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Redeeming Repossession

Lender repossesses the equipment of its business borrower after it defaults on its secured loan agreement. Because borrower needs the equipment to run its business, it then files a Chapter 11 petition and promptly asks lender to return the equipment. Lender refuses because the equipment secures the defaulted loan. Depending on where the debtor sought bankruptcy relief (e.g., New York or New Jersey), lender may be subject to sanctions for holding on to the equipment.

The debtor (or a bankruptcy trustee) will then ordinarily seek the prompt turnover of the repossessed equipment in court. The debtor will argue the equipment needs to continue operating because the debtor owns it. When the lender is secured, though, the court will have to provide lender with "adequate protection" (e.g., cash payments, additional collateral) before ordering the turnover of the equipment. That is the usual result.

Sanctions for Passive Retention

But what happens when the debtor also seeks sanctions for lender's initial refusal to turn over the equipment? Did lender violate the Bankruptcy Code's automatic stay, i.e., did it "exercise control over property of the [debtor's] estate?" Federal appellate courts covering California, Oregon, Washington, Illinois, Indiana, New York, Connecticut, Vermont, Missouri, Florida and Georgia have held that it did, affirming the bankruptcy court's imposition of sanctions. But three federal appellate courts covering New Jersey, Delaware, Pennsylvania, the District of Columbia and Colorado have held that lender did not violate the automatic stay. These courts focused on whether lender had an affirmative duty to release the collateral.

The City of Chicago recently asked the U.S. Supreme Court to resolve this so-called "split" among the federal courts of appeals. In Chicago's case, the Seventh Circuit Court of Appeals affirmed the bankruptcy court's imposition of sanctions on the City for its failure to return a debtor's car after bankruptcy, having impounded it prior to bankruptcy for unpaid traffic violations. According to the Seventh Circuit, the City's passive retention of the debtor's car was "an act to … exercise control" over that property, warranting sanctions against the City. The Supreme Court agreed in December 2019 to hear the case.

The Supreme Court Precedent

The Supreme Court "considered the interplay between the automatic stay and the turnover provision in" the Bankruptcy Code in a similar case 24 years ago. The court held that a "bank's temporary withholding of funds in a debtor's bank account, pending resolution of the bank's right" to set off that account did not violate the automatic stay. It reasoned the Bankruptcy Code's turnover provision was not "self-executing." Thus, the debtor had to ask the bankruptcy court to order the turnover of the funds.

In another case, 36 years ago, the Supreme Court ordered the repossessing secured lender (the "IRS") to turn over its collateral so long as the debtor provided the lender with some form of "adequate protection," reasoning the lender's right to adequate protection replaced "the protection afforded by possession." Most important, the debtor had to ask the bankruptcy court for a turnover order. The lender was entitled to resist turnover if the debtor failed to provide adequate protection. And the bankruptcy court had to rule on the issue.

The Supreme Court in Chicago's case should resolve the split among the federal courts of appeals. More important, though, lenders need certainty when exercising their bargained for remedies. Most important, debtors and bankruptcy trustees should not be able to threaten lenders with sanctions for exercising their pre-bankruptcy remedies properly.

Why the Supreme Court Should Fix the Problem

Here are the reasons why the Court should reverse the Seventh Circuit in the Chicago case. First, the Bankruptcy Code's automatic stay is meant to stop collection efforts and

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pending foreclosure actions. It also protects the creditor body by preventing individual creditors from grabbing assets ahead of other creditors, ensuring an orderly bankruptcy case administration. The automatic stay merely bars creditors from taking any affirmative act to exercise control over the debtor's property. It is prospective in nature. For a creditor to exercise control over a debtor's property, the language of the automatic stay requires some post bankruptcy affirmative act. In the words of one Court of Appeals, "Stay means stay, not go."

When a lender repossesses equipment prior to bankruptcy, mere passive retention of that property after bankruptcy should not be subject to sanctions when the lender never does anything further to "exercise control over" the equipment. For preserving the pre-bankruptcy status quo, the lender should not be penalized. Congress hardly intended the passive retention of a debtor's property prior to bankruptcy to qualify as an act to exercise control over that property.

The relevant legislative history accompanying the Code's automatic stay is unhelpful. Congress never explained its intent, but three federal courts of appeals have used common sense in applying the Code.

Turnover Requires a Court Order

Debtors and trustees argue that the Code's turnover provisions, when read literally, provide for the automatic turnover of the debtor's property by the repossessing lender. The relevant section does provide the third party holding the debtor's property "shall deliver [it] to the trustee," but the Supreme Court and three circuit courts of appeals have held that this provision is not "self-executing." Instead, the debtor or trustee must sue the lender in the bankruptcy court to give that court a chance to determine whether the property is subject to turnover. The Federal Bankruptcy Rules provide for a streamlined court procedure. Courts routinely require explicit proof before property is ordered to be turned over. For example, the bankruptcy court must first decide whether the property even belongs to the debtor. And if it does belong to the debtor, the secured lender is entitled to "adequate protection" (e.g., periodic cash payments; insurance coverage) to ensure that the lender's collateral will not be harmed by the debtor's continued use of it during the bankruptcy case.

Courts can provide the right balance between debtors' and creditors' rights. By preserving the status quo and the debtor's right to reclaim its property, they can relieve secured lenders from the threat of sanctions. The Bankruptcy Code's automatic stay should not require lenders, on the pain of sanctions, to do what the Code's turnover provision does not—immediately surrender repossessed collateral in the absence of a court ruling.

No Threat to Reorganization

The Supreme Court should also reject a debtor's argument that its ability to reorganize would be threatened in the absence of an immediate turnover by the lender. The debtor or trustee can quickly start a turnover proceeding to recover any essential property with a court order. As the Supreme Court said a few months ago, the Bankruptcy Code makes "reorganization possible [but] does not permit anything and everything that might advance that goal."