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Stand Pat, Don't Act: Supreme Court Holds That Mere Retention of Debtor Property Does Not Violate Section 362(a)(3) of the Bankruptcy Code's Automatic Stay Provision - Cadwalader

On January 14, 2021, the U.S. Supreme Court issued an opinion addressing a split among circuit courts on whether an entity violates Section 362(a)(3) of the Bankruptcy Code's automatic stay provision by passively retaining possession of a debtor's property after a bankruptcy petition is filed. Section 362(a)(3) prohibits "any act . . . to exercise control over property" of the bankruptcy estate. 11 U.S.C. § 362(a)(3).1 This "automatic stay" provision is automatically triggered once a bankruptcy case is commenced, and is intended to give the debtor a breathing spell from its creditors, including from any collection efforts, foreclosures, and other actions creditors may take against a debtor's property. The question here was whether the automatic stay provision in Section 362(a)(3) is also applicable to property already in the creditor's possession at the time of the bankruptcy filing. In a unanimous2 decision authored by Justice Samuel Alito, the Supreme Court held that mere retention of estate property after the filing of a bankruptcy petition does *not* violate Section 362(a)(3). *City of Chicago, Illinois v. Fulton*, No. 19-357, 2021 WL 125106 (U.S. Jan. 14, 2021).

The Supreme Court's decision provided at least some comfort to creditors that they are unlikely to be considered in violation of the stay under Section 362(a)(3) or incur related damages liability by merely passively retaining debtor property, including collateral, already in their possession. However, the decision did leave open the possibility that retention of debtor property could violate other provisions of the automatic stay under some circumstances, such as where retention is used as leverage to "collect . . . or recover a claim against the debtor." See 11 U.S.C. § 362(a)(6).

The decision also helped clarify the relationship between the Bankruptcy Code's automatic stay provision (Section 362) and its express "turnover" provision (Section 542) by establishing that only Section 542, and not Section 362(a)(3), imposes an obligation to turn over debtor property to the debtor's bankruptcy estate. This clarification is favorable to parties in possession of debtor property, because turnover under Section 542 includes exceptions and usually entails the commencement of an adversary proceeding and an opportunity to present defenses, which would not necessarily be available if turnover were required automatically under Section 362(a)(3).

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