Give Me Back My Stuff! Mere Retention Of Property Does Not Violate The Bankruptcy Code!

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In *City of Chicago v. Fulton*, the Supreme Court held that mere retention of property does not violate the automatic stay imposed by § 362(a)(3) of the Bankruptcy Code.[1] You may be thinking: "I am a litigator, this article does not apply to me. I now intend to stop reading this article." Not so fast.

Consider the following hypothetical situation that you likely may have seen before: your client and BrokeCo decide to do business with one another. As a protective measure, your client takes a security interest in some of BrokeCo's assets. Inevitably, a lawsuit arises because BrokeCo fails to pay your client's invoices. Your client obtains possession of the personal property in which BrokeCo granted a security interest. BrokeCo immediately responds with a bankruptcy filing and demands return of the property under § 362(a)(3) of the Bankruptcy Code.

Is your client required to return the personal property to BrokeCo? Is your client violating the bankruptcy automatic stay if it does not? While *Fulton* resolved a circuit split holding that mere retention of property does not violate the automatic stay, there are still plenty of unanswered questions about this hypothetical - but all too real - situation.

Upon the filing of a bankruptcy petition, the Bankruptcy Code imposes an automatic stay that freezes the assets held in the bankruptcy estate.[2] In turn, this freeze restrains creditors from racing to confiscate the debtor's property. The purpose of the automatic stay is to serve "the debtor's interests by protecting the estate from dismemberment, and it also benefits creditors as a group by preventing individual creditors from pursuing their own interests to the detriment of the others."[3]

To further achieve this end, the Bankruptcy Code contains multiple provisions that prohibit dissipation or allow return of property to the bankruptcy estate.[4] At issue in *Fulton* was the portion of § 362 that imposes the automatic stay on "any act . . . to *exercise control* over property of the estate[.]"[5] Prior to this decision, courts throughout the country struggled to clearly decipher which actions violated § 362(a)(3). Ultimately, the federal circuit courts diverged quite bluntly in their holdings.[6]

The Supreme Court resolved this split in *Fulton*. There, the City of Chicago repossessed and impounded individuals' vehicles for failure to pay certain fines.[7] After filing for bankruptcy, the debtors requested that the City return their vehicles.[8] The City refused.[9] The debtors brought suit, arguing that the City's retention of their vehicles violated the automatic stay imposed by § 362(a)(3) of the Bankruptcy Code.[10] Ultimately, the Seventh Circuit sided with the debtors, holding that the City exercised control over the debtors' property when it refused to return their vehicles, thereby violating § 362(a)(3).[11] The Supreme Court reversed in favor of the City.[12] Considering the full text and the history of the Bankruptcy Code, the Court held that a violation of the automatic stay under § 362(a)(3) requires *affirmative* action "that would disturb the

status quo of estate property as of the time when the bankruptcy petition was filed," and that retention alone is not an affirmative action.[13]

At the outset, the Court grounded its decision in two statutory bases. The first was the plain language of § 362(a)(3). The words used in that provision – "stay," "act," and "exercise control" – the Court reasoned, can be read to prohibit only *affirmative* acts.[14] This is because the definition of "act" itself requires that something be done or performed.[15] Likewise, to "exercise control," one must "put into practice or carry out in action."[16] And to "stay" something "suspend[s] judicial alteration of the status quo."[17] Read together, these words mean that *passive* retention of pre-bankruptcy property is not an act to exercise control, and thus cannot violate § 362(a)(3).[18]

Second, reading § 362(a)(3) to prohibit retention of a debtor's property would render another provision of the Bankruptcy Code – § 542 – superfluous.[19] Section 542(a), dubbed the turnover provision, directs an entity in possession, custody, or control of a debtor's property to deliver that property to the trustee, subject to limited exceptions.[20] So, reading § 362(a)(3) to impose a blanket turnover obligation renders § 542, and consideration of its exceptions, purposeless.[21] Instead, a full reading of the Code indicates 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."[22]

The Court discussed the relationship between the automatic stay of § 362(a)(3) and the turnover provisions of § 542 at considerable length. Keep in mind that debtors primarily rush to file bankruptcy to effectuate the automatic stay and thwart eager creditors from picking apart their estate. For this reason, the automatic stay is an incredibly debtor-friendly device. Section 542, on the other hand, is not a product of the automatic stay at all. Rather, it is a provision that empowers a debtor to claw back property into the estate. Accordingly, from the debtor's perspective, a major fault of § 542 is its sluggish administration.[23] Bankruptcy is urgent. A debtor desires to mitigate any additional depletion to his or her estate. And claiming a violation of the automatic stay to either maintain or recoup property is one of the surest and quickest ways to do so. For this reason, the Supreme Court's foreclosure of one of those opportunities is a significant development. But this is not the entire account of the Court's decision. Rather, the Supreme Court hinted at, but declined to opine on, several other avenues that *would* require turnover of debtors' retained property.

First, in response to the City's position that its retention was an omission, not action, the Court noted that in some circumstances, omissions *can* qualify as actions.[24] The Court acknowledged that to exercise control over something means "more than merely having that power."[25] The Court remarked, however, that it did not "definitively rule out the alternative interpretation adopted by the court below and advocated by [the debtors]."[26] What appears to be a brief aside in the opinion is actually quite a significant declaration. The Court did not parse out the nuances of omissions qualifying as acts. But, with this remark, the Court refused to concede that § 362(a)(3) would *never* impose a turnover obligation of retained property. Through this statement, the Court created just enough ambiguity for litigators to probe.

Second, the Court acknowledged, but did not evaluate, the bankruptcy court's holding that the City's actions also violated §§ 362(a)(4) and (a)(6) of the Bankruptcy Code.[27] Section 362(a)(4) applies the automatic stay to "any act to create, perfect, or enforce any lien against property of the estate."[28] Section 362(a)(6) applies the automatic stay to "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case . . . ."[29] Justice Gorsuch picked up on this nuance at oral arguments, questioning whether Section 362(a)(6) would require return of debtors' vehicles even if § 362(a)(3) did not.[30] Ultimately, the Court did not

address the validity of these arguments, leaving these provisions exposed to future debate.

And that is exactly what the Seventh Circuit examined on remand. The Seventh Circuit refused the City's request to "summarily reverse the bankruptcy courts' decisions" that the City's actions also violated §§ 362(a)(4) and (a)(6).[31] Instead, the court stressed that the Supreme Court issued a narrow holding limited to § 362(a)(3), and left subsections (a)(4) and (a)(6) open for consideration.[32] Accordingly, the Seventh Circuit remanded the decision to the bankruptcy court for further analysis of these provisions.[33]

Finally, while the Supreme Court analyzed the relationship between § 362(a)(3) and § 542 at some length, the Court did not decide whether § 542 would require the City to return debtors' vehicles.[34] But, as Justice Sotomayor aptly pointed out in her concurrence, the City's actions may very well violate *any* of these provisions of the Bankruptcy Code.[35]

Fulton initially looks like a win for your client in the hypothetical case involving BrokeCo. The Court's holding resolves a hotly litigated bankruptcy issue. However, the Court's opinion is arguably narrow and contains roadmaps steering litigators onto several other paths to achieve turnover of retained property. We can anticipate that lawyers (and BrokeCo's counsel) will test the bounds of these avenues to obtain return of personal property. After all, the purpose of the Bankruptcy Code is to grant a fresh start to debtors.[36] One way to ensure rehabilitation of the debtors is to allow them to retain possession of their property during the administration of their case. Depriving debtors of their property has the potential to perpetuate financial distress and frustrate debtors' ability to repay creditors – a result that challenges the principal purpose of the Bankruptcy Code.[37]

ENDNOTES

1. *Chicago of Chicago v. Fulton*, 141 S. Ct. 585, 592 (2021).
2. 11 U.S.C. § 362(a).
3. *Fulton*, 141 S. Ct. at 589.
4. *See generally* 11 U.S.C. § 362; 11 U.S.C. §§ 541-550.
5. *Fulton*, 141 S. Ct. at 589; 11 U.S.C. § 362(a)(3) (emphasis added).
6. *California Empl. Dev. Dep't v. Taxel (In re Del Mission)*, 98 F.3d 1147, 1151 (9th Cir. 1996) (holding that "the knowing retention of estate property violates the automatic stay of § 362(a)(3)."); *In re Denby-Peterson*, 941 F.3d 115, 119 (3rd Cir. 2019) (holding that "a secured creditor does not have an affirmative obligation under the automatic stay to return a debtor's collateral to the bankruptcy estate immediately upon notice of the debtor's bankruptcy because failure to return the collateral received pre-petition does not constitute an act . . . to exercise control over property of the estate.") (internal quotations and citations omitted)).
7. *Fulton*, 141 S. Ct. at 589.
8. *Id*.
9. *Id*.
10. *Id*.
11. *Id*. (citing *In re Fulton*, 926 F.3d 916, 924-25 (7th Cir. 2019)).

12. *Id*.
13. *Id*. at 590.
14. *Id*.
15. *Id*. (citing Black's Law Dictionary 30 (11th ed. 2019); Webster's New International Dictionary 25 (2d ed. 1934)).
16. *Id*. (citing Webster's Third New International Dictionary 795 (1993); Webster's New International Dictionary, at 892)).
17. *Id*. (citing *Nken v. Holder*, 556 U.S. 418, 429 (2009) (brackets in original; internal quotation marks omitted)).
18. *Id*; Id. at 592 (Sotomayor, J., concurring).
19. *Id*. at 591.
20. 11 U.S.C. § 542(a).
21. *Fulton*, 141 S. Ct. at 591.
22. *Id*.
23. *Id*. at 594 (Sotomayor, J., concurring).
24. *Id*. at 590 (citing *Thompson v. General Motors Acceptance Corp*., 566 F.3d 699, 702 (7th Cir. 2009) (quoting Merriam-Webster's Collegiate Dictionary 272 (11th ed. 2003)).
25. *Id*.
26. *Id*.
27. *Id*. at 595 n.2.
28. 11 U.S.C. § 362(a)(4).
29. 11 U.S.C. § 362(a)(6).
30. Transcript of Oral Argument at 40-43, *City of Chicago v. Fulton*, 141 S. Ct. 585 (2021) (No. 19-357).
31. *In re Fulton*, Nos. 18-2527, 18-2793, 18-2835, 18-3023, 2021 U.S. App. LEXIS 10322, at *6 (7th Cir. April 12, 2021) (order remanding applicable cases to the bankruptcy court for further proceedings.).
32. *Id*. at *7.
33. *Id*.
34. *Fulton*, 141 S. Ct. at 592.
35. *Id*. (Sotomayor, J., concurring).
36. *Id*. at 593 (Sotomayor, J., concurring) (citing *Marrama v. Citizens Bank of Mass*., 549 U.S. 365, 367 (2007) (quoting *Grogan v. Garner*, 498 U.S. 279, 286 (1991)).
37. *Id*.

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