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## The Regulatory Power Exception to the Automatic Stay

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### Introduction

Upon a filing a petition under title 11 of the United States Code (the "Bankruptcy Code"), all actions against a debtor are generally automatically stayed.<sup>1</sup> While the automatic stay is broad, there are exceptions. Under the regulatory power or police power exception, a governmental unit or organization is not stayed from taking any action "to enforce such governmental unit's or organization's police and regulatory power."<sup>2</sup> Not all actions by a government are immune from the automatic stay. Courts have generally held that an action to effectuate a "public policy" is not stayed, but an action to advance the government's "pecuniary interest" is stayed.<sup>3</sup>

This memorandum explores the regulatory power exception of the automatic stay. Part A of this memorandum will describe the subcategories of the regulatory power exception, namely public policy or public welfare actions. For the purposes of this memorandum, the discussion is limited to government actions against corporations in the environmental and employment law

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<sup>1</sup> 11 U.S.C. § 362(a)(1).

<sup>2</sup> *Id.*

<sup>3</sup> *Kupperstein v. Schall (In re Kupperstein)*, 994 F.3d 673, 677 (1st Cir. 2021) (citation omitted).

spheres, as these are the two major areas where the regulatory exception is asserted. Part B will describe actions in the government's pecuniary interest that do not qualify as exempt.

## **Discussion**

The automatic stay is designed to "give the debtor breathing room by 'stop[ping] all collection efforts, all harassment, and all foreclosure actions.'"<sup>4</sup> This interlude gives debtors an opportunity to "resolve their debts in a more orderly fashion . . . and at the same time safeguards their creditors."<sup>5</sup> Yet, Congress recognized that the automatic stay was "particularly vulnerable to abuse by debtors improperly seeking refuge under the stay in an effort to frustrate *necessary governmental functions*."<sup>6</sup> Thus, the regulatory power exception to the automatic stay intends to discourage debtors from filing bankruptcy petitions" for the purpose of evading impending governmental efforts to invoke the governmental police powers to enjoin or deter ongoing debtor conduct which would seriously threaten the public safety and welfare."<sup>7</sup> Congress instructed that the exception should be construed narrowly.<sup>8</sup>

### **A. Government Actions to Effectuate a Public Policy or Promote Public Welfare Will Not Be Stayed.**

In analyzing "public policy" actions, courts will inquire whether the government is attempting to effectuate public policy or to adjudicate private rights.<sup>9</sup> A government's action to effectuate public policy will not be subject to stay.<sup>10</sup> However, an action to adjudicate private

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<sup>4</sup> Soares v. Brockton Credit Union (*In re Soares*), 107 F.3d 969, 975 (1st Cir. 1997).

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

<sup>6</sup> United States v. Nicolet, Inc., 857 F.2d 202, 207 (3d Cir. 1988) (emphasis added).

<sup>7</sup> McMullen v. Sevigny (*In re McMullen*), 386 F.3d 320, 325 (1st Cir. 2004).

<sup>8</sup> See Corporacion de Servicios Medicos Hospitalarios de Fajardo v. Hon. Luis Izquierdo Mora (*In re Corporacion de Servicios Medicos Hospitalarios de Fajardo*), 805 F.2d 440, 447 (1st Cir. 1986).

<sup>9</sup> See *In re Montalvo*, 537 B.R. 128, 143 (Bankr. D. P.R. 2015).

<sup>10</sup> See *id.*

rights will be stayed.<sup>11</sup> Where the action advances public and private interests, it should be exempt from the stay if "the private interests do not significantly outweigh the public benefit from enforcement."<sup>12</sup>

Bankruptcy courts have reasoned that governmental actions to enforce labor and employment laws promote public policy by "protecting legitimate businesses from unfair competition, and that they are neither intended to adjudicate private rights, nor calculated to advance the government's pecuniary interests."<sup>13</sup> Thus, government actions in relation to fair labor and employment practices are most often found to be exempt from the automatic stay. For instance, the imposition of injunctions and civil penalties under the Fair Labor Standards Act ("FLSA") has been held exempt from the stay.<sup>14</sup> In *Donovan v. Timbers of Woodstock Restaurant, Inc.*, the Northern District of Illinois held that FLSA enforcement proceedings "plainly constitute an exercise of 'police or regulatory power'" and thus are exempt from the automatic stay pursuant to § 362(b)(4).<sup>15</sup> Similarly, courts have found National Labor Relations Board (NLRB) unfair labor practice proceedings to be exempt from the automatic stay pursuant to the police power exception.<sup>16</sup>

Courts have also found that the automatic stay will not apply to governmental actions concerning environmental matters under the public welfare test.<sup>17</sup> For example, courts have held

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<sup>11</sup> *Id.*

<sup>12</sup> *Id.* (citation omitted).

<sup>13</sup> *In re Crockett*, 204 B.R. 705, 708 (Bankr. W.D. Tex. 1997) (citation omitted).

<sup>14</sup> *See, e.g., Donovan v. Timbers of Woodstock Restaurant, Inc.*, 19 B.R. 629, 629 (N.D. Ill. 1981); *Donovan v. Health Care Resources, Inc.*, 44 B.R. 546, 547 (Bankr. W.D. Mo. 1984); *In re Perez*, 61 B.R. 367, 368 (Bankr. E.D. Cal. 1986).

<sup>15</sup> 19 B.R. at 629.

<sup>16</sup> *See N.L.R.B. v. Evans Plumbing Co.*, 639 F.2d 291 (5th Cir. 1981); *see also In re Rath Packing Co.*, 38 B.R. 552 (Bankr. N.D. Iowa 1984).

<sup>17</sup> *See, e.g., United States v. Nicolet, Inc.*, 857 F.2d 202, 207 (3d Cir. 1988); *City of New York v. Exxon Corp.*, 932 F.3d 1020, 1023–24 (2d Cir. 1991); *Tennessee Department of Health and*

that proceedings to recover clean-up costs of removing hazardous waste are exempt from the automatic stay because such actions seek to ensure that responsible parties are held accountable for "environmental misdeeds."<sup>18</sup> Thus, where the primary purpose of the action is to deter environmental misconduct, the regulatory exception is likely to apply.<sup>19</sup> Additionally, action to enforce violations of environmental protection statutes such as the Clean Air Act and Oil Pollution Act have been held to be valid exercises of the police power, and thus not stayed.<sup>20</sup>

### **B. Government Actions to Further Its Pecuniary Interest Will Be Stayed.**

Under the "pecuniary purpose" analysis, courts will evaluate whether the government's proceedings "seek to enforce a matter of public safety and welfare, . . . or its pecuniary interest."<sup>21</sup> The governmental action will be exempt from the stay if it was not brought primarily to benefit the government's pecuniary interest.<sup>22</sup> A government action with a pecuniary component will not necessarily prevent the action from coming within the scope of the exception; the action will only be stayed if it is "pursued *solely* to advance a pecuniary interest of the governmental unit."<sup>23</sup>

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Environment, and the Tennessee Water Quality Board v. Commerce Oil Company (*In re* Commerce Oil Co.), 847 F.2d 291, 294–96 (6th Cir. 1988); United States v. Federal Resources Corp., 525 B.R. 759 (Bankr. D. Idaho 2015).

<sup>18</sup> See *Nicolet, Inc.*, 857 F.2d at 210; see also *Penn Terra Ltd. v. Dep't of Env't Servs.*, 733 F.2d 267, 278 (3d Cir. 1984); *In re Commonwealth Oil Refining Co., Inc.*, 58 B.R. 608, 615 (Bankr. W.D. Tex. 1985).

<sup>19</sup> See *Nicolet, Inc.*, 857 F.2d at 2010; see also *City of New York v. Exxon Corp.*, 923 F.2d 1020, 1024 (2d Cir. 1991).

<sup>20</sup> See *U.S. v. LTV Steel Co., Inc.*, 269 B.R. 576 (Bankr. W.D. Pa. 2001); see also *U.S. v. Oil Transport Co., Inc.*, 172 B.R. 834 (Bankr. E.D. La. 1994).

<sup>21</sup> *In re Montalvo*, 537 B.R. 128, 143 (Bankr. D. P.R. 2015).

<sup>22</sup> See *id.*

<sup>23</sup> *Universal Life Church, Inc. v. United States (In re Universal Life Church, Inc.)*, 128 F.3d 1294, 1297 (9th Cir. 1997) (emphasis added).

A governmental action to prevent fraud, even when seeking some sort of monetary relief, can pass the pecuniary interest test and fall within the regulatory power exception to the stay.<sup>24</sup> The Southern District of Texas found in *In re RGV Smiles by Rocky L. Salinas, D.D.S. P.A.* that state court action against debtors pursuant to the Texas Medicaid Fraud Prevention Act falls within the exception to the automatic stay.<sup>25</sup> Similarly, in *In re Bloomfield Nursing Operations*, the state of New Mexico argued that the automatic stay provision in the Bankruptcy Code did not apply to its Medicaid fraud enforcement actions against Chapter 11 debtors because the government's actions fell within the regulatory power exception.<sup>26</sup> The Court there agreed with the state, holding that the action was being brought for regulatory purposes, namely to prevent future fraudulent activities.<sup>27</sup> The Court reiterated that the fact that monetary relief is sought does not preclude the action from coming within the regulatory power exception.<sup>28</sup> In fact, "[w]hen the government seeks to impose financial liability on a party, it is plainly acting in its police or regulatory capacity—it is attempting to curb certain behavior . . . by making the behavior that much more expensive."<sup>29</sup>

The regulatory power exception does not apply to a governmental unit's action that is *only* for the purpose of protecting its pecuniary interest in property of the estate.<sup>30</sup> In *In re THG Holdings*, the Centers for Medicare and Medicaid Services (CMS) withheld postpetition Medicare payments to True Health laboratory.<sup>31</sup> There, the Court held that CMS' withholding of

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<sup>24</sup> See *In re RGV Smiles by Rocky L. Salinas, D.D.S. P.A.*, 626 B.R. 278, 291 (Bankr. S.D. Texas 2021).

<sup>25</sup> See *id.*

<sup>26</sup> See *In re Bloomfield Nursing Operations, LLC*, 609 B.R. 185, 190 (Bankr. N.D. Tex. 2019).

<sup>27</sup> See *id.* at 192.

<sup>28</sup> See *id.*

<sup>29</sup> See *id.* (quoting *SEC v. Brennan*, 230 F.3d 65, 72–73 (2d Cir. 2000)).

<sup>30</sup> See *In re THG Holdings LLC*, 604 B.R. 154, 161 (Bankr. D. Del. 2019) (emphasis added).

<sup>31</sup> *Id.* at 158.

post-petition reimbursement payments did not fall within the police power exception because the action was not "for any purpose other than protecting its pecuniary interest in property of the estate over the interests of other unsecured creditors."<sup>32</sup> The Court stated that this type of behavior by the governmental unit was exactly the conduct that the pecuniary interest test was aimed at preventing.<sup>33</sup> Additionally, there was no evidence that CMS acted in an effort to enforce any public policy.<sup>34</sup> As such, where a governmental unit's proceeding against a debtor is purely for pecuniary interest without the enforcement of any public policy, the regulatory exception will not apply, and the proceeding will be stayed.<sup>35</sup>

## **Conclusion**

The automatic stay allows debtors breathing room and an opportunity to organize and resolve their debts.<sup>36</sup> The automatic stay is not absolute, and exceptions exist. Under the police power exception, a governmental action or proceeding is exempted from the automatic stay when that action or proceeding is "to enforce such governmental unit's or organization's police and regulatory power."<sup>37</sup> To determine whether the action falls within the organization's police and regulatory power, courts will evaluate whether the action is to effectuate a public policy, in which the exception would apply, or is in the government's pecuniary interest, in which the exception would not apply.<sup>38</sup> Where the governmental unit is acting in the interest of labor and employment fairness, to deter fraudulent activity, or to prevent environmental misdeeds, courts are likely to find that the government action falls within the regulatory exception and is

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<sup>32</sup> *Id.* at 161.

<sup>33</sup> *See id.*

<sup>34</sup> *See id.*

<sup>35</sup> *See id.*

<sup>36</sup> *See In re Soares*, 107 F.3d 969 at 975.

<sup>37</sup> *Id.*

<sup>38</sup> *See In re Kupperstein*, 994 F.3d at 677.

exempted from the stay. On the other hand, where the government is acting purely in its own pecuniary interest, the exception will not apply, and the stay will be enforced.