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Supreme Court to Decide Whether Creditor's Inaction Violates the Automatic Stay

December 31, 2019

Michael Traison
Chicago/NYC - 312.860.4230
Michael Kwiatkowski
Garden City - 516.296.9144

A primary element of the United States Bankruptcy Code is the automatic stay injunction which goes into effect immediately upon the filing of a bankruptcy case. The injunction prohibits actions against the debtor and its property. During this past year, we have issued several legal alerts as cases were decided around the country on the issue of whether creditor's failure to act to reverse a process of garnishment or seizure, initiated prepetition and already underway when the bankruptcy case was filed, constituted a violation of the automatic stay under 11 U.S.C. § 362. (Prior legal alerts are available at: The Automatic Stay: Even Pre-Petition Seizures May Be Covered; Yet Another Court Addresses Violation of the Automatic Stay; Automatic Stay Violators and Prepetition Seizures).

As we mentioned in those prior legal alerts, circuit courts of appeal differ on this issue. On December 18, 2019, the U.S. Supreme Court agreed to resolve this conflict.

The Supreme Court granted *certiorari* to hear an appeal from the Seventh Circuit's decision in *City of Chicago v. Fulton*, No. 19-357 (Sup. Ct.). In agreeing to hear the case, the Supreme Court is expected to resolve the question of "[w]hether an entity that is passively retaining possession of property in which a bankruptcy estate has an interest has an affirmative obligation under the Bankruptcy Code's automatic stay, 11 U.S.C. § 362, to return that property to the debtor or trustee immediately upon the filing of the bankruptcy petition." This issue arose in the *Fulton* case because the City of Chicago, prior to the debtors' bankruptcy filings, was impounding vehicles for failure to pay traffic fines and refusing to return the vehicles after the debtors filed for bankruptcy. *In re Fulton*, 926 F.3d 916, 920 (7th Cir. 2019).

The majority of circuit courts to address this issue have held that the automatic stay requires creditors to immediately turn over any property in which the bankruptcy estate has an interest. In general, these courts reason that a creditor's passive retention of property in which the debtor's bankruptcy estate has an interest is "an act . . . to exercise control over property of the estate" in violation of section 362(a)(3) of the Bankruptcy Code. The minority of circuit courts have concluded that such passive retention of property only maintains the *status quo*, is not an affirmative act and thus does not violate the automatic stay. The majority courts include the

Second, Seventh, Eighth, Ninth, and Eleventh Circuits, and the minority courts are the Third, Tenth, and the District of Columbia Circuits.

In the *In re Fulton* case, the Seventh Circuit acknowledged the conflict among the courts of appeal and reaffirmed its position in line with the majority of the courts, finding that the automatic stay, which "becomes effective immediately upon filing the petition" requires the creditor to return property seized prepetition "and is not dependent on the debtor first bringing a turnover action." *In re Fulton*, 926 F.3d at 924. By contrast, as we reported in a recent legal alert (Automatic Stay Violators and Prepetition Seizures), the Third Circuit, in *In re Denby-Peterson*, 941 F.3d 115 (3d Cir. 2019), recently held in favor of the creditor. Joining the minority of circuit courts, the Third Circuit found that the debtor must initiate an adversary proceeding to have the creditor turn over the property. *In re Denby-Peterson*, 941 F.3d at 130. The court held 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'." *Id*. at 119 (brackets in the original).

A recent Virginia bankruptcy court decision shows the importance of the issue to be decided by the Supreme Court and the potential penalties facing creditors due to the current uncertainty in the law. In *In re Nimitz*, No. 19-12741 (BFK) (Bankr. E.D. Va. Dec. 11, 2019) (available at http://www.vaeb.uscourts.gov/opinions/), a law firm creditor had effectuated a prepetition garnishment on a former client's wages to satisfy unpaid legal fees. *In re Nimitz*, at p. 2. While the garnishment was complete, proceeds were being by local county court and have not yet been paid to the law firm. *Id.* Upon bankruptcy filing, the debtor demanded that the law firm have the garnishment released. *Id*. The law firm refused, asserting that it was unaware of any statute or opinion requiring it to terminate the ongoing garnishment proceeding. *Id.* at p. 3. The bankruptcy court acknowledged that, "[i]n fairness to the [law firm], the issue of a refusal to release seized property upon a bankruptcy filing is now the subject of some controversy in the case law" and discussed the circuit court split which the Fourth Circuit (whether the *Nimitz* court sits) has not addressed. *Id*. at p. 6. Nevertheless, the bankruptcy court found that the law firm violated the automatic stay "by continuing to exercise control over the garnished funds post-petition." *Id*. at p. 7. Moreover, the bankruptcy court decided that the debtor was entitled to damages because the violation of the automatic stay was "willful." *Id*. at p. 11. While the bankruptcy court did not assess punitive damages against the law firm, it directed the law firm to pay the debtor's legal fees incurred in prosecuting her motion to recover garnished wages. *Id*. Notably, the bankruptcy court noted that the law firm's research of legal issues was "minimal" and seemed to have little sympathy for what was arguably a good-faith dispute on an issue that circuit courts have disagreed. *Id*.

Until the Supreme Court resolves this issue, creditors are advised to seek counsel in addressing situations where they seized or garnished debtor's property and the debtor subsequently filed bankruptcy.

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Attorneys

- Michael H. Traison
- Michael Kwiatkowski