ALERT MEMORANDUM

Supreme Court Holds Mere Retention of Property Does Not Violate Automatic Stay Under §362(a)(3) of the Bankruptcy Code

January 19, 2021

On January 14, 2021, the United States Supreme Court (the "Court") issued an 8-0 opinion in *City of Chicago v. Fulton*, holding that the "mere retention" of property of the bankruptcy estate does not violate the automatic stay under §362(a)(3) of the Bankruptcy Code where the party had not taken further affirmative actions to exercise control over the property.[1] The Court had granted certiorari to address a split among several Circuit Courts of Appeals as to whether an entity that passively retains possession of debtor property has an affirmative obligation to return that property under 11 U.S.C. §362(a)(3), even prior to the debtor seeking return of the property (or "turnover") under §542. In vacating and remanding the decision of the Court of Appeals for the Seventh Circuit below, the Court addressed only the narrow issue of whether the phrase "to exercise control" under §362(a)(3) requires the affirmative turnover of estate property to avoid an automatic stay violation, leaving open the question of whether the retention of debtor property could violate other subsections of §362(a) even before a debtor affirmatively seeks turnover under §542.

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[1] *City of Chicago v. Fulton*, 592 U.S. ___ (2021).

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Background and Procedural History

The proceedings in this case arise out of four individual bankruptcy cases which were consolidated on appeal.[2] Prior to filing for bankruptcy, the City of Chicago (the "City", or "Petitioner") impounded the vehicles of Robbin Fulton, Timothy Shannon, George Peake and Jason Howard (collectively, the "Respondents") for failure to pay multiple traffic fines.[3]

After Respondents filed for bankruptcy under chapter 13, each sought the return of their vehicle, but Petitioner refused, arguing that it needed to maintain possession of the vehicles to maintain the perfection of its possessory liens, and would only return the vehicles when Respondents each paid their outstanding fines in full.[4] The bankruptcy courts each held that the City's retention of the vehicles constituted "exercis[ing] control over property of the estate" in violation of §362(a)(3), and ordered the vehicles' return.[5]

The Seventh Circuit Opinion

On appeal, the Seventh Circuit affirmed each bankruptcy court's decision.[6]

In so holding, the Seventh Circuit relied on its prior decision in *Thompson v. General Motors Acceptance Corp.*, 566 F.3d 699 (7th Cir. 2009), wherein a creditor refused to release a debtor's car, which had been seized due to the debtor's default on his car payments.[7] In *Thompson*, the Seventh Circuit held that passively holding an asset satisfied the Bankruptcy Code's definition of "exercise control" under §362(a)(3).[8] The Seventh Circuit also reaffirmed its prior holding in *Thompson* that §362(a)(3) "becomes effective immediately upon filing the petition and is not dependent on the debtor first bringing a turnover action [under §542(a)]."[9] As a result, the City's obligation to return the impounded vehicles arose automatically—and immediately—upon the owners' chapter 13 filings.

The Seventh Circuit underscored that its reading of §362 satisfied the fundamental purpose of the Bankruptcy Code: "to allow the debtor to regain his financial foothold and repay his creditors."[10] The panel reasoned that, in order to regain that foothold, "a debtor must be able to use his assets while the court works with both debtor and creditors to establish a rehabilitation and repayment plan."[11] In plain terms, the Seventh Circuit determined that an individual debtor's ability to rehabilitate would be hobbled by an inability to use their car, for example, to commute to work.

The Seventh Circuit also noted that its view of §362(a)(3) aligned with the view held by the majority of Circuits.[12] The Second, Eighth and Ninth Circuits all previously had found that continued retention of debtor property constituted unlawful exercise of control over that property in violation of the automatic stay.[13] By contrast, the Third and Tenth Circuits had

[2] *City of Chicago v. Fulton*, 592 U.S. ___ (2021) at 2; *In re Fulton*, 926 F.3d 916, 920 (7th Cir. 2019).
[3] *In re Fulton*, 926 F.3d at 920.
[4] *Id*.
[5] *Id*. The bankruptcy court in Shannon's case also held that the City's conduct violated additional components of the automatic stay, including §§362(a)(4) and (a)(6). *Id*. at 926, n. 1.
[6] *Id*. at 920.
[7] *Thompson*, 566 F.3d at 700.
[8] *Thompson*, 566 F.3d at 702 ("The primary goal of reorganization bankruptcy is to group all of the debtor's property together in his estate such that he may rehabilitate his credit and pay off his debts; this necessarily extends to all property, even property lawfully seized pre-petition.") *citing U.S. v. Whiting Pools*, 462 U.S.198 at 203–04 (1983).
[9] *In re Fulton*, 926 F.3d at 924; *Thompson*, 566 F.3d at 702.
[10] *In re Fulton*, 926 F.3d at 925, *citing Thompson*, 566 F.3d at 706.
[11] *In re Fulton*, 926 F.3d at 925 (internal citations and quotations omitted).
[12] *In re Fulton*, 926 F.3d at 925.
[13] *In re Weber*, 719 F.3d 72, 81–82 (2d Cir. 2013) (secured creditor's refusal to promptly return vehicle of chapter 13 debtor upon bankruptcy filing constituted unlawful exercise of control, notwithstanding the fact that the debtor had not provided adequate protection for the creditor's security interest in the vehicle); *In re Del Mission Ltd.*, 98 F.3d 1147, 1151–52 (9th Cir. 1996) (State of California's continued retention of taxes which it had been ordered to repay violated automatic stay); *In re Knaus*, 889 F.2d 773, 774–75 (8th Cir. 1989) (failure to return goods purchased on

found that §362(a)(3) only prohibited affirmative acts and not passive possession.[14]

Finally, the Seventh Circuit held that the City was not protected by §362(b)(3), which provides a limited exception to the automatic stay for perfection of certain lienhold interests,[15] nor §362(b)(4), which limits the applicability of the automatic stay to certain exercises of governmental police and regulatory power.[16]

The City appealed to the Court, which granted certiorari to resolve the Circuit split over whether passive possession of estate property, without more, violates §362(a)(3).[17]

The Supreme Court's Decision

The United States filed an amicus brief in support of Petitioner, and was granted leave to participate in oral argument as amicus curiae.[18] Among amici for Respondents was a group of nonprofit organizations, including the American Civil Liberties Union, and the Cato Institute.[19] The group's amicus submission provided context on a nationwide trend of state and municipal governments increasingly turning to fines and fees to raise revenue, and in particular, traffic ticketing enforced by impoundment, which the group noted disproportionally affected low income drivers and people of color.[20]

Majority Opinion

On January 14, 2021, Justice Alito delivered the unanimous opinion of the Court; Justice Sotomayor also filed a concurring opinion.[21]

In a succinct, seven page opinion, the Court held that the "mere retention" of estate property does not violate the automatic stay under §362(a)(3) of the Bankruptcy Code.[22] In arriving at this narrow holding, the Court determined that the "most natural reading" of the language in §362(a)(3) is that it "prohibits affirmative acts that would disturb the status quo of estate property" as of the petition date.[23] Thus, because the City had taken no affirmative acts to collect its prepetition debt, but rather only passively continued its retention of the vehicles, there was no disturbance of the status quo and, therefore, no "exercise of control" over estate property in violation of §362(a)(3).[24]

In arriving at its decision, the Court considered Respondents' reading—which would require the affirmative transfer of estate property upon commencement of a bankruptcy case—and found that it would result in two "serious problems."[25]

credit, which creditor had seized prepetition, violated automatic stay).

[14] *In re Cowen*, 849 F.3d 943, 950 (10th Cir. 2017) (holding that "only affirmative acts to gain possession of, or to exercise control over, property of the estate violate § 362(a)(3)" in case where creditors of chapter 13 debtor refused to return vehicles which had been repossessed); *In re Denby-Peterson*, 941 F.3d 115, 132 (3d Cir. 2019) (holding that "a creditor in possession of collateral that was repossessed before a bankruptcy filing does not violate the automatic stay by retaining the collateral post-bankruptcy petition" and rejecting argument that §542(a)'s turnover provision is self-executing).

[15] *In re Fulton*, 926 F.3d at 927–29.

[16] *Id.* at 929–31. The Seventh Circuit declined to reach the additional holdings of the lower courts with respect to §§362(a)(4) and (a)(6). *Id.* at 926, n. 1.

[17] *City of Chicago v. Fulton*, 592 U.S. ___ (2021) at 3, n. 1.

[18] The National Association of Counties, together with the National League of Cities, the United States Conference of Mayors, et. al., and a group of bankruptcy law professors also filed amicus briefs in support of Petitioner.

[19] The National Consumer Bankruptcy Rights Center, the National Association of Consumer Bankruptcy Attorneys, and Legal Aid Chicago; the National Association of Bankruptcy Trustees; and the National Association of Chapter Thirteen Trustees, among others, filed amicus briefs in support of Respondents.

[20] *Brief for the American Civil Liberties Union et al. Supporting Respondents as Amicus Curiae, Chicago v. Fulton*, 19-357 (March 18, 2020).

[21] Recently installed Justice Amy Coney Barrett, who previously sat on the Seventh Circuit, took no part in the consideration or decision of the case. *City of Chicago v. Fulton*, 592 U.S. ___ (2021).

[22] *Id.* at *1.

[23] *Id.* at *3. The Court clarified that its opinion did not foreclose that possibility that in certain circumstances an omission might qualify as an "act" and consequently an "exercise of control" in violation of §362(a)(3). *Id.* at *4.

[24] *Id.* at *1.

[25] *Id.* at *5.

First, the Court determined that such a reading would render the central purpose of §542 superfluous.[26] In the Court's view, §542 acts as the primary means by which a debtor seeks turnover of estate property and, if Respondents' interpretation of "to exercise control" were adopted, it would effectively transform §362(a)(3) into the "chief provision governing turnover."[27] Rather than accept this result, the Court observed that "[t]he better account of the two provisions is that §362(a)(3) prohibits collection efforts outside the bankruptcy proceeding that would change the status quo, while §542(a) works within the bankruptcy process to draw far-flung estate property back into the hands of the debtor or trustee."[28]

Second, the Court found that Respondents' reading would render the commands of §362(a)(3) and §542 contradictory. Because §542 carves out certain exceptions to turnover, reading §362(a)(3) to require automatic turnover would seemingly override, or at least countermand, the specified exceptions under §542.[29] Respondents had argued that there was no conflict between §362(a)(3) and §542(a) in part because §542(a) was both self-executing and automatic insofar as it states that an entity in possession of debtor property "shall" return the property (or its value) to the debtor.[30] The Court rejected this reading, although it declined to "decide how the turnover obligation operates."[31]

Finally, the Court observed that legislative history confirmed its reading of the relevant statutes. Although both §362(a)(3) and §542(a) were enacted in the original Bankruptcy Code in 1978, the phrase "or to exercise control over the property of the estate" was not added into §362(a)(3) until 1984. The Court found that had Congress wished to make the phrase "exercise control" in §362(a)(3) an affirmative and automatic turnover provision, it would have at least included a cross-reference to §542(a) or otherwise indicated its intent to do so.[32] In reaching this holding, the Court implicitly rejected the Seventh Circuit's finding that this Congressional amendment was intended for the very purpose the Court rejected: to make the stay "more inclusive by including conduct of creditors who seized an asset pre-petition."[33]

Finally, the Court declined to decide whether other provisions in §362, namely §§362(a)(4) and (a)(6), might require automatic turnover of estate property, noting that the Seventh Circuit had not reached either issue.[34]

Sotomayor's Concurrence

Justice Sotomayor issued a concurring opinion to emphasize that the limited nature of the Court's holding. In particular, in the Supreme Court's opinion was limited to §362(a)(3), and did not bear on any other part of the automatic stay codified in §362, including §362(a)(4) and §362(a)(6), which prohibit under the automatic stay "any act to create, perfect, or enforce any lien against property of the estate," and "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of [the bankruptcy case]," respectively. Justice Sotomayor's concurrence went one step further than the Court's express agnosticism on the issues, suggesting that "[t]he City's conduct may very well violate one or both of these other provisions."[35]

[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] *Id.* at *6.
[30] *Brief for Respondents, Chicago v. Fulton*, 19-357 (March 4, 2020) at 34–38. By contrast, Petitioners had emphasized that the various conditions precedent to turnover under §542 mean that it cannot be self-effectuating, but instead must be effectuated 'by virtue of judicial action.'" *Brief for Petitioners*, *Chicago v. Fulton*, 19-357 (Feb. 3, 2020) at 37 (internal citations and quotations omitted).
[31] *City of Chicago v. Fulton*, 592 U.S. at *7.
[32] *Id*. at *6-7.
[33] *In re Fulton*, 926 F.3d at 920 (internal quotations and citations omitted).
[34] *City of Chicago v. Fulton*, 592 U.S. at 7, n.2. (The Court acknowledged that in respondent Shannon's case, "the Bankruptcy Court determined that by retaining Shannon's vehicle and demanding payment, the City also had violated §§ 362(a)(4) and (a)(6). Shannon presented those theories to the Court of Appeals, but the court did not reach them. 926 F.3d at 926, n. 1. Neither do we.").
[35] *City of Chicago v. Fulton*, 592 U.S. ___ (2021) (Sotomayor, concurring) at *2.

Justice Sotomayor also observed that the City's policy of refusing to return impounded vehicles, "[r]egardless of whether [it]. . . satisfies the letter of the Code, [] hardly comports with its spirit."[36] Indeed, Justice Sotomayor observed, picking up on arguments raised by an amicus submission by a group of non-profit organizations, that having a car was critical for many chapter 13 debtors, and that, paradoxically, "[b]y denying [Respondent] Peake access to the vehicle he needed to commute to work, the City jeopardized Peake's ability to make payments to *all* his creditors, the City included."[37]

Finally, Justice Sotomayor observed that, in light of the lengthy process required for turnover in adversary proceedings under §542(a), some courts have permitted abbreviated turnover mechanisms, including by simple motion or by expedited proceedings. Justice Sotomayor implicitly approved of these efforts to expedite the return of estate property, but called on "rule drafters and policymakers" to fill any gap left by the Court's ruling.[38]

Implications and Conclusion

In some ways, the Court's opinion is more notable for the issues it leaves unanswered than for the Circuit split it resolves. To be sure, the reversal of the balance of lower court authority on whether passive acts of possession violate §362(a)(3) will have consequences for debtors in cases to come. But, a creditor's retention of debtor property rarely, if ever, occurs in a vacuum. Indeed, in *City of Chicago v. Fulton* itself, the City effectively conceded its actions implicated §362(a)(4), by claiming it needed to retain the cars to maintain the perfection of its liens, and §362(a)(6), by predicating return of the vehicles on payment of the prepetition traffic fines.[39] And, as other courts have observed, certain of these remaining issues involve thorny application of underlying state law, which remains unaddressed by this decision.[40] Nor is it likely to lead to a streamlining of turnover proceedings which, as Justice Sotomayor discusses in her concurrence, can often lead to protracted litigation (all while the property in question remains out of the debtor's reach). Moreover, the Court's perceived conflict between §542's turnover regime and §362's automatic stay would appear to be equally present with any number of potential automatic stay violations that could be triggered by the "mere retention" of debtor property.

At base, this decision produces helpful guidance on the Court's thinking into how to harmonize the statutory and automatic stay and turnover provisions, but it is unlikely to deter litigation over such issues. For debtors, the Court has closed off one argument but leaves open the possibility of pursuing other stay violations if property is not turned over. For creditors, §362 and its broad protections likely will remain a third rail, requiring careful consideration and counsel before taking any action (or, in some cases, refusing to take an action) regarding a debtor's property. As many have come to expect from the Court's increasingly incrementalist approach, it is unlikely that the *City of Chicago v. Fulton* will be the final word on how courts, and parties-in-interest, should construe §362 or §542.

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[36] *Id.* at *2.
[37] *Id.*
[38] *Id.* at *4–5.
[39] *In re Fulton*, 926 F.3d at 920.
[40] *See, e.g.*, *In re Coated Sales*, 147 B.R. 842 (S.D.N.Y. 1992); *In re LoPrirore*, 115 B.R. 462 (Bankr. S.D.N.Y. 1990); *and In re Metromedia Fiber Network, Inc.*, 290 B.R. 487, 489 (Bankr. S.D.N.Y. 2003).