*Consumer Track*

# Headaches, Relief and Other Remedies: Let's Look in That Medicine Cabinet Again

**Hon. Phillip J. Shefferly, Moderator**
*U.S. Bankruptcy Court (E.D. Mich.); Detroit*

**Jeffrey C. Dan**
*Crane, Heyman, Simon, Welch & Clar; Chicago*

**Rebecca R. DeMarb**
*Sweet DeMarb LLC; Madison, Wis.*

**Victoria E. Powers**
*Ice Miller LLP; Columbus, Ohio*

# Headaches, Relief and Other Remedies: Let's Look in That Medicine Cabinet Again (Translation: Interesting Automatic Stay Issues)

**Rebecca R. DeMarb**
**Sweet DeMarb LLC**
**Madison, Wisconsin**

**Victoria E. Powers**
**Ice Miller, LLP**
**Columbus, Ohio**

**Jeffrey C. Dan**
**Crane, Heyman, Simon, Welch & Clar**
**Chicago, Illinois**

**Hon. Phillip J. Shefferly**
**Chief Bankruptcy Judge for the**
**United States Bankruptcy Court**
**for the Eastern District of Michigan**
**Detroit, Michigan**

# PREPETITION WAIVERS OF THE AUTOMATIC STAY

**Rebecca R. DeMarb**
**Sweet DeMarb LLC**
**Madison, Wisconsin**

## PREPETITION WAIVERS OF THE AUTOMATIC STAY

Prepetition agreements that purport to alter or waive a debtor's protections under the Bankruptcy Code are generally unenforceable for public policy reasons. *See, e.g.*, *Hayhoe v. Cole (In re Cole)*, 226 B.R. 647, 652 n. 6–7 (B.A.P. 9th Cir. 1998) (citations therein). This policy reflects an understanding that parties cannot, by contract, circumvent the essential provisions of the Bankruptcy Code. *Continental Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 671 F.3d 1011, 1026–27 (9th Cir. 2012). For example, courts have recognized that a debtor's right to a discharge is one such "essential provision" and cannot be preemptively waived. *See, e.g.*, *Klingman v. Levinson*, 831 F.2d 1292, 1296 n. 3 (7th Cir. 1987) ("For public policy reasons, a debtor may not contract away the right to a discharge in bankruptcy."); *Lichtenstein v. Barbanel*, 161 F. App'x 461, 468 (6th Cir. 2005) ("A pre-petition stipulation in a state-court action waiving a debtor's right to obtain a discharge of a specific debt in a future bankruptcy case is void because it offends the public policy of promoting a fresh start for individual debtors."); *In re Church*, 328 B.R. 544, 548 (B.A.P. 8th Cir. 2005) ("The courts, however, will not enforce a prepetition agreement that denies a debtor bankruptcy relief."). Blanket prohibitions against discharge waivers are not surprising as they are arguably tantamount to *ipso facto* clauses prohibiting debtors from seeking bankruptcy relief. However, whether the same reasoning applies to other enshrined provisions of the Code, such as the automatic stay, is less clear.

In fact, courts are split on whether and to what extent a debtor's prepetition agreement to waive the automatic stay (or to refrain from opposing a creditor's efforts to lift the automatic stay) is enforceable. The tension stems from competing public policies favoring out-of-court workouts and settlements and protecting the collective interests of creditors. *Compare Ostano Commerzanstalt v. Telewide Sys., Inc.*, 790 F.2d 206, 207 (2d Cir. 1986) ("Since the purpose of the stay is to protect creditors as well as the debtor, the debtor may not waive the automatic stay.") *and Association of St. Croix Condominium Owners v. St. Croix Hotel Corp.*, 682 F.2d 446, 448 (3d Cir. 1982) ("Under the new Code, relief from a stay must be authorized by the Bankruptcy Court to prevent certain creditors from gaining a preference for their claims against the debtor.") *with In re Club Tower L.P.*, 138 B.R. 307, 312 (Bankr. N.D. Ga. 1991) ("[E]nforcing pre-petition settlement agreements furthers the legitimate public policy of encouraging out of court restructurings and settlements.") *and In re Excelsior Henderson Motorcycle Mfg. Co., Inc.*, 273 B.R. 920, 924 (Bankr. S.D. Fla. 2002) (holding prepetition agreement to waive automatic stay valid and enforceable).

The Circuit Courts of Appeal give very little guidance on this matter. While courts in the Second and Third Circuits seem certain that only the Bankruptcy Court can modify the automatic stay to protect the collective interests of a debtor's creditors (*see citations above*), bankruptcy courts in other jurisdictions are less clear. Consequently, three basic approaches have emerged: (1) uphold prepetition stay waivers to encourage out-of-court settlements; (2) reject such waivers as

unenforceable *per se* as against public policy; and (3) consider the waiver as a factor in deciding whether there is "cause" to lift the automatic stay. *In re Triple A&R Capital Inv., Inc.*, 519 B.R. 581, 584 (Bankr. D.P.R. 2014) (citations omitted). The third approach has gained ground in recent years. *Id.* Unfortunately, it remains difficult to predict how bankruptcy courts will tackle this thorny issue.

One case that considered a prepetition waiver of the automatic stay in the Eighth Circuit was *Matter of Pease*, 195 B.R. 431 (Bankr. D. Neb. 1996), which held that such waivers are unenforceable *per se*. In *Pease*, the debtors were farmers who had entered into a "debt resolution agreement" with their primary secured creditor before filing their chapter 11 bankruptcy. The agreement with the bank provided that if the debtors filed a bankruptcy case, they would not dispute the bank's motion for relief from stay or motion to dismiss the bankruptcy case in its entirety. The *Pease* court held that prepetition waivers of the automatic stay are *per se* invalid for three reasons: (1) the prepetition debtor does not have authority to bind the post-petition debtor in possession; (2) the Bankruptcy Code specifically prohibits certain contractual provisions that take effect upon filing in §§ 363, 365 and 541; and (3) the Bankruptcy Code extinguishes the private right to contract around its essential provisions. *Id*. at 433. The *Pease* court focused on the automatic stay being part of a collective process mandated by the Bankruptcy Code to protect debtors and creditors. *Id.* at 434. Finally, the court stressed that the bank was not without its remedy. The bank could still move for relief from the automatic stay pursuant to

§ 362, move to dismiss the case, file a competing plan, or move to convert the case to a Chapter 7 case. The bank would need to meet the requirements of the Code for all of those remedies, though, rather than relying on a provision in a prepetition agreement with the debtors. *Id.* at 435.

The *Pease* decision has not been reversed or challenged by any other court in the Eighth Circuit. On the contrary, *Pease* has been recently cited with approval in other bankruptcy courts and will likely remain influential. *E.g.*, *In re DB Capital Holdings LLC*, 454 B.R. 804 (Bankr. D. Colo. 2011) (holding that prepetition waivers of the automatic stay are unenforceable and are tantamount to an agreement not to file bankruptcy). Moreover, recent decisions by the Eight Circuit B.A.P. seem to support the *Pease* case's reasoning for disapproving prepetition stay waivers. *E.g.*, *In re Carter*, 502 B.R. 333, 336 (B.A.P. 8th Cir. 2013) (calling the automatic stay a "fundamental right afforded to debtors"); *In re Church*, 328 B.R. 544, 548 (B.A.P. 8th Cir. 2005) (citing *Pease* for the proposition that courts "will not enforce a prepetition agreement that denies a debtor bankruptcy relief.").

In *In re Desai*, 282 B.R. 527 (Bankr. M.D. Ga. 2002), the debtor and its primary secured creditor had agreed on plan treatment in an earlier Chapter 11 case that included, among other things, the debtor's consent to the bank's relief from the automatic stay in any future bankruptcy proceeding. After confirmation of that plan, the debtor filed another Chapter 11 case. The court held that,

> Although prepetition agreements waiving the protection afforded by the automatic stay are enforceable, such waivers are not per se enforceable, nor are they self-executing. The court further finds that in deciding whether relief from stay should be granted based on such waivers, the following factors should be considered: (1) the sophistication of the party making the waiver; (2) the consideration for the waiver, including the creditor's risk and the length of time the waiver covers; (3) whether other parties are affected including unsecured creditors and junior lienholders, and; (4) the feasibility of the debtor's plan.

*Id.* at 532 (citations omitted). After considering all of these factors in *Desai*, the court ruled that because the secured creditor has not carried its burden to show that the property had no equity, the court would not grant relief from the stay. *Id*. at 533; *see also In re Atrium High Point Ltd. P'ship*, 189 B.R. 599 (Bankr. M.D.N.C. 1995).

Taking a different approach to prepetition waivers made as part of an earlier bankruptcy case, the court in *In re Blocker*, 411 B.R. 516 (Bankr. S.D. Ga. 2009), enforced such a waiver. In *Blocker*, the debtor and creditor had entered into a "consent order" as part of an earlier Chapter 12 case that provided for the debtors' waiver of the automatic stay in a future case. The court decided that the debtors were "collaterally estopped from attacking the validity and enforceability of the Consent Order." *Id.* at 518. The judge in *Blocker* specifically declined to follow the test from *Desai*, and rested solely on collateral estoppel grounds. *See id.* at 519 n. 1. It may be worth noting that this filing was the debtors' fourth bankruptcy filing in ten years.

The court in *In re Club Tower L.P.*, 138 B.R. 307 (Bankr. N.D. Ga. 1991) most clearly provided for the enforcement of a prepetition waiver of the automatic stay. In *Club Tower*, a prepetition forbearance agreement provided for the debtor's consent to the bank's motion for relief from stay should the debtor ever file a bankruptcy. The debtor filed a Chapter 11 case, a single asset case, and the court enforced the prepetition waiver. In doing so, the court made two points: (1) even in a single asset case, waiving the automatic stay is not the same as waiving the right to file a bankruptcy because, as is evident, the debtor did file a bankruptcy; and (2) if prepetition waivers are not enforceable, creditors may be less likely to agree to out of court workouts. *Id.* at 311–12.

Recently, the U.S. Bankruptcy Court for the Eastern District of Wisconsin adopted the view that a prepetition waiver of the automatic stay can be considered as a factor in determining "cause" to lift the stay. *See In re 4848, LLC*, 490 B.R. 343, 348–49 (Bankr. E.D. Wis. 2013). In *4848, LLC*, the single-asset Chapter 11 debtor and the bank presented the arguments for and against *per se* enforcement of the prepetition waiver of the stay, and Judge McGarity rejected them both stating,

> The public policy arguments made by both sides are relatively balanced in this case. The debtor claims the clause is unenforceable *per se* because the protection afforded is of fundamental and vital importance to any debtor. In the case of a single asset real estate debtor, like this one, the entire disposition of the case depends on not being able to waive the stay as an early loss of the only property in the estate dooms reorganization. The Court does not take this policy lightly and would be dismayed if such clauses were used routinely.

> Nevertheless, the *Desai* court and others have persuasively held that a waiver can be a consideration in determining "cause" for relief from stay. It is not the only consideration and must be only one of many possible circumstances that can constitute cause. This Court finds this latter approach is the better view.

*Id.* at 349. The court recognized that the automatic stay may be of vital importance to some debtors (*e.g.*, single asset real estate debtors) and that blanket enforcement of stay waivers would not be appropriate. *Id.* However, the court tempered this concern by noting that a stay waiver would not be the only consideration in determining cause. *Id.* Although the *4848, LLC* court did not expressly adopt them, it cited ten factors that were considered by another court for the same issue:

> (1) the sophistication of the party making the waiver;
>
> (2) the consideration for the waiver, including the creditor's risk and the length of time the waiver covers;
>
> (3) whether other parties are affected including unsecured creditors and junior lienholders;
>
> (4) the feasibility of the debtor's plan;
>
> (5) whether there is evidence that the waiver was obtained by coercion, fraud or mutual mistake of material facts;
>
> (6) whether enforcing the agreement will further the legitimate public policy of encouraging out of court restructurings and settlements;
>
> (7) whether there appears to be a likelihood of reorganization;
>
> (8) the extent to which the creditor would be otherwise prejudiced if the waiver is not enforced;
>
> (9) the proximity in time between the date of the waiver and the date of the bankruptcy filing and whether there was a compelling change in circumstances during that time; and

> (10) whether the debtor has equity in the property and the creditor is otherwise entitled to relief from stay under § 362(d).

*Id.* (citing *In re Frye*, 320 B.R. 786, 791 (Bankr. D. Vt. 2005)).

Despite the conflicting approaches that have emerged on enforcing prepetition waivers of the automatic stay, it remains the majority view that such waivers are not absolutely binding or self-effectuating without an order lifting the stay. By considering a prepetition waiver as merely one of many factors in determining "cause" to lift the automatic stay, a bankruptcy court preserves its discretion to resolve the competing interests involved in any given case.

# EVERYBODY FREEZE!

**Victoria E. Powers**
**Ice Miller, LLP**
**Columbus, Ohio**

## EVERYBODY FREEZE!

Courts continue to be faced with challenges in working out the balance intended by Congress among Bankruptcy Code Sections 362(a)(3), (a)(6) and (a)(7) relating to the automatic stay, 553(a) relating to the right of setoff, and 542(b) and (c) relating to the turnover requirements.

### Setoff Rights

The Bankruptcy Code specifically provides that, with certain exceptions, the Code does not affect any right of a creditor to offset a pre-bankruptcy debt owing by the creditor to the debtor against a claim of the creditor against the debtor that also arose pre-petition. 11 U.S.C. § 553(a). The right to set off two debts against one another is governed by state law. *See, e.g., In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009). Setoff permits parties that owe each other debts to apply those mutual debts against each other. Setoff requires "mutuality" – that there be debts owing between the two parties, and where a debt arises post-petition, courts have determined that no mutuality, and therefore no right of setoff, exists. *See, e.g., In re Harris*, 260 B.R. 753 (Bankr. D. Md., 2001). The right of setoff by a bank with respect to a debtor depositor's account applies only to funds deposited into the bank account prepetition. *See, e.g.*, *In re Schwartz*, 213 B.R. 695 (Bankr. S.D. Ohio 1997); *In re Nase*, 297 B.R. 12 (Bankr. W.D. Pa. 2003).

The automatic stay of Bankruptcy Code Section 362, however, continues to be in effect with respect to a right of setoff, and the creditor must obtain bankruptcy court authority to affect a setoff through a motion for relief from the stay: Section 362(a)(7) provides that the automatic stay operates to stay "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…" *See, e.g.,*

*Matter of Corland Corp.*, 967 F.2d 1069 (5th Cir. 1992); *In re Ealy*, 392 B.R. 408 (Bankr. E.D. Ark. 2008). Accordingly, a creditor must obtain bankruptcy court authority through a motion for relief from the stay before affecting its right of setoff.

**The Banker's Dilemma and *Strumpf***

The so-called "banker's dilemma" arises for a bank when a creditor and depositor files bankruptcy, forcing the bank to consider whether to freeze the account in potential violation of the stay or risk the loss of its setoff rights in the event the funds on deposit are withdrawn. It is easy to understand why a depository bank would want to freeze or place an administrative hold on a bank account prior to obtaining relief from the stay. But would such a hold constitute "an act to obtain possession of property of the estate…or to exercise control over property of the estate," prohibited by §362(a)(3), or an "act to collect, assess, or recover a claim against the debtor that arose before to the commencement of the case…" prohibited by §362(a)(6)?

In 1995, the U.S. Supreme Court unanimously resolved the "banker's dilemma" in favor of the banks, holding that when a bank places a temporary administrative freeze on a debtor's depository account for the purpose of protecting a right of setoff, the bank has not violated the automatic stay. *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995). Cases subsequent to *Strumpf* have required that the temporary nature of the freeze upheld in *Strumpf* requires that the freeze last only a short amount of time, and that relief from the stay be sought immediately. In *Strumpf*, while the freeze was not imposed until some 8 months following the filing of the petition, the stay relief motion was filed within five days of the administrative hold or freeze. *Id.* at 17-18.

In *Strumpf*, Justice Scalia framed the question as whether the bank's refusal to pay its debt to the debtor upon the debtor's demand constituted an exercise of the right of setoff, and

was therefore a stay violation. *Id.* at 19. The *Strumpf* opinion stated it would be foolish to read the lead-in exception language in the setoff section, §553, "except as otherwise provided in this section and in section 362 and 363," to intend that §553 be limited by anything other than when an actual setoff has occurred. Noting that setoff requires an intent *permanently* to settle an account (the Court cited to *Baker v. National City Bank of Cleveland*, 511 F.2d 1016, 1018 (6th Cir. 1975) for the elements of when a setoff has occurred), the *Strumpf* court concluded that no actual setoff had been effected within the meaning of §362(a)(7), only an action to preserve the right of setoff.

The Supreme Court's short opinion examined the interplay between §542(b), which requires a turnover of property of the estate to the bankruptcy trustee *except* property that may be offset under §553 and §362(a)(7), concluding that Congress could not have intended a bank with a right of setoff to pay a claim with when 542(b) specifically excuses a turnover to the trustee.

The *Strumpf* Court also addressed §§362(a)(3) and (a)(6), and stated that the administrative hold did not violate these stay provisions because a bank account does not consist of money belonging to the depositor and held by the bank, but instead consists of "nothing more or less than a promise to pay, from the bank to the depositor..." *Strumpf* at 21, citing *Bank of Marin v. England*, 385 U.S. 99, 101 (1966). The Court concluded that the bank's administrative hold was merely a refusal to perform its promise. On balancing the stay provisions of §§362(a)(3) and (a)(6) against the general rule of §553 and the exception for setoffs contained in §542(b), the Supreme Court concluded that "the temporary refusal of a creditor to pay a debt that is subject to setoff against a debt owed by the bankrupt" would prevail, and a bank has the right to place an administrative freeze on a debtor's account pending resolution of the bank's right of setoff without violating the automatic stay. *Strumpf* at 21.

*Strumpf* is clear that where a bank has a valid right of setoff, places a temporary freeze, and moves for relief from the stay, the bank will not have violated the automatic stay of §362(a)(7). Following *Strumpf*, however, there has been significant back and forth regarding the scope of the ruling, and the limitations on not only a bank's right to place an administrative freeze on a debtor's account, but also the debtor's standing to address an alleged stay violation.

**Case Law Where There's No Setoff Right**

Following *Strumpf*, there has been a series of reported cases involving a Wells Fargo Bank administrative freeze. Wells Fargo instituted a procedure for addressing individual depositors' chapter 7 bankruptcies. Based on the reported opinions, the procedure is described as generally including the following:

- Wells Fargo reviews ECF filings to determine whether a bank depositor is the subject of a bankruptcy filing;
- If a depositor is in bankruptcy, the bank places a hold or freeze on the accounts if funds in the accounts aggregate in excess of $5,000;
- The bank immediately alerts the bankruptcy trustee and debtor's counsel of the freeze, states that the funds will not be released other than on order of the trustee or until the deadline for objection to the debtor's claimed exemptions under Bankruptcy Rule 4003 has elapsed; and
- The bank outlines options for the trustee which include instructing (i) release of the funds to the debtor, and (ii) turnover of the funds to the trustee.

In 2005, in *Jimenez v. Wells Fargo Bank, N.A. (In re Jimenez)*, 335 B.R. 450 (Bankr. D.N.M. 2005) ("*Jimenez I*"), (*vacated* by *In re Jimenez*, 2009 WL 1514496 (Bankr. D.N.M. 2009)), the New Mexico Bankruptcy Court ruled that Wells Fargo Bank's administrative freeze of the debtor's bank accounts violated the automatic stay, distinguishing *Strumpf* because Wells Fargo did not have a setoff right. The Bankruptcy Court determined that *Strumpf* had addressed §§362(a)(3) and (a)(6) only in dicta because the characterization of bank accounts as promises to pay and not property of the estate was not necessary to the *Strumpf* decision. *Strumpf*, the court

concluded, therefore was not binding precedent on the issue of whether a freeze violates the stay when there is no right of setoff on grounds that the bank account is not estate property.

The Bankruptcy Court determined that *Strumpf* should be read narrowly to have determined only the "banker's dilemma" of preserving setoff rights. *Jimenez I* at 458-459. Concluding that a right to payment from a bank is property of the estate protected by the automatic stay, the Bankruptcy Court ruled that the bank had violated § 362(a)(3). *Jimenez I* at 459-460. Wells Fargo argued that because it was required to comply with § 542, it should not be held liable for a stay violation, but the Bankruptcy Court felt that the bank should have turned over the accounts, or should have been satisfied with the safe harbor of 542(c), which permits a bank to honor checks against the account without liability for turnover if the bank was without actual notice or knowledge of the bankruptcy. *Jimenez I* at 461.

The Court also found that the debtor had standing to enforce a claim for a stay violation. Wells Fargo argued that the filing of the bankruptcy divested the debtor of the ownership of the account funds, which became property of the estate, and only the trustee had standing. Further, Wells Fargo asserted the debtor had suffered no compensable injury. Wells Fargo had prevailed on these arguments in *Calvin v. Wells Fargo Bank, N.A. (In re Calvin)*, 329 B.R. 589 (Bankr. S.D. Tex. 2005). But the New Mexico Bankruptcy Court concluded that the filing of the bankruptcy did not extinguish the debtor's property rights, and that the debtors retained their direct economic interest in the funds and therefore the right to enforce the automatic stay of § 362(a)(3). *Jimenez I* at 455-456.

On appeal, the District Court framed the question as whether the bank's imposition of its administrative freeze, preventing the debtor from accessing the deposit accounts, violated the stay. *Wells Fargo Bank, N.A. v. Jimenez*, 406 B.R. 935 (D.N.M. 2008) ("*Jimenez II*") at 940.

The freeze was placed on the debtor's accounts within days of the filing of the petition. The District Court noted that debtor's complaint was that she was deprived of the use of her property during the period for objections to the debtor's claimed exemptions. The Court found that during that period, however, as the trustee had not released the funds claims as exempt to the debtor, the accounts were property of the bankruptcy estate, and were not available for the debtor's use.

The District Court first looked at the debtor's standing, which required the debtor to show (1) injury in fact, (2) traceable to the challenged action, (3) that will be redressed by a favorable decision. *Id.* at 941. Citing to *Strumpf's* conclusion that a bank account is nothing more than a promise to pay, the District Court determined that the debtor could not establish an injury because the bank's administrative freeze took nothing from the debtor that belonged to her. *Jimenez II* at 940-941. Disagreeing with the Bankruptcy Court, the District Court concluded that the Debtor's claim of exemption in the accounts did not give the debtor standing to assert a violation of the stay because the property claimed as exempt remained property of the estate and had not been distributed as exempt. *Id.* at 942.

The District Court recognized that its ruling would result in the debtor not having standing to pursue the bank in the Bankruptcy Court. The debtor did not have standing before the exemptions became effective, and once the debtor's accounts become exempt, the Bankruptcy Court would lack subject matter jurisdiction under 28 U.S.C. § 1334(b) because the dispute would not have any impact on administration of the estate.

The *Jimenez II* Court cited *In re Calvin* with approval in support of its conclusions that the debtor lacked standing to enforce the stay, and noted its agreement with *Calvin's* reading of *Strumpf* that an administrative freeze on an account does not violate § 362(a)(3) because the freeze is neither a taking of, nor an exercise of dominion over, the debtor's property. *Jimenez II*

at 946. The Court also noted that the purpose of the stay as described in the legislative history is to prevent dismemberment of the estate, and there had been no dismemberment of the estate. The District Court found that the bank had not exercised control over property of the estate, but had relinquished control to the trustee. *Id.* at 946.

The District Court rejected the notion that *Strumpf's* permission of a freeze should apply only where the bank held a setoff right on the grounds that *Strumpf* says that a freeze is not tantamount to a setoff. The *Jimenez II* court also rejected the Bankruptcy Court's conclusion that *Strumpf's* treatment of §§362(a)(3) and (a)(6) was dicta, and concluded instead that because § 542 *requires* turnover, *Strumpf* harmonizes the various provisions of the Bankruptcy Code and dictates that § 362(a)(3) be read to permit the bank to refuse the debtor access to the accounts when, pursuant to § 542(b), the trustee had the right to a turnover of the accounts.

Wells Fargo's policy of freezing debtors' accounts and alerting the trustee and debtor's counsel was also addressed in a series of opinions arising out of the bankruptcy of Eric Mwangi and Pauline Mwicharo. In the *Mwangi* matter, pursuant to its policy, Wells Fargo froze the debtors' accounts, alerted the trustee seeking instructions, and declined to release funds to the debtors, who claimed exemption. The debtors asserted a willful stay violation by the bank. The Bankruptcy Court held that exempt property never becomes property of the estate, so the account funds were not property of the estate and accordingly, the bank's failure to release the funds was not a violation of the stay. The Bankruptcy Court also determined that the stay was not violated because the bank was not attempting to collect, assess or recover a claim against the debtors.

On appeal, the Bankruptcy Appellate Panel reversed and remanded for further proceedings. *Mwangi v. Wells Fargo Bank, N.A. (In re Mwangi)*, 432 B.R. 812 (BAP 9th Cir. 2010) ("*Mwangi I*"). The BAP held that (i) *Strumpf* does not apply because there were no setoff

rights, (ii) the exempt property remains property of the estate until it revests in the debtors as exempt and a debtor who has claimed an exemption has an inchoate interest in the property, and (iii) the debtors had standing to pursue a claim for violation of the stay. The BAP also concluded that the bank had not complied with the requirements of § 542(b), holding that the bank had violated both the automatic stay and the turnover requirements. Disagreeing with both *Calvin* and *Jimenez II*, the BAP held that *Strumpf* determined only the very narrow issue of the banker's dilemma – a freeze to protect a setoff right – and refused to extend *Strumpf* to situations where there is no right of setoff. The *Mwangi I* BAP decision, like *Jimenez I*, treated *Strumpf's* discussion of §§ 362(a)(3) and (a)(6) as limited by the setoff right.

Following remand for determination of whether there was a willful violation of the stay, the debtors filed an amended complaint as a class action seeking sanctions under 11 U.S.C. §362(k), and the Bankruptcy Court granted Wells Fargo's motion to dismiss, determining that the debtors did not have standing to pursue the alleged and the debtors could not establish an injury to any inchoate right in the account funds because during the time the freeze was in place, the funds had not revested in the debtors but remained property of the bankruptcy estate.

On appeal of that decision, the debtors contended that the bank had violated both the automatic stay and the turnover provisions of the Code and asserted standing to pursue enforcement of both provisions. This time, the appeal went to the District Court, which disagreed with the debtors and affirmed the Bankruptcy Court's ruling. *Mwangi v. Wells Fargo Bank, N.A. (In re Mwangi)*, 473 B.R. 802 (D. Nev. 2012) ("*Mwangi II*"). The District Court concluded that the account funds had remained property of the estate, but even if the debtors did have an inchoate right to the account funds, they could not allege a plausible injury resulting from the hold during the period the exemption had not taken effect, as the debtors had no right to

possess the funds and the funds were property of the estate and subject to the trustee's sole control. *Mwangi II* at 810. The District Court also concluded the debtors lacked no standing to pursue the trustee's turnover rights under § 542 *Id.* And, in any event, the District Court held, citing *Strumpf*, that a bank does not exercise control over property of the estate within the meaning of §363(a)(3) when it refuses to perform on its contractual obligation to pay the owner of the account, and accordingly, there was no violation of the automatic stay as a matter of law. *Mwangi II* at 812.

The debtors appealed to the Ninth Circuit, which affirmed as well. *Mwangi v. Wells Fargo Bank (In re Mwangi)*, 763 F.3d 1168 (9th Cir. 2014) ("*Mwangi III*"). The Ninth Circuit was persuaded that only the trustee, and not the debtors, had standing to pursue a claim for violation of the stay. *Mwangi III* at 1175-1177. The Ninth Circuit also rejected the debtors' arguments that they could suffer injury both during and after the pre-revesting period of Rule 4003. The Court found no plausible injury to the debtors during the first period when they had no right to control the account funds, and similarly did not recognize an injury to the debtors after revesting, because at that point, the funds were no longer estate property, so were not subject to the protections of the automatic stay, including 362(k). *Mwangi III* at 1177.

The Ninth Circuit in *Mwangi III* discussed with approval the Bankruptcy Court's suggestion that the debtor could have sought the trustee's agreement that the exempt property was no longer estate property, or could have moved to compel abandonment of the property, and noted that the bank had opted to seek direction of the trustee, as permitted by 542(c). *Mwangi III* at 1178. Fundamentally, the Ninth Circuit concluded that the trustee, and not the debtor, is in the position to control property of the estate. *Id.*

After *Jimenez II* and *Mwangi III*, the law in the Ninth Circuit is that the debtor does not have standing to pursue a claim for violation of the stay when the bank account is property of the estate and the debtor's exemption has not been distributed as exempt, and that an administrative freeze does not violate the stay, even when there's no right of setoff.

In December, 2014, Wells Fargo Bank's procedures were again put at issue in *In re Weidenbenner*, 521 B.R. 74 (Bankr. S.D.N.Y. 2014). In New York, the results in the Bankruptcy Court were at odds with *Mwangi III* and *Jimenez II*. The Bankruptcy Court determined that the administrative freeze violated the automatic stay of § 362(a)(3), that the turnover provisions of §542(b) and (c) did not excuse the violation, and that the debtor had both constitutional and statutory standing to prosecute the stay violation. *Weidenbenner*, 521 B.R. at 79; 80-81; 82-83. In *Weidenbenner*, the bank was not a creditor, and the Bankruptcy Court held that *Strumpf* therefore did not apply. *Id.* at 80-81. The New York Bankruptcy Court suggested that rather than freeze the accounts, banks should wait for the trustee to request turnover under 542(c). The Court distinguished *Calvin*, *Jimenez* and *Mwangi* and determined that because the debtors had identified an injury, which was a $25.00 penalty charged by Kohl's for return of a check for insufficient funds, the debtors had established constitutional standing to pursue a claim for violation of the stay, and that the debtors were entitled costs and attorney's fees. Wells Fargo's appeal of the Bankruptcy Court's decision was filed January 12, 2015, and its opening brief was submitted on April 2, 2015. The debtors alerted the Court that due to financial inability, they would not file a brief, and the National Association of Consumer Bankruptcy Attorneys, with Wells Fargo's consent, stepped in and filed an amicus brief. The matter was fully briefed as of July 2015 – to date the docket does not reflect a decision. Stay tuned!

# *In Personam/In Rem* Relief from the Automatic Stay

# Modifying the Stay in a Single Asset Real Estate Case

**Jeffrey C. Dan**
**Crane, Heyman, Simon, Welch & Clar**
**Chicago, Illinois**

## *In Personam*/*In Rem* Relief From the Automatic Stay

A mortgagee that wishes to proceed with a foreclosure has to make the decision of modifying the automatic stay pursuant to Section 362 of the Bankruptcy Code to proceed solely against the property (*in rem*) or also to proceed *in personam* against the debtor personally. Obviously, if a mortgagee requests to modify the automatic stay to proceed *in personam* as well as *in rem*, they will be seeking to liquidate their claim and obtain a deficiency judgment against a debtor. There would be no right to collect on the *in personam* judgment during the pendency of the bankruptcy case; however, the mortgagee has the opportunity to seek the opportunity to liquidate its claim as a deficiency judgment. The decision made by the mortgagee can bind them in the future as to how they proceed.

A. Modifying the Stay

The first step that the mortgagee must proceed with in being allowed to pursue its foreclosure case, is to modify the automatic stay. Some mortgagee's request the relief solely *in rem* against the debtor's property, while other seek the relief from the stay in general. If the relief from the stay is sought generally to proceed with the foreclosure, to protect itsef the mortgagee should proceed both *in rem* and *in personam* in the state court foreclosure action. Generally, actions pursued on a note without foreclosing are merely *in personam* proceedings on an ordinary debtor without recourse to the security. *Bank of Chicago/Lakeshore v. Menaldi*, 814 F. Supp. 685 (N.D. Ill. 1992). Mortgage foreclosure proceedings are quasi *in rem* actions. *ABN Amro Mortg Group, Inc., v. McGahan*, 237 Ill. 2d 526, 535 (2010). Despite the fact that a mortgage foreclosure proceeding is a quasi *in rem*, generally mortgagees will seek a deficiency judgment against the mortgagor after the foreclosure sale which creates the *in personam*

judgment. The risk is that by failing to proceed against both the property and the debtor, the mortgagee may be barred from ever proceeding against the debtor personally.

It is common practice for bankruptcy courts to grant a party relief from the automatic stay to prosecute claims in State Court and fix the personal liability of the debtor of the debtor by obtaining a judgment. *In re Davis*, 91 B.R. 970, 471-72 (Bankr. N.D. Ill. 1988). This returns parties to a legal relationship that existed before the automatic stay became operative and whatever non-bankruptcy law governed the transactions and relationships of the parties prior to the application of the Bankruptcy Code is the law which controls the conduct of the parties once the stay is lifted. *In re Winslow,* 39 B.R. 869, 871 (Bankr. N.D. Ga. 1984). However, once the stay is lifted and the judgment is obtained, during the pendency of a bankruptcy case, the litigant is precluded by the automatic stay solely from **executing** on the judgment. *In re Parkinson*, 102 B.R. 141, 143 (Bankr. C.D. Ill. 1988) (lifting the stay to allow the plaintiff to proceed to State Court litigation, "provided however, that [the plaintiff] may not attempt to enforce any judgment against the debtor"); See also *In re Tyler*, 166 B.R. 21, 25 (Bankr. W.D. N.Y. 1994) ("when... this court modifies or terminates the automatic stay... to allow a party to commence or continue a pending State Court mortgage foreclosure proceeding against a debtor's real property, it is the court's expectation that it is modified or terminated the stay for the completion of all related State Court mortgage foreclosure proceeding, including the establishment of any deficiency judgment, unless any such State Court proceedings are specifically excepted by the order.

B. *Res Judicata* Can Apply to Any Judgments

Courts have held that it is a well settled principal that *res judicata* bar is not only what was actually decided in the first action, but also whatever could have been decided. *River Park, Inc. v. City of Highland Park,* 184 Ill. 2d 290, 302; 703 N.E. 2d 883, 889 (1998). Based on this

principal, a mortgagee that has a right to seek an *in personam* judgment against the debtor and only seeks *in rem* relief, would not be able to later proceed against the debtor based on *res judicata*.

The doctrine of *res judicata* prevents the multiplicity of lawsuits between the same parties involving the same facts and issues. *Turczak v. First American Bank*, 2013 IL. App. (1st) 121964, 997 N.E. 2d 996, 375 Ill.Dec. 685. Obviously, the same facts and issues would be used in the foreclosure to obtain an *in personam* or an *in rem* judgment. Courts have found that when a creditor has requested an *in personam* deficiency in its complaint, yet only sought an *in rem* judgment, the doctrine of *res judicata* applies in that situation. A party that does not seek an *in personam* judgment when it had the opportunity to do so is barred from later doing so. *LSREF2 Nova Investments III, LLC v. Coleman*, 2015 IL. App. (1st) 140184, 33 N.E.3d 1030, 393 Ill.Dec. 286. In *LSREF2*, a lender filed a foreclosure complaint alleging the defendant was personally liable for any deficiency, after which a judicial sale was conducted and the mortgagee purchased the property for $100,000.00. An order entered with an *in rem* deficiency judgment of $227,416.32. The mortgagee then filed a complaint to enforce the promissory note against the defendant, which was dismissed based on *res judicata* grounds. The Appellate Court ruled as follows:

> Plaintiff seeks to recover the amount of the deficiency as adjudicated in the foreclosure action from defendant. Although plaintiff contends the current action as brought strictly on the promissory note, the underlying complaint sought to recover from the defendant the deficiency which resulted from the foreclosure of the mortgage in the amount determined in the order confirming the sale. The question before this court for *res judicata* purposes is whether the claim raised in the underlying lawsuit could have been resolved in the prior lawsuit. The answer is yes. In the foreclosure action, plaintiff sought to recover any amount not covered by the foreclosure sale against the defendant as provided by Section 15-1508(e) based on plaintiff's default on the mortgage and the

> promissory note. In the claim underlying this appeal, plaintiff again sought recovery based on the same default by defendant on the note and recovery of the amount of the deficiency as determined by the order confirming the sale in the foreclosure action. We, therefore, conclude that plaintiff's claim as alleged in the complaint before us and its claim for personal deficiency judgment in the foreclosure suit arise from a single group of operative facts - the deficiency which resulted from after the foreclosure sale based on plaintiff's default - albeit on different causes of action against the defendant. As a result, plaintiff's claim is barred by the doctrine of *res judicata*.

*Id*. at ¶16

See also *In re Wright*, 486 B.R. 491 (Bankr. D. Ariz. 2012), which held that the failure to seek an *in personam* judgment when the order modifying the automatic stay allowed for said relief requires the imposition of *res judicata* to bar the mortgagee from later seeking a judgment against the debtor.

Other courts have held that filing a foreclosure action solely against a property that does not include an action *in personam* against a guarantor, does not bar a later action on the guaranty. *LP XXVI, LLC v. Goldstein*, 349 Ill.App.3d 237, 811 N.E.2d 286, 285 Ill.Dec. 45 (2nd Dist. 2004). Thus the mortgagee must be careful how the original foreclosure complaint is plead. If a deficiency judgment is sought against the mortgagor, the mortgagee should seek to modify the automatic stay to proceed *in rem* and *in personam*.

The practical application of *res judicata* in this situation does not solely stop a lawsuit from proceeding separate from the foreclosure in which the *in rem* judgment was obtained. In the situation where only an *in rem* judgment is obtained and the mortgagee then attempts to file a claim in the debtor's bankruptcy case, there is a basis to object to the claim as barred by *res judicata*. Since the mortgagee did not seek a judgment against the debtor when it had the

opportunity to do so, it could be barred from later trying to collect a deficiency from the debtor's estate.

C. Proceeding Can Lead to Sanctions

In the situation where the modification of the stay is limited to an *in rem* proceeding, by obtaining an *in personam* judgment the mortgagee could also be open to sanctions. *In re Velez Arcay*. 499 B.R. 225 (Bankr. Puerto Rico 2013). In *Velez Arcay*, the Chapter 13 Plan provided for the modification of the automatic stay to foreclose on the real property. The mortgagee obtained a judgment *in rem* and a deficiency judgment *in personam* against the Debtor. In the Debtor's complaint for violation of the automatic stay, the mortgagee sought summary judgment that it had not violated the stay since it was only seeking the *in rem* judgment and the foreclosure court entered the *in personam* judgment without the mortgagee's intention to do so. Not only did the court deny the mortgagee's motion for summary judgment based on the *in personam* judgment and certain property taken by the mortgagee, but it also ordered the mortgagee to show cause as to why the court should not enter summary judgment in favor of the debtor for a violation of the automatic stay. The case was settled before summary judgment was entered and any sanction was levied, but the court was prepared to move forward against the mortgagee.

## MODIFYING THE STAY IN A SINGLE ASSET REAL ESTATE CASE

A. Determination of Single Asset Real Estate Case

The first step to determine if the stay should be modified in a single asset real estate case is to determine if the case is even a single asset real estate case. The term "single asset real estate" means real property with fewer than 4 residential units that generates substantially all of the gross income for the debtor and there is no substantial business being conducted by the debtor other than operating the real estate and activities incidental thereto. 11 U.S.C. §101(51B). The determination of the single asset status rests on the test of generating substantially all of the gross income of the debtor. If there is income generated from other sources, including litigation recoveries, those can hardly be associated with the property and such a case would not be a single asset real estate case. *In re Charterhouse Boise Downtown Properties, LLC*, 2008 WL 4735264 (Bankr.D.Idaho Oct. 24, 2008). See also *In re Global One L.L.C.*, 411 B.R. 524, 528 (Bankr.S.D.GA. 2009), which held that a counterclaim in a lawsuit was not real property or an attachment or appurtenance to the property and thus it was not a single asset case. See also *In re Kkemko, Inc.*, 181 B.R. 47, 51, (Bankr. S.D. Ohio 1995). The *Kkemko* court held that a marina does not qualify as a single asset real estate case due to other business of the marina including storage of boats, selling gas and providing other amenities such as showers to its customers.

B. Section 362(d)(3)

Once it is determined that the case is a "single asset real estate" case, the test for modification of the automatic stay is determined by 11 U.S.C. §362(d)(3), which states:

> (3) with respect to a stay of an act against single asset real estate under subsection (a) by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later-

> (A) the debtor has filed a plan or reorganization that has a reasonable possibility of being confirmed within a reasonable time; or
>
> (B) the debtor has commenced monthly payments that-
>
> (i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien); and
>
> (ii) are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate...

The test for violation is as simple as filing the plan or commencing monthly payments within 90 days of the filing of the case or within 30 days of the determination of single asset real estate status. If the debtor commences the payments at the non-default contract rate of interest on the note regarding the property, within the time period specified, or files a confirmable plan of reorganization, there is no basis to modify the stay under §362(d)(3). The court could then turn to the other sections of 362(d) to determine if the stay should be modified.

The more difficult issue is the filing of a plan that has a reasonable possibility of being confirmed within a reasonable time. Generally, courts have held that if the debtor is making sufficient progress towards a sufficient realizable goal, it should be allowed to continue with its efforts. *In Re Brian Wise Trucking, Inc.*, 386 B.R. 215, 219 (Bankr. N.D.Ind. 2008). Furthermore, debtors are generally granted sufficient leeway in the early stages of a Chapter 11 case to establish that a successful reorganization is possible. In order to establish the possibility of an effective reorganization, the Debtor should establish that it is moving toward proposing a plan, that the plan has a realistic chance of being confirmed and that the plan is not patently unconfirmable. *In Re Ashgrove Apts. Of DeKalb County, Ltd.,* 121 B.R. 752, 756 (Bankr. S.D.Ohio 1990).

Most lenders that seek to modify the automatic stay will not agree to the debtor's plan if they are not paid in full at confirmation. One of the issues relating to a feasible plan then would turn on the debtor's ability to confirm over the rejection of the plan by the lender. The main argument raised in opposition is that the lender would control the case due to it having a secured claim and an unsecured deficiency claim that would usually be large enough to control the unsecured class to prevent cram-down by the debtor. This is defeated, however, by separately classifying the lender's unsecured deficiency claim from the claims of other unsecured creditors. As set forth in *In Re Woodbrook Associates*, 19 F. 3d 312, 319 (7th Cir. 1994), the separate classification of a lender's deficiency claim from the claims of other unsecured creditors is not only permissible, such separate classification is mandatory. See also, *In Re Greenwood Point LP*, 2011 WL 721549 (Bankr. S.D. Ind.) at *3 and *4; *In Re Bjolmes Realty Trust*, 134 B.R. 1000 (Bankr.D.Mass. 1991). This provides an easier road to cram-down a plan on the secured creditor by obtaining the votes of other unsecured creditors. This necessary separate classification can demonstrate that a plan has a reasonable possibility of being confirmed.

Lenders have many ways to attack the plan to show that it is not confirmable, which generally is a Section 1129 issue, but those arguments need to be dealt with in the context of the motion to modify the automatic stay. However, when the court turns to the Section 1129 issues, the debtor need not prove that the success of the plan is guaranteed and the court has considerable latitude when deciding whether a Chapter 11 plan is feasible. *In Re Sea Garden Motel and Apartments*, 195 B.R.294, 304-305 (D.N.J.1996); *In Re Eddington Thread Mfg. Co., Inc.*, 181 B.R.826, 832-833 (Bankr. E.D. Pa.1995). The Court should simply find that a plan sets forth a reasonable probability of success. *In Re T-H New Orleans Limited Partnership*, 116 F.3d 790, 801-802 (5th Cir.1997).

The extent to which a debtor must prove the possibility of an effective reorganization is judged on a sliding scale and depends on the stage of the case. *In re SSK Partners, LLC*, 2012 WL 4929019 *4 (Bankr. N.D.Ill.), citing *In re Cadwell's Corners P'ship*, 174 B.R. 744, 759 (Bankr.N.D.Ill. 1994) and *In re Ashgrove Apartment of DeKalb Cnty, Ltd.,* 121 B.R. 752, 756 (Bankr.S.D.Ohio 1990) in which the court explained that in the initial stages of a Chapter 11, the debtor should be granted significant leeway to establish a successful reorganization. Even at the latter stages, the motion to modify the stay should not be turned into a confirmation hearing and the scales that should tip in favor of the debtor early in the case with the burden of proof becoming greater in the latter stages.

If the debtor is able to demonstrate in a summary fashion that it has reorganization alternatives that can be implemented into a viable Chapter 11 exit strategy and confirmable plan relief from the automatic stay can be denied.

C. Assignment of Rents Issues

Another issue that has arisen in the context of single asset real estate cases is that some lenders argue that they have an absolute interest in the rents from a property and the debtor retains no interest based on the assignment of rents executed by the debtor. The lender's argument is that by virtue of a default by the debtor and the lender executing on the assignment of rents, this extinguishes the debtor's property interest in the rents such that they are not property of the estate. The debtor's right to the rents during the bankruptcy case is determined by state law. *Buttner v. United States*, 440 U.S. 48, 49 (1979). In Michigan, for example, a "...default is sufficient to finalize the mortgagee's interest in rents as against the mortgagor." *Otis Elevator Co. v. Mid-Am Realty Inv'rs*, 206 Mich. App. 710 (1994). In that case, the perfection of the rents after the default was enough to establish that the rents belonged to the

mortgagor and were no longer property of the mortgagee. This can greatly affect the issues for plan feasibility if the rents are determined to not be property of the estate.

There is dissent from the *Otis Elevator holding*. See *In re Newberry Square, Inc.*, 175 B.R. 910 (Bankr. E.D. Mich. 1994), holding that the debtor retained an equitable interest in the assigned rents, making them property of the estate. The *Newberry* court also did not follow the *Otis Elevator* holding since it was a determination between two creditors and not involving the rights of the debtor mortgagee vs. the mortgagor. There are also cases that have extended the Otis Elevator holding to bankruptcy cases. See *In re Woodmere Inv'rs Ltd. P'ship*, 178 B.R. 346 (Bankr. S.D.N.Y. 1995), which held that the rents had been transferred and ownership has changed, therefore the rents are no longer property of the estate. See also *In re Madison Heights Grp., LLC*, 506 B.R. 728 (Bankr. E.D. Mich. 2013), which held that since the rents were transferred once the mortgagor perfected its interest, they were not property of the estate and therefore not cash collateral. In a recent decision of the district court in *In re Town Center Flats, LLC*, 2016 WL 1237662 (E.D. Mich), the district court overturned the bankruptcy court's ruling that rents were property of the estate. The bankruptcy court denied the mortgagor's motion to confirm that the automatic stay was not in effect regarding the rents or in the alternative seeking to prohibit the debtor from using the rents and cash collateral due to the mortgagor perfecting its interest in the rents. The district court vacated the ruling and remanded for further proceedings consistent with its findings of an absolute transfer of the rents.

This issue is unresolved, however, it remains a contested issue regarding not only the use of the rents as cash collateral but also in aiding in the determination of the feasibility of a plan that intends to use the rents in a single asset real estate case.

D. Other Bases to Modify the Stay

Many lenders will also use provisions of Section 362(d) that do not pertain solely to single asset real estate cases. Lenders will argue that "cause" exists under Section 362(d)(1) of the Bankruptcy Code for relief from the automatic stay. This is due to a lack of adequate protection. A secured creditor is only entitled to adequate protection in the form of monthly payments in order to insure that the secured creditor does not suffer a decline in the value of its secured interests in property of the estate. *In Re Thompson*, 2008 WL 2157163 (Bankr. N.D. Ill.); *In Re Addison Properties Ltd. Ptnrshp.*, 185 B.R. 766, 769, 772 (Bankr. N.D. Ill. 1995). *In Re Reddington/Sunarrow Ltd.*, 119 B.R. 809, 813 (Bankr. D.N.M. 1990); *United States Savings Assn. Of Texas v. Timbers of Inwood Forest Assocs. Ltd., 484 U.S. 365, 108 S.Ct. 626, 98 L.Ed. 2d 740 (1988).* If the value of the lender's collateral is not declining, it is not entitled to payments from the debtor prior to confirmation of the Plan, other than the §362(d)(3) payments.

Lenders will also file pursuant to Section 362(d)(2) if there is no equity in the property and the property is not necessary to an effective reorganization. If there is no equity in the property, the test turns on the term "necessary for an effective reorganization." The debtor must establish that there is a reasonable probability of a successful reorganization within a reasonable time. *In re SSK Partners, LLC*, 2012 WL 4929019 *4 (Bankr. N.D.Ill.), citing *United States Savings Assn. Of Texas v. Timbers of Inwood Forest Assocs. Ltd.,* 484 U.S. 365, 376. This is nearly identical to the test in 362(d)(3) described above.

# Selected Issues Regarding the Effect of the Automatic Stay on Pending Non-Bankruptcy Litigation

**Hon. Phillip J. Shefferly**
**Chief Bankruptcy Judge for the**
**United States Bankruptcy Court**
**for the Eastern District of Michigan**
**Detroit, Michigan**

## Selected Issues Regarding the Effect of the Automatic Stay on Pending Non-Bankruptcy Litigation[1]

One of the most important and powerful aspects of the Bankruptcy Code is the automatic stay. Section 362 provides that a bankruptcy petition "operates as a stay, applicable to all entities" of certain actions against the debtor or the property of the bankruptcy estate. It is axiomatic that the automatic stay serves a dual purpose: "to protect the debtor from the collection activities of creditors and to protect the court's process in marshaling and distributing estate assets." In re Stinson, 221 B.R. 726 (Bankr. E.D. Mich. 1998). There are volumes of cases that stand for the proposition that litigation against a debtor must cease when the debtor files bankruptcy. In addition, there are extensive scholarly materials that discuss the application, modification, and termination of the automatic stay with respect to pre-petition litigation brought against a debtor. These brief materials will not attempt to replicate those resources. Instead, these materials will focus on four particular issues, all of which involve the relationship of the automatic stay to pending non-bankruptcy litigation.

First, what is the effect of the automatic stay on an appeal taken by a debtor from an adverse decision in litigation that was pending when a bankruptcy petition is filed? Can the debtor pursue it without running afoul of the automatic stay? Second, can a debtor choose to waive the automatic stay after it files its petition where it wishes to continue with pre-petition litigation? Third, what is the effect of the automatic stay on pre-petition litigation where there are multiple defendants, but only one of them has filed a bankruptcy petition? Fourth, can a non-bankruptcy court presiding over pre-petition litigation determine whether the automatic stay applies? Is the bankruptcy court then bound by that determination?

[1] These materials were prepared by Alesia Dobbins, Law Clerk for the Bankruptcy Court for the Eastern District of Michigan, with assistance by Chief Judge Phillip J. Shefferly and his Law Clerk, Barbara Bailey for the 23rd Annual Central States Bankruptcy Workshop, June, 2016.

**1. Appeals of adverse decisions**

Whether an appeal constitutes a "continuation . . . of a judicial . . . proceeding against the debtor," so as to bring it within the automatic stay provision of § 362(a)(1), depends on whether the debtor was the plaintiff or the defendant in the initial judicial proceeding. The majority rule is that the stay applies if the debtor was the defendant but not if the debtor was the plaintiff, regardless of who files the appeal. The rationale for this view is that "[i]t is inconceivable that Congress intended or envisioned construction of the phrase 'against the debtor' to oscillate in any given judicial proceedings depending upon which stage of trial the action had progressed on the date of the filing of the bankruptcy petition." Cathey v. Johns-Manville Sales Corp., 711 F.2d 60, 62 (6th Cir. 1983).

For example, in Farley v. Henson, 2 F.3d 273 (8th Cir. 1993), two creditors filed suit against two defendants and received a money judgment. The defendants appealed and during the pendency of the appeal, both defendants filed bankruptcy. The creditors argued that the appeal was stayed. The defendants, on the other hand, argued that because they brought the appeal, the proceeding was not "the commencement or continuation . . . of a judicial . . . proceeding against the debtor" so as to bring it within the scope of the automatic stay. 11 U.S.C. § 362(a)(1). The Eighth Circuit acknowledged that "it is well established that [the stay] does not apply to a proceeding brought by the debtor that inures to the benefit of the debtor's estate." Farley, 2 F.3d at 274. However, the court held that "an appeal by a debtor in a case in which the debtor originally was the defendant is a 'continuation' of a 'proceeding against the debtor' and thus is subject to the automatic stay." Id. at 275. The court noted that at least six other federal circuit courts, including the Sixth and Seventh Circuits, follow this majority rule. See, Cathey, 711 F.2d at 61-2 ("Since the instant appeals are continuations of judicial proceedings, the only pertinent

inquiry is whether such proceedings are 'against the debtor.' 11 U.S.C. § 362(a) . . . this Court concludes that satisfaction of that criteria must be ascertained from an examination of the debtor's status at the *initial* proceeding."); Sheldon v. Munford, Inc. 902 F.2d 7 (7th Cir. 1990) (automatic stay prevented court from hearing debtor's appeal of adverse decision rendered against it in case filed by creditor).

This same logic holds true for judicial proceedings that were initially commenced by the debtor: an appeal of the decision in such a case is not subject to the automatic stay because the initial proceeding was not "against the debtor." In Carley Capital Group v. Fireman's Fund Ins. Co., 889 F.2d 1126 (D.C. Cir. 1989), the plaintiff filed suit against its insurer seeking recovery under its policy for loss of a building in a fire. The district court granted summary judgment in favor of the insurer and the plaintiff appealed. While the appeal was pending, the plaintiff was forced into involuntary bankruptcy. The court held that the automatic stay did not apply to the appeal because the case "originated as an action by [the debtors] against the [defendant]." Id. at 1127. Likewise, in Freeman v. C.I.R., 799 F.2d 1091 (5th Cir. 1986), the debtors filed a petition in Tax Court for a redetermination of their federal income tax liability. Because the petition was not filed timely, it was dismissed. The debtors appealed the dismissal and while the appeal was pending, they filed bankruptcy. However, the debtors failed to notify the court of appeals about the bankruptcy and the court affirmed the dismissal. The debtors then sought to have the affirmance vacated because it should have been stayed. The court disagreed. The court noted that the debtors initiated the proceedings and held that "[i]f the initial proceeding is not against the debtor, subsequent appellate proceedings are also not against the debtor within the meaning of the automatic stay." Id. at 1093.

An interesting scenario which does not appear in the cases discussed above is the situation where the debtor filed the initial proceeding, prevailed in that proceeding, and the creditor (or potential creditor) filed an appeal with the debtor filing bankruptcy at some point after winning the initial proceeding. According to the majority view, the appeal would not be stayed because the initial judicial proceeding was commenced by the debtor and therefore the appeal would not be a "continuation of . . . a judicial . . . proceeding against the debtor." 11 U.S.C. § 362(a)(1). However, such litigation would appear to fall within the policies advanced by the automatic stay: to provide the debtor a breathing spell to allow the debtor to reorganize or to liquidate assets in an orderly manner. A debtor could perhaps argue that the appeal in this scenario is subject to the automatic stay under another provision of § 362; for example, the debtor's claim from the initial proceeding would be considered property of the bankruptcy estate and the appeal could then be considered "any act to obtain possession of property of the estate," which would be stayed under § 362(a)(3). Likewise, a debtor could always request the bankruptcy court to enter a separate order staying the proceedings under the broad authority contained in § 105(a), which provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

**2. Waiving the protection of the automatic stay**

If a debtor-in-possession ("DIP") or a trustee desires to pursue claims against third-parties, must the DIP or trustee first seek approval to do so from the bankruptcy court? Or can the DIP or trustee act unilaterally, essentially waiving the protection of the stay? At least one court has held that the DIP or trustee need not seek permission from the court before taking actions that could arguably violate the automatic stay.

In In re Mid-City Parking, Inc., 332 B.R. 798 (Bankr. N.D. Ill. 2005), a creditor received a money judgment against the debtor in state court. After filing bankruptcy, the DIP appealed the judgment to the state appellate court. The creditor argued that the automatic stay prevented the debtor from filing the appeal and the appellate court agreed, dismissing the appeal. The creditor then brought a motion in the bankruptcy case seeking an award of the costs and attorneys' fees associated with obtaining the dismissal of the appeal under § 105(a) arguing that the debtor's actions in pursuing the appeal were a willful violation of the automatic stay. The court framed the issue as whether the DIP could unilaterally waive protection of the stay such that its actions in pursuing the appeal would not be considered a willful violation of the stay. The court concluded that the DIP could act unilaterally in furtherance of its statutory duties to administer the bankruptcy estate because the protections afforded by the automatic stay are intended to assist the DIP in performing these duties, not to hinder it. Consequently, the court held that there was no willful violation of the stay and the creditor was not entitled to reimbursement of his fees and costs.

This decision, however, arguably conflicts with Federal Rule of Bankruptcy Procedure 4001(d)(1)(A)(iii) which provides that a party must file a *motion* for approval of an agreement to terminate or modify the automatic stay. This language suggests that, even if the DIP or trustee agrees to terminate or modify the automatic stay, it must still file a motion seeking approval of the agreement by the court. On the other hand, one of the rationales for the court's decision in Mid-City Parking was that the definition of "entity" for purposes of § 362 does not include the DIP or trustee of the estate. 332 B.R. at 814-15. This rationale suggests that the court's ruling could be construed as holding that the automatic stay simply does not apply to actions by the DIP, rather than a recognition that a DIP can waive the automatic stay. This interpretation would

not necessarily conflict with Rule 4001(d)(1)(A)(iii); however, if the holding in Mid-City Parking is correct, it calls into question the need for that rule at all – if the stay does not apply to actions the DIP or trustee takes in furtherance of administration of the estate, why have a rule governing approval of agreements to lift the stay? It seems the more prudent approach would be for debtors and creditors to seek approval from the bankruptcy court to terminate, modify or clarify the automatic stay in any situation in which there may be an issue as to whether the stay applies.

**3. Multi-Party Litigation**

Another issue that arises at the intersection of the automatic stay and litigation is when there are multiple parties involved and only one of them files bankruptcy. As noted in the previous section, the automatic stay applies only to actions commenced against the debtor. 11 U.S.C. § 362(a)(1). Consequently,

> [a]ll proceedings in a single case are not lumped together for purposes of automatic stay analysis. Even if the first claim filed in a case was originally brought against the debtor, section 362 does not necessarily stay all other claims in the case. Within a single case, some actions may be stayed, others not. Multiple claim and multiple party litigation must be disaggregated so that particular claims, counterclaims, crossclaims, and third-party claims are treated independently when determining which of their respective proceedings are subject to the bankruptcy stay. Thus, within one case, actions against a debtor will be suspended even though closely related claims asserted *by* the debtor may continue.

Maritime Elec. Co., Inc. v. United Jersey Bank, 959 F.2d 1194, 1204-5 (3rd Cir. 1991). In Maritime Electric two plaintiffs, an individual and his corporation, sued two defendants, another individual and his corporation, for conversion, among other things. The two defendants filed counterclaims. The individual defendant later filed bankruptcy and the Third Circuit ultimately held that the bankruptcy filing stayed the conversion claim against the individual defendant (and

the many post-trial motions related to that claim) but did not stay the plaintiffs' claims against the corporate defendant or the individual defendant's claims against the plaintiffs.

A recent decision is typical of the problem faced by creditors suing multiple parties, although not so typical as to this particular creditor's conduct. In In re Johnson, no. 14-57104, 2016 WL 1719149 (S.D. Ohio Apr. 28, 2016), the debtor was a professional hockey player. About a month before the bankruptcy, a creditor filed a demand for arbitration against the debtor, his parents and a related LLC, asserting a secured claim against the debtor's multi-year player contract. The debtor disputed the creditor's secured status and asserted counterclaims including usury. Both sides alleged fraud.

The creditor was fully engaged in the Chapter 11 bankruptcy case, objecting to the debtor's use of its alleged cash collateral and filing an adversary proceeding both objecting to discharge and dischargeability. At the same time, without notice to the debtor, the creditor proceeded with arbitration, ostensibly only against the debtor's parents and the LLC. But in fact, the creditor sought and obtained findings, which the state court confirmed and memorialized in a judgment, that the creditor held a perfected security interest in the player contract, that it was exempt from usury laws, (the note had an effective interest rate of over 42%), and that the parents and the LLC had committed fraud based on documents that the debtor had signed as manager of the LLC. Although the creditor "stated that it might at some point 'seek relief from the stay [ ] to continue the Arbitration [Action,]' . . . it never did." Id. at *7.

The bankruptcy court found that the creditor had not violated § 362(a)(1) by taking any action against the debtor, but it had willfully violated § 362(a)(3) by exercising control over property of the bankruptcy estate, i.e. the debtor's rights under the player contract and his counter claims against the creditor. The creditor's arbitration brief did not sufficiently

distinguish between the debtor and the non-debtor parties, and it appeared that its real target was twofold – pursuit of its fraud claims against the debtor to help in its § 523 and § 727 adversary proceeding, and a full recovery through a secured claim. The creditor's "assurances that it never intended to seek to use the Arbitration Award against the Debtor mean[ ] little coming after [the creditor] got caught with its hand in the proverbial cookie jar." Id. at *20. The Johnson court voided the arbitration award and awarded § 362(k) sanctions.

A recurring issue that arises in multi-party litigation is whether the automatic stay can be extended to halt proceedings against non-debtor defendants. The court in Saleh v. Bank of America, 427 B.R. 415 (Bankr. S.D. Ohio 2010) summarized the law in this area in the Sixth Circuit. In that case, an individual debtor filed chapter 13 and sought an injunction to stay litigation pending against a small grocery store owned by the debtor.

> In the Sixth Circuit, the type of injunction requested by the Debtors has been granted in limited circumstances within Chapter 11 cases using the court's inherent powers emanating from Bankruptcy Code Section 105(a) "whose purpose is to assist the court in carrying out the provisions of the Bankruptcy Code, one of which is to oversee the reorganization of the debtor's business." The Sixth Circuit clarifies that the granting of a § 105(a) injunction is a radical measure to be granted only in "unusual circumstances." What constitutes "unusual circumstances" is described as an identity of interests between the debtor and the third party such that a judgment against the third party will in effect be a judgment against the debtor. An example is given as a case in which a third-party defendant is entitled to absolute indemnity by a debtor on account of any judgment that might result.

Id. at 420 (quoting American Imaging Services v. Eagle-Picher Indus., Inc. 963 F.2d 855, 860, 861 (6th Cir. 1992) and citing A.H. Robins Co., Inc. v. Piccinin, 788 F.2d 994, 999 (4th Cir. 1986) and Class Five Nev. Claimants v. Dow Corning Corp., 280 F.3d 648, 658 (6th Cir. 2002)). Further, in determining whether to issue an injunction under § 105(a), the bankruptcy court should also balance the traditional factors governing preliminary injunctions issued pursuant to Federal Rule of Civil Procedure 65, namely: the likelihood of the plaintiff's success on the

merits, whether the plaintiff will suffer irreparable injury without the injunction, the harm to others if the injunction is granted and whether it would serve the public interest. Eagle-Picher, 963 F.2d at 858.

In Eagle-Picher, the Sixth Circuit upheld an injunction staying litigation against the two principal officers of the debtor. In that case, the Court noted that both the bankruptcy court and the district court had found that irreparable harm would come to the debtor and its creditors without the injunction because the action would "needlessly divert key employees from the debtor's reorganization effort," "the debtor's estate will be unnecessarily diminished" because of the costs of litigation and "the same issues have been asserted in the [state] action against the debtor and [the two principals]" such that the "debtor must actively participate in the [state] action in order to protect its interests." Eagle-Picher, 963 F.2d at 860 (quoting the district court opinion).

The Sixth Circuit was also careful to note that the rationale for the injunction was to protect the debtor's creditors, not the two principals of the debtor. Id. at 862. Additionally, the injunction at issue in Eagle-Picher could be reconsidered by the bankruptcy court one year after it was entered on motion of the creditor. Id. at 857. Limiting injunctions in this way is a means for the bankruptcy court to balance the debtor's need to focus on reorganizing with the creditor's right to pursue non-debtors in the non-bankruptcy forum. See also, Venzke Steel Corp. v. LLA, Inc., 142 B.R. 183 (Bankr. N.D. Ohio 1992) (one-year injunction staying action against principal because debtor had established possibility of a viable plan (i.e. likelihood of success on the merits), the continued action would cause the debtor and its creditors irreparable harm by reducing the pool of assets available for the plan and would promote the public interest by encouraging reorganization).

Conversely, in Saleh, the court ruled that the creditor should not be enjoined from pursuing its action against the store owned by the debtor. The court noted that there was no precedent for extending the co-debtor stay in chapter 13 to corporate co-debtors and that there was substantial evidence that corporate formalities were observed and there were readily distinguishable assets of the corporation such that there was not an identity of interest between the corporation and the debtor to warrant the "extraordinary remedy of issuing an injunction pursuant to § 105(a)." Saleh, 427 B.R. at 424.

**4. The Intersection of Concurrent Jurisdiction and the Rooker-Feldman Doctrine**

Non-bankruptcy courts, including state courts, have concurrent jurisdiction to determine whether the automatic stay of the Bankruptcy Code applies to actions before them. As the Sixth Circuit has explained

> the exclusivity of the bankruptcy court's jurisdiction reaches only as far as the automatic stay provisions of 11 U.S.C. § 362. That is, if the automatic stay applies to an action directed at the debtor or its property, jurisdiction is exclusive in the bankruptcy court. If the automatic stay does not apply – e.g., if an exception to the stay covers the action in question – the bankruptcy court's jurisdiction is concurrent with that of any other court of competent jurisdiction.
>
> . . .
>
> [Consequently,] courts have uniformly held that when a party seeks to commence or continue proceedings in one court against a debtor or property that is protected by the stay automatically imposed upon the filing of a bankruptcy petition, the non-bankruptcy court properly responds to the filing by determining whether the automatic stay applies to (*i.e.*, stays) the proceedings.

Chao v. Hospital Staffing Services, Inc. 270 F.3d 374, 383-4 (6th Cir. 2001).

The Sixth Circuit recently cited Chao in ruling that "[a] non-bankruptcy court presiding over a proceeding that is exempted from the automatic stay may enter orders that are not inconsistent with the stay," even when the non-bankruptcy court did not expressly rule on the

record that an exception to the stay applied. Leonard v. RDLG, LLC, No. 15-5452, 2016 WL 1178649, at *3 (6th Cir. Mar. 28, 2016). It was enough that a default judgment for sanctions entered post-petition

> acknowledged the pending bankruptcy proceeding and stayed the remainder of the case–resolving the issue of damages–until after the termination of the bankruptcy proceedings. To be sure, this carried a risk. An order based on an erroneous jurisdictional determination may later be declared void. But that uncertainty does not diminish the power of a non-bankruptcy court to determine whether a pending matter is stayed by a debtor's bankruptcy filing.

Id. (citing Chao, 270 F.3d at 384 and Singleton v. Fifth Third Bank of Western Ohio, 230 B.R. 533, 538-39 (B.A.P. 6th Cir. 1999)).

In In re Kallabat, 482 B.R. 563 (Bankr. E.D. Mich. 2012) the debtor filed for bankruptcy the day before trial was to start in his divorce case. Despite being given a copy of the notice of the debtor's bankruptcy case, the state court found that the trial did not violate the stay, and proceeded to take evidence and rule. The debtor filed a motion in the bankruptcy case for violation of the stay. The bankruptcy court held that the state court had jurisdiction to decide if the trial violated the automatic stay. However, the state court had an overly broad interpretation of the exception to the stay, and certain aspects of the trial were stayed. As a result, the state court's rulings that adjudicated property interests and liability on a credit card debt were void.

But what happens if a debtor participates in a non-bankruptcy court action in which the court determines the stay does not apply and later wants to challenge that determination in the bankruptcy forum? Such a course of action raises issues under what is known as the Rooker-Feldman doctrine.

Under the U.S. Supreme "Court's Rooker-Feldman abstention doctrine, . . . a party losing in state court is barred from seeking what in substance would be appellate review of the state court judgment in a United States district court, based on the losing party's claim that the state

judgment itself violates the loser's federal rights." Johnson v. De Grandy, 512 U.S. 997, 1005-6 (1994) (citing District of Columbia Court of Appeals v. Feldman, 460 U.S. 462, 482 (1983); Rooker v. Fidelity Trust Co., 263 U.S. 413, 416 (1923)). This language suggests that the Rooker-Feldman doctrine bars a bankruptcy court from even reviewing a state court's determination on the applicability of the stay not just the merits of the underlying dispute between the parties. Indeed, some federal courts have come to this very conclusion.

For example, in Singleton v. Fifth Third Bank of Western Ohio, 230 B.R. 533 (B.A.P. 6th Cir. 1999), a debtor argued in a state court proceeding that his personal bankruptcy stayed the sale of property owned by the debtor's corporation. The state court specifically found that the stay did not apply and allowed the sale to go forward. Instead of appealing that decision to a state appellate court, the debtor filed an adversary proceeding in his bankruptcy for violation of the stay. In upholding the state court's decision, the bankruptcy appellate panel concluded that no exception to the Rooker-Feldman doctrine applied because the "Ohio Court did not presume to grant relief from any stay; it only determined that the stay of the Debtor's personal bankruptcy did not apply to the sale of the [] property – a decision fully within the jurisdiction of the state court." Id. at 539.

Most other courts, however, have held that the Rooker-Feldman doctrine is not a bar to a bankruptcy court review of a state court determination regarding the stay. These courts all rely on some variation of the truism that a court has the inherent jurisdiction to determine its own jurisdiction. For example, one variation of this reasoning is that, if the bankruptcy court rules differently from the state court on the automatic stay issue, the bankruptcy court's ruling trumps the state court's ruling under the Supremacy Clause. See, Chao, 270 F.3d at 384; Mid-City Parking, 332 B.R. at 805.

Another variation on the jurisdictional argument is that the bankruptcy court has exclusive jurisdiction over, not only the bankruptcy proceeding itself, but also over "'all of the property, wherever located, of the debtor as of the commencement of such case, and of property of the estate.'" Chao, 270 F.3d at 383 (quoting 28 U.S.C. § 1334(e)). Thus, if the bankruptcy court determines that the state court was wrong and that the stay actually did apply, any action thereafter taken by the state court would be void *ab initio* because the state court lacked jurisdiction to hear the case in the first place. In this sense, the bankruptcy court would be vacating or nullifying the state court action, not performing an appellate review of the state court decision. See, Raymark Industries, Inc. v. Lai, 973 F.2d 1125, 1132 (3rd Cir. 1992) ("Here, the bankruptcy court has the power to vacate the decision of the California Court of Appeals dismissing Raymark's appeal because actions taken in violation or the automatic stay are void *ab initio*."). Many of these cases hold that in such circumstances, the Rooker-Feldman doctrine is not even implicated. See e.g., Gruntz v. County of Los Angeles, 202 F.3d 1074, 1083 (9th Cir. 2000).[2]

Yet another variation in the case law is that the bankruptcy court has exclusive jurisdiction to modify or terminate the stay. If a state court erroneously determined that the stay did not apply when in reality it did, any action taken by the state court could be considered an impermissible modification to or termination of the stay. Mid-City Parking, 332 B.R. at 805. This rationale would also hold true if the state court erroneously concluded that the stay did

[2] In the Sixth Circuit, violations of the automatic stay are considered voidable, not void *ab initio*. Easley v. Pettibone Michigan Corp., 990 F.2d 905 (6th Cir. 1993). In Easley, the Sixth Circuit held "that actions taken in violation of the stay are invalid and voidable and shall be voided absent limited equitable circumstances." Id. at 911. Consequently, at least in the Sixth Circuit, a bankruptcy court could find that a state court violated the stay but still leave the state court action in place on the grounds that equitable circumstances exist to do so. In other circuits where it has been held that such stay violations are void *ab initio*, it appears bankruptcy courts would be bound to hold the state court action invalid.

apply when, as later determined by a bankruptcy court, it actually did not because this would be an impermissible expansion of the automatic stay. Id.

Not all decisions by a state court as to the extent of the automatic stay implicate Rooker-Feldman. The procedural posture of the state court and bankruptcy proceedings may obviate the application of Rooker-Feldman. For example, in Rugiero v. DiNardo (In re Rugiero), 502 Fed. Appx. 436, 2012 WL 4800059 (6th Cir. Oct. 10, 2012), a custody dispute intersected with the bankruptcy case of one of the parents. The state court ruled that it could proceed under the domestic support exception to the automatic stay. The debtor sought to enforce the stay, but the bankruptcy court agreed with the state court, and went on to hold that the Rooker-Feldman doctrine applied as well. After the district court affirmed on the same grounds, the Sixth Circuit affirmed but held that Rooker-Feldman did not apply. This was because the debtor "filed for bankruptcy *before* the state court issued its order regarding a stay" and "[t]he Rooker-Feldman doctrine applies, if it applies at all, only when the state court loser files a new lawsuit in federal court *after* the state court adversely rules." Id. at 438.

A final variation of the jurisdictional justification that the Rooker-Feldman doctrine does not apply is that many courts emphasize that the bankruptcy court is not reviewing the merits of the state court proceeding, but only the jurisdictional underpinning of the state court's ability to hear the action in the first place. For example, in James v. Draper, 940 F.2d 46 (3rd Cir. 1991) the state had obtained a default forfeiture judgment against a debtor, which was entered two days after the debtor filed bankruptcy. When the debtor filed an adversary proceeding in her bankruptcy case for violation of the automatic stay, the bankruptcy court vacated the state court judgment after reviewing the facts of the case and determining that the police power exception to the automatic stay did not apply. The district court then reversed the bankruptcy court

concluding that the facts of the case did support a holding that the police power exception applied. The Third Circuit reversed them both on the grounds that they had impermissibly reviewed the merits of the state court case rather than simply determining whether the state court had jurisdiction to hear the case. See also, Raymark Industries, 973 F.2d at 1132 ("Raymark did not ask the bankruptcy court to review the merits of the California proceeding but only to examine its jurisdictional underpinnings in light of the automatic stay. Therefore, the bankruptcy court had the power to and should have vacated the [state court] order . . . ."); Gruntz, 202 F.3d at 1083 ("A bankruptcy court simply does not conduct an improper appellate review of a state court when it enforces an automatic stay that issues from its own federal statutory authority.").

This seems a rather fine distinction to make. How can a bankruptcy court determine whether a state court was correct in applying a given exception to the stay without undertaking some review of the facts of the case? Indeed, In re Benalcazar, 283 B.R. 514 (Bankr. N.D. Ill. 2002) involved the same police power exception that was at issue in James and appears to directly contrast with that case. In Benalcazar, a creditor sought a ruling from a state court that a debtor be held in civil contempt for making false statements on the record. The debtor filed an adversary proceeding in his bankruptcy for violation of the stay and the creditor argued that the action was within the police power exception. The bankruptcy court determined that the Rooker-Feldman doctrine did not apply because the court was simply determining whether the state court had jurisdiction to hear the case. However, that court went on to evaluate the merits of the case and determined that the police power exception did not apply to the facts of the case. Id. at 529-533. According to James and other courts, this would appear to be an impermissible review of the merits of the state court case.

Ultimately, what practitioners should take away from this discussion is that a party is free to ask a state court to determine whether the automatic stay of § 362 applies to a given state court action. However, the practitioner does so at his or her own peril. A bankruptcy court (or a district court) can review the state court decision and determine that the state court was wrong for any of the reasons listed above, rendering the state court proceeding a nullity. Likewise, if a practitioner comes to a bankruptcy court asking it to find that a state court's determination regarding the stay was erroneous, the best practice would be to couch one's arguments in terms of a jurisdictional default, not a review of the merits of the case, even if such a distinction is essentially illusory.