The Supreme Court Teaches A Lesson In Passive Non-Aggression: City of Chicago v. Fulton

By Daniel E. Burgoyne, Christian R. Jenner or Christopher M. Wildenhain

In a recent decision, the U.S. Supreme Court gave a narrow win to creditors in a dispute over the proper interpretation of the automatic stay provisions in the Bankruptcy Code, ruling that creditors may passively retain a debtor's property after the debtor files for bankruptcy. The decision provides some concrete benefits for creditors, but hardly represents a license for aggressive collection measures. Careful adherence to the bankruptcy code is necessary to realize the decision's full benefit.

The Issue

When a debtor files for bankruptcy, the filing triggers an automatic stay that halts all collection activity and creates the bankruptcy estate (a legal construct that consists of most of the debtor's property). The goal of the stay is to permit the bankruptcy to go forward in an orderly fashion, preventing one creditor from unfairly gobbling up the debtor's assets at the expense of other creditors. But what happens if a creditor is in control or possession of a debtor's property when the debtor files for bankruptcy? Does the filing of a bankruptcy petition require the creditor to return the property to the debtor? The Supreme Court confronted this precise question in *City of Chicago v. Fulton*.

In *Fulton*, the city of Chicago (the "City") impounded four debtors' cars for failure to pay fines for motor vehicle infractions. After their cars were impounded, the debtors filed for Chapter 13 bankruptcy. When debtors file for Chapter 13 bankruptcy, they retain possession of their property and work toward completing a court-approved repayment plan. For a Chapter 13 bankruptcy to succeed, therefore, the debtors must continue earning an income so they can pay their creditors. Section 362(a)(3) of the Bankruptcy Code furthers that goal by providing that the filing of a bankruptcy petition "operates as a stay" of any act "to exercise control over property" of the bankruptcy estate.

In need of their cars to help pay down their debt, the *Fulton* debtors contended that the automatic stay in 11 U.S.C. § 362(a)(3) required the City to cease "exercising control" over the debtors' property and return their vehicles. The City refused. It claimed that the debtors needed to use the Bankruptcy Code's turnover provisions in 11 U.S.C. § 542(a) to formally request that the City relinquish their cars. The difference between the two statutory sections is one of timing and convenience. If § 362 controlled, simply filing a bankruptcy petition would require the City to return the vehicles to the debtors. On the other hand, if § 542 controlled, the debtors might need to launch an adversary proceeding—a separate lawsuit within a bankruptcy—to get their cars back.

The Court's Decision

Siding with the City, the Court held that simply filing a bankruptcy petition did not require the City to immediately return the debtors' cars, and that the debtors instead must seek § 542(a) turnover orders to recover their property. The Court reasoned that the language used in § 362(a)(3) suggests that "merely retaining possession" of the debtor's property did not violate the automatic stay. Under that provision, the filing of a bankruptcy petition operates as a "stay" of "any act" to "exercise control" over the property of the estate. "Taken together," the Court concluded, 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," but not mere passive possession of such property.

The Court acknowledged that there was some ambiguity in § 362(a)(3)'s text. But, "any ambiguity" was "resolved decidedly in the City's favor" by the existence of a separate provision—§ 542—that expressly governs the turnover of estate property to the debtor or bankruptcy trustee. Reading § 362(a)(3) to cover mere

retention of property (and require its return), as the debtors contended, would "render the central command of § 542 largely superfluous." The better account of the two provisions, the Court concluded, "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."

Implications and Takeaways

Although offering a meaningful protection to creditors, the *Fulton* decision is very narrow, limited to a creditor's passive possession of a debtor's property. *Fulton* does not seem to protect creditors who are in the process of acquiring possession of a debtor's property when the petition is filed, as opposed to those who have already taken possession. The case, moreover, does not give license to creditors to continue collection efforts after the debtor seeks bankruptcy protection. It strongly suggests the opposite. In wrapping up its opinion, the Court noted that the bankruptcy court had concluded that the City's decision to retain a debtor's vehicle and demand payment in exchange for the car's return violated the automatic stay. Although the Supreme Court declined to weigh in on that ruling, the Court's observation serves as a reminder that a creditor in possession of a debtor's property after the filing of a bankruptcy petition must be very careful. Demands to "pay up" in exchange for a return of the bankruptcy debtor's property would likely violate the automatic stay. Those who make such demands with knowledge of the bankruptcy can be subject to various penalties, including an award of any actual damages the debtor suffers, costs, attorney's fees, and in an appropriate case, punitive damages. Creditors must still remain vigilant in their contacts with bankruptcy debtors to avoid running afoul of the automatic stay.

For the creditor that has already taken possession of its collateral (whether it be a debtor's car, construction equipment, or some other property), *Fulton* does, however, work some appreciable benefits. First, *Fulton* makes clear that this category of creditor does not violate the automatic stay (and risk sanctions) by simply retaining property it acquired prior to the bankruptcy filing. Second, although the creditor can still be required to return the property, the debtor must now bring § 542 proceedings within the bankruptcy to obtain that result. Because of the time and expense associated with these proceedings, the creditor has more time and therefore more leverage to negotiate an advantageous arrangement with the debtor for adequate protection of the creditor's rights in the collateral before returning the property.

But to realize this second benefit, a creditor who takes possession of a debtor's property only to see the debtor go into bankruptcy would be well-advised to consult counsel. Bankruptcy proceedings are "choppy seas" for creditors to navigate on their own. Counsel can assist the creditor in determining whether it is possible to seek relief from the automatic stay to proceed with a sale of the debtor's property. Further, if the debtor is entitled to keep the collateral during the bankruptcy, counsel can assist the creditor in obtaining the best possible adequate protection arrangement. It is important to let counsel negotiate these types of accords to avoid possible accusations that the creditor has demanded payment in violation of the automatic stay (and is subject to the sanctions that the Supreme Court alluded to at the end of *Fulton*). In this fashion, creditors can fully capitalize on the narrow protections that *Fulton* offers, without venturing outside its passive possession safeharbor.

Partridge Snow & Hahn's Litigation Practice Group is ready to answer questions regarding the implications of this decision. For more information, contact Daniel E. Burgoyne, Christian R. Jenner or Christopher M. Wildenhain.

Date Created
February 16, 2021