Benchnotes

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Passive Retention of Impounded Vehicles Violates Automatic Stay

In *In re Fulton*,[1] the Seventh Circuit Court of Appeals deepened an existing circuit split in holding that the City of Chicago violated the automatic stay by its continued post-petition retention of motor vehicles that it had impounded pre-petition. It is very possible that *Fulton*, or a case dealing with similar issues moving its way through the Third Circuit, *Denby-Peterson v. Nu2uAuto World*,[2] will make its way to the U.S. Supreme Court in the next year.

The Second, Seventh, Eighth and Ninth Circuits have held that a secured creditor must turn over, pursuant to § 542(a) of the Bankruptcy Code, repossessed property upon demand post-petition or risk a stay violation.[3] Conversely, the Tenth and D.C. Circuits have ruled that passively holding an asset of the estate in the face of a demand for turnover does not violate the automatic stay in § 362(a)(3), which prohibits "any act ... to exercise control over property of the estate."[4] In *Fulton*, the Seventh Circuit reaffirmed its prior holding in *Thompson*.

Fulton was a consolidated appeal of four different bankruptcy cases, each of which contained substantially similar facts. Prior to the commencement of their chapter 13 cases, the City of Chicago impounded each of the debtors' vehicles for failure to pay traffic fines. Post-petition, the city refused to return the vehicles, claiming that it needed to maintain possession to continue perfection of its statutory possessory liens on the vehicles and that it would only return the vehicles when the debtors paid their outstanding fines in full. The lower courts each held that the city violated the automatic stay by "exercising control" over property of the estate, and that none of the exceptions to the stay in § 362(b) were applicable.

The Seventh Circuit noted that there was no dispute that the vehicles were property of the estate notwithstanding the fact that they were impounded pre-petition. The court then rejected the city's argument that passively holding the vehicles merely maintained the status quo and thus did not constitute "exercising control" within the scope of § 362(a)(3). Relying on the Supreme Court's decision in *Whiting Pools*, the court held that § 362(a)(3) is self-effectuating and is not dependent on the debtor first bringing a turnover action under § 542(a).[5]

The court rejected the minority view courts' conclusion that the turnover power is subject to various exceptions, including the requirement that a party compelled to turn over property receive adequate protection pursuant to § 363(e). Because "[t]he right of possession is incident to the automatic stay," the court held, the creditor must first return the assets to the bankruptcy estate and thereafter seek adequate protection of any interest that it may have lost.[6] In support of its conclusion, the court stated:

> More fundamentally, the City's arguments ignore the purpose of bankruptcy — "to allow the debtor to regain his financial foothold and repay his creditors." To effectively do so, a debtor must be able to use his assets "while the court works with both debtor and creditors to establish a rehabilitation and repayment plan."[7]

Finally, the court held that the city's conduct was not protected by § 362(b)(3)'s stay exception, which allows acts necessary to continue perfection of liens post-petition. The court held that continued possession of the vehicles was not necessary to protect the city's possessory lien because the turnover compelled by the Bankruptcy Code is involuntary. Likewise, the police or regulatory power stay exception set forth in § 362(b)(4) did not protect the city because, on balance, its efforts to impound vehicles was focused more on revenue collection than public safety.

Case Must Be Dismissed Where Debtor Intended to Lease Real Property to a Marijuana Dispensary

In *In re Basrah Custom Design Inc.*,[8] the U.S. Bankruptcy Court for the Eastern District of Michigan joined a number of other courts and held that "cause" existed under § 1112(b)(1) to dismiss a chapter 11 case based on the debtor's involvement with a medical marijuana dispensary business. The debtor was a custom cabinetmaker who filed a bankruptcy case days after a state court ordered it to sell certain real property in accordance with a contract that it had signed with a state-licensed marijuana dispensary. The court found that the primary purpose of the bankruptcy filing was to escape the terms of the sale contract and the state court judgment, thereby allowing the debtor to negotiate a lease or sale of the property to a third party, who also intended to operate a dispensary, but on more favorable terms.

1 *In re Fulton*, 2019 WL 2521455 (7th Cir. June 19, 2019).
2 *See Denby-Peterson v. Nu2uAuto World*, 595 B.R. 184, 188 (D.N.J. 2018).
3 *See In re Weber*, 719 F.3d 72 (2d Cir. 2013); *Thompson v. Gen. Motors Acceptance Corp. LLC*, 566 F.3d 699 (7th Cir. 2009); *In re Knaus*, 889 F.2d 773 (8th Cir. 1989); *In re Del Mission Ltd.*, 98 F.3d 1147 (9th Cir. 1996).
4 *See In re Garcia*, 740 Fed. App'x 163 (10th Cir. 2018); *In re Cowen*, 849 F.3d 943 (10th Cir. 2017); *U.S. v. Inslaw*, 932 F.2d 1467 (D.C. Cir. 1991).
5 *In re Fulton*, 2019 WL 2521455 at *4 (discussing *U.S. v. Whiting Pools Inc.*, 462 U.S. 198 (1983)).
6 *Id.*
7 *Id.* at *5.
8 *In re Basrah Custom Design Inc.*, 2019 WL 2202742 (Bankr. E.D. Mich. May 21, 2019).

The U.S. Trustee and the original dispensary sought dismissal of the case, among other relief. The bankruptcy court characterized the issue as "whether the Debtor's entanglement with a medical marijuana dispensary business, which business is illegal under federal criminal law but not necessarily illegal under Michigan law, requires the dismissal of [the] bankruptcy case."[9]

The court dismissed the bankruptcy case, concluding that "cause" existed for dismissal because of the debtor's desire, as determined by the state court in its pre-petition opinion, to lease or sell the property to a party who would operate it as a marijuana dispensary business, which is illegal under the federal Controlled Substances Act.[10] There was no dispute that operating a medical marijuana dispensary is a violation of that statute because, notwithstanding the recent wave of state laws permitting the sale and use of marijuana for medical and/or recreational purposes, marijuana remains an illegal Schedule 1 controlled substance. Owning or renting a place where such a dispensary is operated, the court suggested, might also be a federal crime under the Controlled Substances Act.[11]

Because of these federal statutes, the court noted that "several bankruptcy courts have found cause to dismiss a bankruptcy case filed by a debtor whose income was derived, directly or indirectly, at least in part, from the business of selling marijuana."[12] Joining such courts, the court held:

> The actual purpose of filing and prosecuting this bankruptcy case is for the Debtor and its 100% shareholder to use this bankruptcy court, and the Bankruptcy Code, to assist them in obtaining a result that is contrary to federal criminal law under the Controlled Substances Act, and therefore contrary to public policy. This federal court cannot allow itself to be used in this way. The Court finds that the Debtor has unclean hands, and that there is "cause" to dismiss or convert this case under 11 U.S.C. § 1112(b)(1).[13]

Finding "no practical alternative," the court dismissed the bankruptcy case instead of converting it to a chapter 7 and, in doing so, barred the filing of any new bankruptcy case, by or against the debtor, for a period of two years.

Miscellaneous

• *Ashmore v. CGI Group Inc.*, 923 F.3d 260 (2d Cir. 2019) (*pro se* debtor's initial bankruptcy filings failed to properly list his pending *Sarbanes-Oxley* litigation as "asset," but he disclosed lawsuit on numerous subsequent occasions; Second Circuit reversed district court, holding that it erred when it applied judicial estoppel to dismiss debtor's suit; "[W]e note that in [the debtor's] very first filing, as part of the SOFA, he listed the ... litigation by name and docket number. Undoubtedly, he should have listed it on the Schedule B. But it is difficult to attribute to a *pro se* litigant a scheme to hide a fact that he disclosed on what would surely appear to a lay person to be a parallel schedule");

• *In re Bressler*, 2019 WL 2070733 (Bankr. S.D.N.Y. May 10, 2019) (creditor's counsel and debtor's counsel orally agreed to extension of time for creditor to file nondischargeability proceeding; stipulation to that effect was prepared but never executed, and objection deadline passed; subsequently, court declined creditor's request to extend objection deadline based on theories of equitable tolling or estoppel; "because any extension of the deadline to object to discharge must be sought from the Court before the deadline expires, a verbal agreement between counsel, without a timely application to the Court before the deadline expires, cannot provide a basis to extend the deadline");

• *In re Cambridge Analytica LLC*, 2019 WL 2486745 (Bankr. S.D.N.Y. June 14, 2019) (court precluded creditor from obtaining discovery from debtor's chapter 7 trustee pursuant to Bankruptcy Rule 2004 examination when creditor was involved in related class-action proceeding pending in another court against third party, Facebook; court found that creditor, who had purchased its claim in the bankruptcy case for $650, sought discovery "for the purpose of obtaining discovery for use in the Delaware derivative action"; court noted that it did not want to incentivize parties to purchase nominal claims in bankruptcy cases solely to pursue their outside litigation agendas);

• *In re Chieftain Steel LLC*, 2019 WL 1225716 (Bankr. W.D. Ky. March 13, 2019) (professional firms retained in chapter 11 case filed motion to compel payment of allowed professional fees from funds held by the debtors' secured lender; several stipulated cash-collateral orders in case provided that professionals would be paid $40,000 per month by debtor and before payment of any indebtedness for bank; such orders also stated that bank's liens were "subject and subordinate to payment of the Carve-Out"; nevertheless, debtor failed to make budgeted payments; court held that bank could not be compelled to pay fees when there was no provision in cash-collateral order or in confirmed plan expressly making bank liable for such amounts);

• *In re Ladder 3 Corp.*, 2019 WL 2293193 (2d Cir. May 29, 2019) (court rejected argument that dismissal of bankruptcy case rendered null settlement between debtor and creditor pursuant to Bankruptcy Rule 9019; "[u]nder the plain meaning of § 349(b)(3), the provision operates only to revest property in entities that had a vested right in the property prior to the initiation of bankruptcy proceedings"; here, court found that post-petition settlement created new rights that did not exist pre-petition, thus § 349(b)(3) was inapplicable);

• *In re On-Site Fuel Service Inc.*, 2019 WL 2252003 (Bankr. S.D. Miss. May 24, 2019) (creditor with alleged $6.4 million claim commenced involuntary proceeding against debtor pursuant to § 303; debtor contested petition, arguing that creditor's claim was subject to *bona fide* dispute because it asserted counterclaim against creditor; court rejected debtor's argument, holding that "the mere assertion of a counterclaim that does not go to the merits of the claimholder's claim does not necessarily give rise to a *bona fide* dispute"; in addition, court rejected debtor's argument that it was bad faith for lead creditor to agree to indemnify (through

continued on page 71

9 *Id.* at *1.
10 21 U.S.C. § 801, *et seq.*
11 *In re Basrah Custom Design Inc.* at *8 (citing 21 U.S.C. § 856(a), which generally precludes parties from leasing or maintaining any real property being used for purpose of unlawfully manufacturing, distributing or using any controlled substance).
12 *Id.* (discussing various cases).
13 *Id.* at *12.

joint prosecution agreements) other creditors who subsequently signed on to involuntary petition); and

• *In re Schatz*, 2019 WL 2017602 (Bankr. D. Conn. May 5, 2019) (bankruptcy court addressed practice of using "appearance counsel" to represent chapter 13 debtor on temporary or "drop-in" basis for, among other matters, § 341 meeting of creditors, and held that disgorgement was required due to attorneys' insufficient disclosures, unauthorized fee-sharing and inadequate representation; noting that courts nationwide discourage use of appearance counsel to represent debtor, court required appearance counsel to disgorge all fees received, and debtor's counsel of record to disgorge all fees but initial $2,500 retainer that she received from debtor). abi