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Cordova V. Chicago Could Narrow Fulton Creditor Protection

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In its much-discussed 2020 decision, City of Chicago v. Fulton, the U.S. Supreme Court ruled that the city of Chicago was not in violation of Section 362(a)(3) of the Bankruptcy Code for failing to release an impounded car to a debtor in bankruptcy.

Section 362(a)(3) imposes an automatic stay over "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."[1]

According to the Supreme Court, the city did not violate the stay because it did not undertake an affirmative act to obtain possession of, or otherwise exercise control over, the vehicle following the commencement of the debtor's bankruptcy case — mere retention of estate property was not enough.

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The decision resolved a split among the circuit courts and secured creditors applauded it.

Fulton served as a shield, seemingly relieving creditors of some responsibility to affirmatively return property of their borrowers that may have been impounded, seized or otherwise have come into their possession prior to bankruptcy. This was important, of course, because a knowing violation of the automatic stay can lead to the imposition of sanctions, the amount of which could exceed the value of a lender's collateral in extraordinary circumstances.

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The Fulton decision, however, was limited to the particular section before it, Section 362(a)(3), and did not address potential automatic stay violations set forth in other sections, including Sections 362(a)(4), (6) and (7), of the Bankruptcy Code.

Indeed, in her concurrence, Justice Sonia Sotomayor specifically points out: "I write separately to emphasize that the Court has not decided whether and when [Section] 362(a)'s other provisions may require a creditor to return a debtor's property."[2]

Whether the reasoning in Fulton applies to these other sections remains an open question, but one that may soon be answered.

The U.S. Bankruptcy Court for the Northern District of Illinois in a Dec. 6 decision Cordova et al. v. City of Chicago[3] addressed the gap in the analysis pointed out by Justice Sotomayor in her Fulton concurring opinion.

The court denied, in part, the city's motion to dismiss claims brought by a putative class of plaintiffs whose automobiles were not released by the city upon the commencement of their bankruptcy cases.

In light of Fulton, the plaintiffs amended their original complaint to assert that the city's failure to release their vehicles amounted to a stay violation, not under Section 362(a)(3), but under Sections 362(a)(4), (6) and (7).

The plaintiffs also sought a ruling that the city violated Section 542(a) by failing to turn over estate property. In its motion to dismiss, the city argued that the alleged stay violations required an affirmative act, seeking to extend the reasoning of Fulton regarding Section 362(a)(3).

Regarding the turnover count, the city argued that it was not faced with an adversary proceeding to compel turnover and there is no express obligation to return bankruptcy estate property under Section 542(a).

While an affirmative act may be required to exercise control, that phrase is found nowhere in the sections before the court in Cordova and may lead to a very different result despite a similar fact pattern at issue in Fulton.

Section 362(a)(4) protects a debtor against "any act to create, perfect, or enforce any lien against property of the estate."[4] The court noted that the Bankruptcy Code defines lien as a "charge against or interest in property to secure payment of a debt or performance of an obligation."[5] The city did not appear to dispute that its interest in each plaintiff's vehicle constituted a lien — although recognizing that the nature or validity of such liens might be in dispute.

Section 362(a)(6) provides a shield from "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case."[6] The court recognized that this section applies to debtors, not property, but posited that the failure to return property of the estate might be deemed an "act to collect" a debt in certain instances.[7]

With respect to both sections, the plaintiffs alleged that the city demanded advance payments in connection with the release of any vehicle and that it held the vehicles in an effort to perfect its liens. Accordingly, the court allowed those claims to proceed.

Section 362(a)(7) offers protection from "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor."[8] In order to prevail, a plaintiff must establish each of the elements of a setoff. The court found that the plaintiffs failed to plead facts necessary to do so and dismissed this cause of action, but with a right to replead.[9]

In doing so, the court did not rule out that the city's actions may be deemed to constitute a setoff. The court's commentary highlights its intent to consider the issues carefully in light of the facts and perhaps see fit to squeeze the city's actions, or inactions, within the contours of Sections 362(a)(4), (6) and (7).

The court also allowed the plaintiffs' claims under Section 542(a) to proceed. The court pointed out that

Section 542(a) is "self-executing, and does not require that the trustee take any action or commence a proceeding or obtain a court order to compel the turnover."[10]

The court noted that the city had a statutory obligation to return the vehicles, notwithstanding the failure of the plaintiffs to commence an adversary proceeding. If the city has defenses to these claims, it will have to litigate to present them.[11]

The court's decision was guided, not only by the express limitations of Fulton, but also the context of the matter at hand — i.e., debtors facing financial hardships may need their vehicles to recover and may have no other recourse. The court explained:

What this court can do is what it does here, refuse to adopt in the context of a motion to dismiss a reading of Fulton that is so expansive that it eliminates clear and obvious remedies against recalcitrant creditors.[12]

When faced with a putative class of debtors that may have needed their vehicle to continue or secure employment, and that may not have had the resources or benefit of time to pursue a turnover action, the court's approach appears appropriately flexible. That flexibility, however, may lead to a broad interpretation of the city's activities, and return secured creditors to the pre-Fulton landscape where they must swiftly and affirmatively respond to a bankrupt creditor's request for the return of its property.

Indeed, the court's commentary regarding the self-effecting nature of Section 542(a) may lead to a decision that places a greater burden on creditors to return estate property upon receiving notice of a borrower's bankruptcy.

Of course, the holding of Fulton and any ultimate ruling in Cordova are not limited to auto lenders and their consumers but may well apply to all commercial lenders who have repossessed collateral, including that of sophisticated borrowers.

Secured creditors and other contract counterparties of many stripes will eagerly await the ultimate ruling on the plaintiffs' complaint in Cordova to learn if the great comfort they took from Fulton was premature.

In the meantime, in order to avoid the risk of sanctions, secured creditors should reconsider their collateral-retention tactics and policies, recognizing that their actions or inactions may be interpreted to run afoul of Sections 362(a)(4), (6) and (7), and maybe even Section 542(a).

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[1] City of Chicago v. Fulton, 141 S. Ct. 585 (2020).

[2] Id. at 592 (Sotomayor, J., concurring)

[3] Cordova et al. v. City of Chicago, Case No. 19-00684 (Dec. 6, 2021).

[4] 11 U.S.C. § 362(a)(4).

[5] Id. at 10-11.

[6] 11 U.S.C. § 362(a)(6).

[7] Id. at 11.

[8] 11 U.S.C. § 362(a)(7).

[9] Id. at 12.

[10] Id. at 24 (citations omitted).

[11] Id.

[12] Id. at 20.