Supreme Court Clarifies That Section 362 (a)(3) Does Not Prohibit the Mere Retention of a Debtor's Property

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The Supreme Court has lowered (but not eliminated) the risk that a creditor violates the automatic stay by retaining a debtor's property post-petition. On January 14, 2021, the Supreme Court ruled 8-0 (Justice Barrett abstaining) that the "mere retention" of a debtor's property does not violate section 362(a)(3) of the Bankruptcy Code. *Chicago v. Fulton*, 2021 WL 125106 (Jan. 14, 2021). The Supreme Court's ruling resolves a longstanding circuit split regarding whether section 362(a)(3) imposes an affirmative duty on creditors to turn over a debtor's property upon a bankruptcy filing and overrules Ninth Circuit precedent on the issue.

Circuit Split

Section 362(a)(3) of the Bankruptcy Code provides that a bankruptcy filing "operates as a stay, applicable to all entities, of . . . any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." 11 U.S.C. § 362(a)(3). Because the language of section 362(a)(3) is unclear whether the mere retention of estate property constitutes an "act to . . . exercise control over property of the estate," a circuit split developed.

On the one hand, in several circuits, including the Ninth Circuit prior to *Fulton*, the "knowing retention" of estate property violates the automatic stay. *See In re Del Mission Ltd.*, 98 F.3d 1147, 1151 (9th Cir. 1996); *accord In re Weber*, 719 F.3d 72 (2d Cir. 2013); *In re Knaus*, 889 F.2d 773 (8th Cir. 1989). These courts reasoned that the purpose of the automatic stay is best served by putting "the onus to return estate property . . . upon the possessor," rather than requiring "the debtor to pursue the possessor." *Del Mission*, 98 F.3d at 1151.

On the other hand, in a few circuits, including the Third Circuit pursuant to a 2019 ruling, section 362(a)(3) is only violated by an "affirmative act to exercise control." *In re Denby-Peterson*, 941 F.3d 115, 125 (3d Cir. 2019); *accord In re Cowen*, 849 F.3d 943 (10th Cir. 2017); *U.S. v. Inslaw, Inc.*, 932 F.3d 1467 (D.C. Cir. 1991). These courts emphasized the plain language of section 362(a)(3) and observed that "[i]f Congress had meant to add an affirmative obligation," it would likely have been included in the Bankruptcy Code's turnover provision (section 542). *Cowen*, 849 F.3d at 949.

The Seventh Circuit in *In re Fulton*, 926 F.3d 916 (7th Cir. 2019), sided with the Ninth Circuit and other courts adopting the "majority rule" that section 362(a)(3) imposes an affirmative duty on creditors to return estate property. Accordingly, the Supreme Court granted certiorari in *Fulton* to resolve the circuit split.

Chicago v. Fulton

Fulton was a consolidation of several cases, and the operative facts in each such case were the same and very straightforward. In short, the city of Chicago impounded each debtor's vehicle for failure to pay fines relating to traffic infractions. Each debtor subsequently sought chapter 13 bankruptcy relief and requested that the city of Chicago turn over his or her vehicle, which the city refused to do. In each such case, the bankruptcy court held that the city's refusal violated section 362(a)(3). The Court of Appeals affirmed all of the bankruptcy court opinions in a consolidated ruling in 2019.

The Supreme Court, however, reversed the Seventh Circuit and therefore effectively overruled precedent in at least the Second, Eighth and Ninth Circuits. Writing for the Court, Justice Alito observed (emphasis added) that the operative words from section 362(a)(3)—"stay, act, exercise"—suggest that section 362(a)(3) "halts any affirmative act that would alter the status quo as of the time of the filing of a bankruptcy petition." Justice Alito went further and suggested that to the extent any ambiguity in section 362(a)(3) remains, the Court's interpretation is supported by section 542. Section 542 requires a person or entity in possession of a debtor's property to "deliver to the trustee, and account for" any such property. 11 U.S.C. § 542. Although section 542 imposes this obligation on creditors, Justice Sotomayor (in a concurrence) observed that a debtor seeking to enforce this right must usually commence an adversary proceeding in the bankruptcy case to get a "turnover order" from the bankruptcy court and may also be required to provide adequate protection to the party returning the property.

In the Court's view, the majority rule that a mere retention of estate property may violate the automatic stay would "render the central command of [section 542] largely superfluous" and create a conflict between sections 362(a)(3) and 542 with respect to property of inconsequential value (which is carved out from section 542's turnover mandate). *Id.* at *3-4. The Court noted, however, that its ruling only affected the interpretation of section 362(a)(3),

not other subsections of section 362(a), a point emphasized by Justice Sotomayor in a concurring opinion.

Implications for Creditors

The Supreme Court's ruling in *Fulton* should provide some comfort to creditors in the Ninth Circuit (and elsewhere) who act to obtain control or possession of a debtor's property prior to a bankruptcy filing. Following *Fulton*, the mere retention of such property without additional actions or circumstances should not constitute a stay violation, which can (in certain circumstances) result in punitive damages. Still, *Fulton* does not foreclose the possibility that a lone additional action (or change in circumstances) can elevate the mere retention of property into an act that violates section 362(a)(3). *See id.* (noting that section 362(a)(3) "implies that something more than merely retaining power" is required for a stay violation, but not indicating what "something more" could be).

Additionally, creditors should be aware that other provisions of section 362(a) were not at issue in *Fulton* and may be interpreted by bankruptcy courts to prohibit the "knowing retention" of estate property. To use the facts from *Fulton* as an example, it is unclear whether an entity's retention of a vehicle after a bankruptcy filing would constitute an "act to collect, assess, or recover a claim against the debtor . . . ." 11 U.S.C. § 362(a)(3). Indeed, the Seventh Circuit Court of Appeals in *Fulton* did not reach the issue of whether the city of Chicago had violated section 362(a)(4) or (a)(6) by retaining the respondents' vehicles and demanding payment. Accordingly, *Fulton* should not be construed as a get-out-of-jail-free card with respect to retention of a debtor's property after a bankruptcy filing. Rather, the risks and benefits of each act to obtain possession of a debtor's property (or even the mere retention of such property) should be assessed independently and in light of the facts and circumstances of the particular case.

Conclusion

Fulton provides necessary clarification regarding a creditor's potential exposure to stay violations for the mere retention of a debtor's property after a bankruptcy filing. While *Fulton* lowers that risk, it does not, however, eliminate the risk entirely, nor does it eliminate the possibility that something that no longer violates section 362(a)(3) (mere retention of a debtor's property) may nevertheless violate another subsection of section 362(a) or some other provision of the Bankruptcy Code. Accordingly, creditors should embrace the clarity provided by *Fulton* but still exercise caution and discretion when it comes to acts to take possession of a debtor's property (or to retain such possession).

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If you have any questions about the automatic stay, the *Fulton* ruling or any of the issues raised in this alert, please contact any member of the Creditors' Rights & Bankruptcy team.