Secured Creditor Duties Ripe For High Court Consideration

By **Alexandra Dugan and Elizabeth Brusa** (November 21, 2019, 4:36 PM EST)

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The circuit courts continue to wrestle over the duties imposed by the Bankruptcy Code's automatic stay on creditors concerning turnover of a debtor's impounded vehicle. Is a creditor required to automatically turn over the vehicle as soon as the bankruptcy petition is filed, or can it retain possession while awaiting an order of the bankruptcy court adjudicating turnover in an adversary proceeding?

Five circuits, including the U.S. Court of Appeals for the Seventh Circuit in City of Chicago v. Robbin L. Fulton,[1] have held that the automatic stay requires a creditor to immediately release an impounded vehicle when the owner files for bankruptcy. On the other side of the split, the U.S. Court of Appeals for the Tenth and D.C. Circuits have rejected this argument. They have now been joined by the U.S. Court of Appeals for the Third Circuit in In re Denby-Petersen.

The Circuit Split

Under the majority view, a secured creditor, upon learning of the bankruptcy filing, must return the collateral to the debtor, and the failure to do so violates the automatic stay. The majority view relies on the plain language of Section 362(a)(3), which precludes "an[] act ... to exercise control over property of the estate." In other words, the failure to return the vehicle fits within this prohibition. Moreover, according to the majority view, Section 362(a)(3)'s automatic stay provision and Section 542(a)'s turnover provision operates in tandem. The violation of the turnover provision results in a violation of the automatic stay.

On Oct. 28, the Third Circuit in In re Denby-Petersen,[2] rejected the majority view, 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-petition. Following her bankruptcy, the debtor in Denby-Petersen demanded that the creditor release her Chevrolet Corvette, which had been repossessed prepetition. The creditor refused to turn over the vehicle, and the debtor subsequently filed a motion demanding turnover.

The bankruptcy court ordered turnover of the vehicle but denied awarding sanctions to the debtor. The Third Circuit agreed with the bankruptcy court's decision. The court found that a post-petition affirmative act to exercise control over property of the estate is required to find a violation of the automatic stay. Under the facts, mere passive retention of the car post-bankruptcy filing did not constitute such a violation. Additionally, the court rejected the debtor's argument that the Bankruptcy Code's turnover provision was self-effectuating (i.e., automatic).

The court articulated the following framework for processing a debtor's request for return collateral that was repossessed prepetition: (1) debtor files adversary proceeding in bankruptcy case requesting turnover; (2) bankruptcy court determines whether property is

subject to turnover under the Bankruptcy Code; and (3) assuming it is subject to turnover, the court will issue an order compelling creditor to turn over property to the debtor.

In addition to the circuit split, disagreement exists even among the bankruptcy bench in a single district. For example, several decisions came out of the Bankruptcy Court for the Northern District of Illinois requiring immediate turnover. But, in 2017, one Northern District of Illinois bankruptcy judge changed course and did not require the creditor (the City of Chicago) to return the vehicle. The court held that the city had a possessory lien on the vehicle. By keeping the vehicle, the city was maintaining perfection of its possessory lien and did not violate the automatic stay.

Shortly thereafter, four other Northern District of Illinois judges ruled oppositely, each holding that the vehicles should be returned to the debtors. These decisions were appealed to the Seventh Circuit as a consolidated appeal (Chicago v. Robbin L. Fulton).

In Fulton, the Seventh Circuit relied upon its earlier decision in Thompson v. GMAC,[3]to demand that the creditor return the vehicle to the debtor upon learning of the bankruptcy filing. Upon filing, a bankruptcy estate is created, which consists of the debtor's legal and equitable interests in property. The estate includes the debtor's right to redeem property. Under the Bankruptcy Code, Chapter 13 debtors have the right to use estate property, and, therefore, have standing to pursue violations of the automatic stay against creditors and to seek to have certain property returned.

In Thompson, the court found that a secured creditor violated the automatic stay by failing to return the vehicle after the bankruptcy filing. In other words, the creditor exercised control over property of the bankruptcy estate in violation of the automatic stay and was required to return it to the debtor.

This issue has received particular attention in Chicago, as many debtors flock to the bankruptcy courts as a path to return their repossessed vehicles. That practice is so common that some local attorneys leave advertisements on booted vehicles and represent on their websites that they can help residents get their vehicles back for less money than they owe the city. Once the vehicle is returned, many Chicago residents will abandon their bankruptcy cases to be dismissed by other parties or the court.

The strain on the bankruptcy system caused by these bankruptcy filings is evidenced by the number of Chapter 13 cases filed in the Northern District of Illinois as compared to other jurisdictions. In 2018, 17,603 new Chapter 13 bankruptcy cases were filed in the Northern District of Illinois. By comparison, in 2018, the U.S. District Court for the Middle District of Florida, one of the busiest bankruptcy courts, saw 6,650 new Chapter 13 cases filed, and the U.S. District Court for the Southern District of California, another large bankruptcy district, saw 1,426 new filings.

The ABI Report

In April 2019, the American Bankruptcy Institute's Commission on Consumer Bankruptcy released a report of recommendations to improve the consumer bankruptcy system.[4] The report recommends a statutory amendment to balance the debtors' and creditors' conflicting interests regarding collateral repossessed prepetition. Specifically, the commission recommends a Bankruptcy Code amendment to expressly provide that retaining possession of estate property violates the automatic stay. To ensure adequate protection for creditors, property subject to potential loss in value due to accident, casualty or theft (i.e.,vehicles) may be retained by the creditor unless the debtor fails to provide proof of insurance or other

security for the value of the property.

The commission further recommends amending the Bankruptcy Code to protect the status quo for creditors with statutory liens dependent upon possession. For example, if the debtor provided proof of insurance, presumably the creditor would be required to release the vehicle. Any statutory lien dependent upon possession that the creditor had would continue in the same amount and priority as if the creditor had retained possession of the vehicle. If the debtor dismissed the case immediately after retrieving the vehicle, the creditor would have the right to obtain a writ of replevin.

Finally, the report recommends amending the Federal Rules of Bankruptcy Procedure to provide that the debtor could enforce the turnover right by motion instead of adversary proceeding. The commission believes that this allows the debtor a more expedient and cost-effective resolution.

The commission's recommendations do not wholly favor debtors or creditors, but rather attempt to strike a balance between the constituencies' competing interests. As with any negotiated agreement, neither constituency is completely happy with the commission's recommendations. Instead, the purpose of the commission's recommendation is to provide clarity and reduce litigation surrounding this issue, which is desperately needed in light of the growing circuit split. Certainty would afford both parties advance knowledge of the process to retrieve collateral that was repossessed prepetition. This ability to prepare for a discrete outcome under such circumstances allows parties to take steps necessary to protect their interests before engaging in costly and uncertain litigation. Unless and until Congress takes steps to enact legislation on the issue, the courts hold the reins in resolving the current Circuit split.

What's Next?

There are some parallels between Fulton and Citizens Bank of Maryland v. Strumpf.[5] The U.S. Supreme Court resolved another circuit split in Strumpf,[6] where the courts grappled with whether creditor activity to arguably preserve the status quo violated the automatic stay.

In Strumpf, the court evaluated whether a creditor's refusal to pay its debt to the debtor upon his demand constituted an exercise of the setoff right and thus violated the automatic stay. The court held "that a bank's temporary withholding of funds in a debtor's bank account, pending resolution of the bank's setoff right ... did not violate the automatic stay," reasoning "among other things, that [to] interpret ... [Section] 542(b)'s turnover provision as self-executing would 'eviscerate' the provision's exceptions to the duty to pay."[7]

The In re Denby-Petersen opinion relied upon this reasoning in rejecting the view that the retention of collateral constituted a violation of the automatic stay.

Earlier this year, the Supreme Court denied a petition for certiorari filed in Davis v. Tyson,[8] which dealt with the same issue arising out of the Tenth Circuit. However, the Supreme Court now has another opportunity to resolve this entrenched circuit split. The City of Chicago filed a petition of certiorari in City of Chicago v. Fulton[9] on Sept. 17.

On Nov. 8, respondents, Fulton et al., filed a brief in opposition of Chicago's petition of certiorari.[10] Although the respondents' brief, among other things, identifies some factual differences between Fulton and the minority opinions of the Tenth, D.C., and now Third Circuits, it is unlikely that any particular case will provide precisely identical facts to those

underlying the circuit split.

Fulton provides an ample opportunity for the Supreme Court to address this growing circuit split before subjecting additional parties to continued confusion and inconsistent rulings. Fulton and Denby-Petersen illustrate direct confrontations among the circuits interpreting similar situations. The repeated references to Fulton in Denby-Petersen increase the likelihood that the Supreme Court will grant certiorari as they illustrate conflicting interpretations at the federal circuit level (despite respondents' attempts to distinguish the facts of the cases).

For now, we'll continue to watch and see if the Supreme Court grants certiorari in this case.

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Disclosure: Bradley Arant filed an amicus brief on behalf of the International Municipal Lawyers Association in support of the petition for certiorari filed by the City of Chicago in City of Chicago v. Fulton.

[1] In re Fulton, 926 F.3d 916 (7th Cir. 2019).

[2] In re Denby-Peterson, 941 F.3d 115 (3d Cir. 2019).

[3] Thompson v. GMAC.

[4] The American Bankruptcy Institute's Commission on Consumer Bankruptcy, Final Report and Recommendations (2019).

[5] 516 U.S. 16 (1995).

[6] 516 U.S. 16 (1995).

[7] Denby-Peterson, 941 F.3d at 131 (citing, in the first instance, Strumpf, 516 U.S. at 19, and, in the second instance, Strumpf, 516 U.S. at 20).

[8] https://www.supremecourt.gov/Search.aspx?FileName=/docket/docketfiles/html/public%5C18-941.html.

[9] https://www.supremecourt.gov/search.aspx?filename=/docket/docketfiles/html/public/19-357.html.

[10] Brief for Respondents, City of Chicago, Illinois, v. Robbin L. Fulton, et al., (No. 19-357).