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# *City of Chicago v. Fulton*: Supreme Court Rules that Passive Retention of Estate Property Does Not Violate the Automatic Stay

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## I. Introduction

On January 14, 2021, the United States Supreme Court held, in an 8-0 decision,[2] that "the mere retention of estate property after the filing of a bankruptcy petition does not violate § 362(a)(3) of the Bankruptcy Code" in *City of Chicago, Illinois v. Fulton.*[3] The decision resolves a deep and longstanding circuit split. Although the issue arose in the context of a chapter 13 case, the Court's holding and analysis will have broad implications for debtors and creditors in both consumer and business bankruptcy cases.

## II. Background

To understand the issue addressed by *Fulton*, a brief review of sections 362, 363, 541 and 542 of the Bankruptcy Code is necessary.[4] To begin, upon the filing of any bankruptcy case, an estate is created by operation of law. Section 541(a)(1) provides, with limited exceptions, that the bankruptcy estate is comprised of all legal or equitable interests of the debtor in property as of the commencement of the case, regardless of where the property is located and by whom it is held.[5]

When a debtor files for relief under the Bankruptcy Code, section 362 prevents creditors from taking further action against the debtor except through the bankruptcy court. To effectuate this result, section 362(a) imposes a broad automatic stay of various acts including, in subsection (3), "any act to obtain possession of property of the estate . . . or to exercise control over property of the estate."[6] The "exercise control over property of the estate" language in section 362(a)(3) was not in the original 1978 enactment of the Bankruptcy Code. Rather, it was added to section 362(a)(3) as part of the Bankruptcy Amendments and Federal Judgeship Act of 1984. Congress provided no substantive legislative history when it amended section 362(a)(3).[7]

Section 542 sets forth a debtor's turnover power, providing:

> Except as provided in subsection (c) or (d) of this section, an entity, other than a custodian, in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease under section 363 of this title, or that the debtor may exempt under section 522 of this title, shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate.[8]

Generally speaking, section 542(a) requires, subject to certain exceptions, an entity in possession, custody or control of estate property to return such property to the debtor unless the property is of inconsequential value or benefit to the estate.

Because section 542(a) expressly references section 363, which sets forth the power of a debtor to use, sell or lease property of the estate, the turnover power is necessarily subject to section 363(e) which requires the bankruptcy court to "prohibit or condition" such use, sale or lease "as is necessary to provide adequate protection of" the non-debtor's interest in the property.[9] Section 363(e) does not specify who (*i.e.* the debtor or the creditor) has the burden to seek adequate protection in conjunction with turnover of estate property, nor does it contain any guidance regarding the timing for such a request (*i.e.* before or after turnover).

The issue in *Fulton* was whether a creditor violates section 362(a)(3) when it passively retains possession of estate property that it lawfully took possession of prior to the petition date. A longstanding and deep circuit split existed in the case law prior to *Fulton*.[10] A majority of circuit courts of appeal had held that passive retention of estate property constitutes a prohibited exercise of control within the scope of section 362(a)(3).[11] Other circuit courts of appeal had adopted the so-called minority view, concluding that Congress' use of the word "act" in section 362(a)(3) evidences that some affirmative post-petition conduct is required in order for a stay violation to be found and, moreover, that sections 542(a) and 363(e) contemplate a legal process that must play out before lawfully possessed estate property must be returned to the debtor.[12]

## III. *City of Chicago, Illinois v. Fulton*

*Fulton* arose from the consolidated cases of four individual debtors whose cars had been impounded by the City of Chicago for unpaid parking fines. The vehicles were impounded prior to the debtors' bankruptcy filings. Each debtor filed a petition under chapter 13, and each petition demanded that the City return the debtor's vehicle, which constituted property of the estate, so that they could use the vehicle to drive to work and generate income to fund their chapter 13 plan. The City refused to return the vehicles until the fines were paid in full. The bankruptcy courts each held that the City's refusal to return the vehicles constituted an act to exercise control over property of the estate in violation of section 362(a)(3).

The cases were consolidated on appeal. The Seventh Circuit described the issue on appeal as follows: "whether the City is obligated to return a debtor's vehicle upon her filing of a Chapter 13 bankruptcy petition, or whether the City is entitled to hold the debtor's vehicle until she pays the fines and costs or until she obtains a court order requiring the City to turn over the vehicle."[13] Relying on its prior precedent in *Thompson*, the Seventh Circuit affirmed the lower courts, holding that retaining a vehicle and precluding the debtor from using it constitutes an act to exercise control over property of the estate in violation of section 362(a)(3). Notably, the court found that section 362(a)(3) "becomes effective immediately upon filing the petition and is not dependent on the debtor first bringing a turnover action" under section 542(a).[14] The Seventh Circuit concluded that, to the extent that the creditor in possession of estate property: (i) believes that one of the defenses to turnover set forth in section 542(a) is applicable (*e.g.*,

the property is of inconsequential value or benefit to the estate), or (ii) seeks adequate protection of its interest in such property pursuant to section 363(e), it is that creditor's burden to raise such arguments with the court *after* the property has been returned to the debtor.

The City appealed and the Supreme Court granted *certiorari* on December 18, 2019 in order to resolve the circuit split. Oral argument was held on October 13, 2020. The Supreme Court framed the issue as "whether an entity violates [the automatic stay] by retaining possession of a debtor's property after a bankruptcy petition is filed."[15]

In an opinion drafted by Justice Alito, the Supreme Court vacated the judgment of the Seventh Circuit and held that mere retention of estate property does not violate section 362(a)(3). Justice Alito reasoned that the "most natural reading" of the terms of section 362(a)(3) prohibits acts that would disturb the status quo. The statute's use of the terms "act" and "exercise," the court reasoned, suggests that section 362(a)(3) "halts any affirmative act that would alter the status quo as of the time of the bankruptcy petition."[16]

The Court conceded that the debtors' interpretation of the statutory language is not definitively ruled out by the statute. Indeed, the Court noted, "omissions can qualify as 'acts' in certain contexts, and the term 'control' can mean 'to have power over.'"[17] Nevertheless, the Court found that any ambiguities in the statutory text are "resolved decidedly in the City's favor" by applying section 542.[18]

The Court found that the debtors' interpretation of the statute creates two logical inequities. First, it renders the central command of section 542 largely superfluous. Such a result is contrary to the well-recognized canon of statutory interpretation against surplusage. The Court reasoned, "Reading 'any act … to exercise control' in § 362(a)(3) to include merely retaining possession of a debtor's property would make that section a blanket turnover provision" thereby nullifying section 542, which expressly governs "[t]urnover of property to the estate."[19] The court explained:

> Under [the debtors'] interpretation, § 362(a)(3), not § 542, would be the chief provision governing turnover – even though § 362(a)(3) says nothing expressly on that question. And § 542 would be reduced to a footnote – even though it appears on its face to be the governing provision. The 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.[20]

Second, the Court reasoned that the debtors' reading would render the central commands of sections 362(a)(3) and 542(a) contradictory to one another. Section 542, the Court noted, carves out exceptions to the turnover command including, for example, where the property is "of inconsequential value or benefit to the estate."[21] The Court noted that the debtors' broad reading of section 362(a)(3) would mandate turnover even where such exceptions are applicable. Citing its prior opinion in *Citizens Bank of Md. v. Strumpf*, the Court stated, "it would be an 'odd construction of § 362(a)(3) to require a creditor to do immediately what § 542 specifically excuses.'"[22] To resolve this apparent conflict, the debtors argued that the exceptions to section 542 should be imputed into section 362(a)(3). The Court disagreed, stating "there is no textual basis for doing so."[23]

In support of its conclusion, the Court reviewed the history of sections 362(a)(3) and 542(a). It noted that the phrase "to exercise control over property of the estate" was not added to section 362(a)(3) until an amendment in 1984. The Court stated that "it would have been odd for Congress" to transform section 362(c)(3) into an affirmative turnover obligation "by simply adding the phrase 'exercise control,'"

especially because that phrase "does not naturally comprehend the mere retention of property" and "does not admit of the exceptions set out in § 542."[24] According to the Court, "Had Congress wanted to make § 362(a)(3) an enforcement arm of sorts for § 542, the least one would expect would be a cross-reference to the latter provision, but Congress did not include such a cross-reference or provide any other indication that it was transforming § 362(a)(3)."[25] A more natural reading of the amendment, the court found, is that it extends the stay "to acts that would change the status quo with respect to intangible property" that is not possessed.[26]

In his conclusion, Justice Alito stated that the Supreme Court's decision does not decide how the turnover provision of section 542 operates, nor does it settle the meaning of the other subsections of section 362. Those issues are left for another day. The Court's holding is expressly limited to the conclusion that mere retention of property does not violate section 362(a)(3).

Justice Sotomayor penned an important concurrence wherein she stated that while the City's actions may technically comply with the Bankruptcy Code, they "hardly comport with its spirit."[27] She emphasized the importance of the return of debtors' vehicles so they may commute to work, make earnings, and otherwise comply with their chapter 13 plans. She also expressed concern that the decision of the Court may have a disproportionate effect on communities of color. Nevertheless, she concluded, any gaps left in the wake of the Court's decision are best resolved by "rule drafters and policymakers, not bankruptcy judges."[28]

## IV. Conclusion

The Court's decision arose in the context of impounded vehicles in chapter 13 cases, but it's reasoning is applicable in any situation where a creditor possesses or control's a debtor's property as collateral for indebtedness on the petition date. The decision clarifies that, standing alone, section 362(a)(3) does not require such creditors to turn the collateral over to the bankruptcy estate immediately upon the debtor's bankruptcy filing, although they may ultimately be required to do so pursuant to section 542(a).

The Court's conclusion that section 542(a), rather than section 362(a)(3), controls is favorable to creditors. As noted, section 542(a) contains various litigable defenses and exceptions that may, in many cases, be asserted by a creditor in good faith including, notably, the right to demand adequate protection of the creditor's interest. The opinion creates substantial negotiating leverage for creditors, and minimizes the risk that they will be held liable for violating the automatic stay under section 362(k) or otherwise.[29]

The Court's conclusion is problematic to debtors on a number of fronts. First, it should be noted that most courts agree that a turnover action must be commenced by an adversary proceeding pursuant to Bankruptcy Rule 7001. The process of litigating a turnover action can be expensive and time consuming. Even the most straightforward adversary proceedings typically take 100 days or more to be resolved. So the section 542 remedy is far from ideal for many debtors.

Second, as the concurrence points out, although the Court's ruling may comply with the statutory language, it is hard to square it with the fresh start policies of the Bankruptcy Code. Take, for example, the individual chapter 13 debtors in *Fulton.* For a chapter 13 case to succeed, the debtor must continue earning an income so he or she can fund their plan and pay creditors. For most, having a vehicle is essential to maintaining employment. In such circumstances, a debtor's ability to eventually obtain possession of their vehicle by way of a turnover action is of little consolation.

Given the importance of allowing chapter 13 debtors to obtain their vehicles so that they can drive to work, it is possible that the legislature will take Justice Sotomayor up on her invitation to clean up the

gaps left by the *Fulton* opinion. In the meantime, however, debtors who need to obtain possession of vehicles (or other property) in the possession of a creditor should plan to make a proposal of adequate protection early in the case and seek to negotiate a consensual turnover of such property.




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[2] As she had not yet been appointed at the time oral argument took place, Justice Barrett took no part in consideration or decision of the case.

[3] *City of Chicago, Illinois v. Fulton*, 141 S. Ct. 585, 589 (2021).

[4] The Bankruptcy Code is set forth in 11 U.S.C. §§ 101 *et seq*. Specific chapters and sections of the Bankruptcy Code are identified herein as "chapter __" or "section __." Similarly, specific rules from the Federal Rules of Bankruptcy Procedure are identified herein as "Bankruptcy Rule __."

[5] 11 U.S.C. § 541(a)(1).

[6] 11 U.S.C. § 362(a)(3).

[7] The legislative history simply states that:

> This amendment makes it clear that . . . the automatic stay against acts to obtain possession of property of or from the estate also encompasses acts to exercise control over such property without the need for actually obtaining such property.

H.R. Rep. No. 96-1195, at 10 (1980).

[8] 11 U.S.C. § 542(a).

[9] 11 U.S.C. § 363(e).

[10] For a comprehensive analysis of the pre-*Fulton* case law addressing this issue, see Gregg, Hon. John T., *Big Things Have Small Beginnings – Passive Retention of Property of the Estate Repossessed Prepetition*, 28 No. 3 J. Bankr. L. & Prac. NL Art. 2 (2019).

[11] *See, e.g.*, *In re Fulton*, 926 F.3d 916 (7th Cir. 2019); *Weber v. SEFCU (In re Weber)*, 719 Fd..3d 72, 81 (2d Cir. 2013); *Thompson v. Gen. Motors Acceptance Corp.*, 566 F.3d 699, 703 (7th Cir. 2009); *Cal Empl. Dev. Dep's v. Taxel (In re Del Mission, Ltd.)*, 98 F.3d 1147 (9th Cir. 1996); *Knauss v. Concordia Lumber Co. (In re Knaus)*, 889 F.2d 773 (8th Cir. 1989).

[12] *See In re Denby-Peterson*, 941 F3d 115 (3d Cir. Cir. 2019); *Davis v. Tyson Prepared Foods, Inc. (In re Garcia)*, 740 Fed. Appx. 163, 164 (10th Cir. 2018); *WD Equip., LLC v. Cowen (In re Cowen)*, 849 F.3d 943, 948 (10th Cir. 2017); *United States v. Inslaw, Inc.*, 932 F.2d 1467, 1474 (D.C. Cir. 1991).

[13] *In re Fulton*, 926 F.3d at 922.

[14] *Id.* at 923-24.

[15] *City of Chicago, Illinois v. Fulton*, 141 S. Ct. at 590.

[16] *Id.*

[17] *Id.* (citing *Thompson v. General Motors Acceptance Corp.*, 566 F.3d 699 (7th Cir. 2009)).

[18] *Id.*

[19] *Id.* at 591.

[20] *Id.*

[21] *Id.* (citing 11 U.S.C. § 542(a)).
[22] *Id.* (citing *Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 20 (1995)).
[23] *Id.*
[24] *Id.* at 591-92.
[25] *Id.* at 592.
[26] *Id.*
[27] *Id.* at 592-93.
[28] *Id.* at 593.
[29] Section 362(k) provides:

> (1) Except as provided in paragraph (2), an individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages.
>
> (2) If such violation is based on an action taken by an entity in the good faith belief that subsection (h) applies to the debtor, the recovery under paragraph (1) of this subsection against such entity shall be limited to actual damages.

11 U.S.C. 362(k).