyes* court found that the aggrieved client—and not the TREC—was the party bringing the complaint against the debtor.<sup>47</sup>

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<sup>43</sup> *Id.* at 546–47 (internal quotation marks omitted).

<sup>44</sup> *In re Reyes*, No. 10-52366-C, 2011 WL 1522337, at \*1 (Bankr. W.D. Tex. Apr. 20, 2011).

<sup>45</sup> TEX. OCC. CODE ANN. § 1101.204(b) (West 2010).

<sup>46</sup> *Reyes*, 2011 WL 1522337, at \*5.

<sup>47</sup> *Id.* at \*4.

Second, if the government unit or agency has the power to award monetary damages to an individual claimant, the court may find that the action does not fall within the exception. The *Reyes* court found it noteworthy that the TREC “may make a monetary award to the complaining witnesses.”<sup>48</sup> The agency maintained a Real Estate Recovery Trust Account to this end.<sup>49</sup> To recover from this Trust Account, the claimant must file a claim with the TREC that is independent from a license revocation complaint.<sup>50</sup> Accordingly, when a claimant files a complaint with the TREC, he or she seems to be advancing personal interests primarily, while only incidentally vindicating the public interest. Such a claimant could thus be viewed as attempting to collect on a pre-petition debt, an act expressly prohibited by the automatic stay.

Finally, when the government expressly declines to intervene in the matter, the court may hold that the claimant does not come within the exception to the automatic stay. In *United States ex rel. Kolbeck v. Point Blank Solutions, Inc.*, the plaintiff filed an action on behalf of himself and the United States, alleging that the defendants had violated the False Claims Act.<sup>51</sup> Subsequently, the government filed a notice “indicating that it had elected *not* to intervene” in the proceeding.<sup>52</sup> This election not to intervene led the *Kolbeck* court to conclude that the plaintiff’s action “does not constitute an action or proceeding by a government unit” so as to fall within the police or regulatory power exception to the stay.<sup>53</sup> Where the government does not

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<sup>48</sup> *Id.* at \*1.

<sup>49</sup> *Id.* at \*6. The TREC collects fees from licensees and maintains this money in the Trust Account, and uses this money “to pay final judgments against persons who were licensed as real estate brokers or salespersons at the time the real estate transaction occurred.” *Questions and Answers About the Real Estate Recovery Trust Account*, Texas Real Estate Commission, <http://www.trec.texas.gov/pdf/faq/rerf-faq.pdf>.

<sup>50</sup> *Reyes*, 2011 WL 1522337, at \*6.

<sup>51</sup> 444 B.R. 336, 337 (E.D. Va. 2011).

<sup>52</sup> *Id.*

<sup>53</sup> *Id.* at 342 (internal quotation marks omitted).

consider the action “sufficiently significant to merit intervention, any concern that application of the stay would frustrate necessary government functions is greatly diminished.”<sup>54</sup>

## Conclusion

In recognizing the “expansiveness”<sup>55</sup> of the automatic stay provision, courts have generally interpreted the police or regulatory power exception narrowly—to ensure that the claims are brought by “actual governmental groups.”<sup>56</sup> When a government unit or agency brings an action against a debtor, a court will examine the true nature of the complaint and the complaining party to determine whether the action falls within the police or regulatory power exception. In determining whether the exception applies, a court will consider the purpose and responsibilities of the government unit or agency; the unit or agency’s discretion to bring (or not bring) a claim after a private individual files a complaint against the debtor; the type(s) of relief the unit or agency may award; and whether the unit or agency elected to participate in the proceedings at all. Courts are not required by the statute or urged by the case law to find the presence of all of these factors in order to hold that the complaint falls within the exception. Nor are courts compelled to look for any specific combination of these factors. Therefore, courts must analyze each case on its unique facts to determine whether the claimant’s action falls within

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<sup>54</sup> *Id.* (quoting *United States ex rel. Goldstein v. P & M Draperies, Inc.*, 303 B.R. 601, 604 (D. Md. 2004)).

<sup>55</sup> *Reyes*, 2011 WL 1522337, at \*7.

<sup>56</sup> *Kolbeck*, 444 B.R. at 339 (“[B]oth the statutory language and the legislative history demonstrate that the term ‘government unit’ . . . refers exclusively to actual governmental groups and not to organizations [or private citizens] acting in a governmental capacity.”) (quoting *Hudson River Sloop Clearwater, Inc. v. Revere Copper Prods., Inc. (In re Revere Copper & Brass, Inc.)*, 32 B.R. 725, 727 (S.D.N.Y. 1983)). See *Reyes*, 2011 WL 1522337, at \*7 (holding the stay “should be applied *only* when an action against the debtor has been brought by the government”) (emphasis added); *McMullen v. Seigny (In re McMullen)*, 386 F.3d 320, 325 (1st Cir. 2004) (“[T]he exception contained in subsection 362(b)(4) is to be narrowly construed.”).

the exception. By not allowing an action to come within the exception if the action primarily adjudicates private interests, the courts prevent individual complainants from gaining a pecuniary advantage over other creditors of the debtor—a significant priority of the Bankruptcy Code.<sup>57</sup>



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<sup>57</sup> See *Chao v. Hosp. Staffing Servs., Inc.*, 270 F.3d 374, 390 (6th Cir. 2001).