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# Balancing the Automatic Stay

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July 2003

## Balancing the Automatic Stay

Roger Bernhardt and James Stillman

*(After writing this column, I became concerned that I might not know what I was talking about since it is more bankruptcy than real estate. I therefore showed it to prominent bankruptcy attorney Jim Stillman of Ellman, Burke, Hoffman & Johnson, and I have converted his excellent response into the better, latter half of this article. —Roger Bernhardt)*

Whew! For a while it looked as though there might be another exception to the automatic stay in favor of BFPs at nonjudicial foreclosure sales. The idea was squelched, however, by both the Ninth Circuit in *40235 Washington St. Corp. v Lusardi* (9th Cir 2003) 329 F3d 1076, reported at p . . . , and the Ninth Circuit’s Bankruptcy Appellate Panel (BAP) in *Fjelsted v Lien (In re Fjelsted)* (BAP 9th Cir 2003) 293 BR 12, reported at p . . . . While the *Washington Street* decision merely held that there is no BFP exception, *Fjelsted* replaced it with a narrower “balancing of the equities” exception (an exception that is still more generous than the “extreme circumstances” alternative). So now, according to the BAP, purchasers at the trustee sale can move to retroactively annul the stay that originally prohibited the sale, and can succeed if the court finds that the equities are balanced in their favor.

In addition, the *Fjelsted* court propounded a list of 12 (probably nonexclusive) factors to guide courts in determining whether to retroactively lift the stay. That information will not be very useful to debtors whose property was sold despite the stay, but it will assist purchasers in deciding whether to fight or throw in the towel after they discover that a bankruptcy filing had preceded the fall of the trustee’s hammer. (Sorry, this is not advice about whether potential purchasers should proceed at a sale when they already know a bankruptcy has been filed—that is probably never wise.) Thus, it is worth considering how those 12 factors might play out in future cases (and in this case):

1. *Prior filings.* In *Fjelsted*, the debtor’s prior bankruptcy filing had been dismissed 12 days before she refiled and there was no indication that anything new was alleged in the second filing. This is probably the court’s way of saying that a sale in violation of the *first* stay may be set aside, but probably not thereafter.

2. *Intent to delay creditors.* The new filing in *Fjelsted* was made just 49 minutes before the scheduled trustee sale, so the timing appeared to be motivated by no reason other than stopping the sale. It may be that last-minute filings are more likely to induce a court to allow the sale in violation of the stay to stand.

3. *Prejudice to creditors and third parties.* There will be a lot of prejudice when third parties are high bidders at the sale: They will have to give up title to the house they just purchased (and perhaps moved into), and creditors will have to repay the funds they received from that sale. In contrast, there may be little prejudice when creditors are the purchasers and have not taken possession, because everybody can probably be relatively easily restored to their original positions. In between will be the cases where the creditors purchased and then resold to third parties before the stay was discovered.

4. *Debtor's good faith.* Even a debtor who has filed often and at the last minute may have some meritorious claims deserving of consideration, so this factor seems to allow the merits to still play a role.

5. *Creditor's knowledge.* For creditors who foreclosed and sold without knowledge, the bankruptcy court's BFP rule would have let this factor trump all the others. Now, it merely helps. (Knowledge is probably still conclusive when it is the other way, *i.e.*, when the bid at the trustee sale was made *with knowledge* of the bankruptcy filing.) In *Fjeldsted*, the creditors were held to be BFPs because the auctioneer told them the sale was postponed, but not why. However, it is not always the case that anyone actually knows that a bankruptcy was filed shortly before the sale (see *Washington St.*, for example), and so there may frequently be alleged BFPs bidding. They won't always win, but their chances have improved.

6. *Bankruptcy Code compliance.* This factor says, at the very least, that if your clients did purchase in violation of an automatic stay, you ought to learn bankruptcy law before you advise them, or else bring in associate bankruptcy counsel.

7. *Return to status quo.* From the purchaser's point of view, the more time that passes after the sale the better, since the lapse of time will inevitably make matters more difficult to unwind (but see no. 9, below).

8. *Costs of annulment.* This appears similar to the prejudice factor (no. 3, above), although reference to the debtor's annulment costs perhaps means that a court should also consider what the debtor will have to pay to cure all the old mortgage arrears if the sale is to be set aside (and maybe the sale will not be vacated if those reinstatement costs exceed what the debtor claims to have in assets).

9. *Promptness.* I think this trumps no. 7 as far as creditors are concerned; time will not work in their favor even though it complicates the unraveling. Obviously, debtors should have no reasons for wanting to delay.

10. *Creditor's subsequent behavior.* (Expeditious behavior, already covered under no. 9, above, is also included here.) Bankruptcy courts would prefer that the parties, once they learn a stay had been in place, proceed no further, but that does not always happen. Although this standard tells courts to look at what later occurred, it doesn't tell them what to do about it. Should a purchaser who subsequently retrieves, and records, a trustee's deed thereby have fewer rights to annul a stay retroactively than one who allows the deed to remain with the trustee? Does a later resale to an innocent third party make it harder or easier to vacate the sale? This is where guidance would have been most helpful, but none was furnished.

11. *Irreparable injury to the debtor.* Loss of one's residence is always irreparable injury (see CC §3387). That may also be true for any property that was necessary to the debtor's reorganization plan, and perhaps also in cases where she can show she had significant equity in the residence and could have gotten a better price had she been able to sell it at a nondistress, free-and-clear sale.

12. *Judicial economy.* Anything that keeps court costs and taxes down!

*Jim Stillman comments:*

The BAP's opinion in *Fjeldsted* is informative for two reasons. First, it colorfully describes the jumbled and costly stay-relief proceedings below, a description that is always interesting (and

often painful) for practitioners; and second, for guidance on remand, the BAP gives practitioners and trial courts yet another “list of factors” (for ruling on stay annulment motions), to join the other “lists of factors” that are so prevalent in bankruptcy jurisprudence.

In *Fjeldsted*, according to the record presented by the BAP, the bankruptcy judge “lost it” with debtor’s counsel in the course of the stay annulment proceedings. At an early hearing, the judge chastised debtor’s counsel for filing memoranda “full of wild allegations that don’t have any support.” This is known in the parlance of bankruptcy as “testimony by argument,” and although it is common and frustrating, we may assume in this case that Ms. Fjelsted’s lawyer took the tactic to extremes. Some number of hearings later, debtor’s counsel filed a motion for reconsideration that, in the court’s view, “misquoted and misstated” what had happened at a prior hearing. In oral argument, debtor’s counsel wished to defend the accuracy of his pleadings. In the excerpt of the hearing transcript given in the appellate opinion, the bankruptcy judge is made to appear preemptory: “I’m not going to hear another word!” she rules, then sanctions the lawyer \$500, and then another \$100, when he keeps talking. Not sufficient due process, the BAP ruled; the bankruptcy court abused its discretion “if understandably out of frustration with [counsel’s] style of advocacy.”

Is stay annulment the right way to defend title? It was not an easy way, in *Fjeldsted*. From the BAP’s description of the proceedings below, we know that initial briefs and a motion were filed in mid-December 2001, and were met by opposition briefs. The briefing was followed by oral argument at an initial hearing. At the hearing, specific factual issues were reserved for further briefing and for a second evidentiary hearing. After the second evidentiary hearing, further issues were specified for further briefing, argument, and further evidentiary hearing. And then the motion to reconsider was filed, engendering its own round of briefing and a hearing. After all that, the appeal was taken, resulting in a ruling (reversed and remanded), which sent everything back to the starting gate. If the purchaser in *Fjeldsted* was represented by a large firm, the bill for legal services in connection with the foregoing must have been a hundred thousand dollars. So goes bankruptcy court litigation: You may be losing while you’re winning. As General Sun Tzu warned, pick your fights carefully.

In *Fjeldsted*, the BAP seems to signal a change in mood regarding annulment proceedings. An annulment should not be considered “a radical form of relief,” an “extraordinary action,” or relief accorded only in “extreme circumstances,” the BAP writes. Nor should the remedy be limited solely to cases where the creditor was innocent and the debtor engaged in unreasonable or inequitable conduct. No, the BAP says, the annulment remedy should be considered within the “normal operation” of 11 USC §362(d) (relief from stay), and its application should be governed by a general “balancing of the equities” standard.

As an aside, I would observe that if the BAP meant to push the annulment remedy more into the open, I cannot imagine why. The automatic stay is supposed to be terrible and awesome; creditors must tremble before it, so that all enforcement action comes to a halt the moment the bankruptcy estate comes into existence. The automatic stay enforces one of the *Ur*-principles of bankruptcy—equality of treatment among creditors similarly situated—by stopping the race to the courthouse before (or, I guess, after) the petition is filed.

In its ruling, the BAP suggests 12 factors to consider when deciding whether to annul the stay, which my co-commentator, Roger Bernhardt, ably dissects. As Prof. Bernhardt points out, in any given case there are obvious exceptions to any “list of [preordained] factors”: There are “factors”

that should not be factors at all; and there are factors that didn't make the list. One of the best known early lists of factors for practice under the Bankruptcy Reform Act was given by the Fifth Circuit Court of Appeals in *Little Creek Dev. Co. v Commonwealth Mortgage Corp. (In re Little Creek Dev. Co.)* (5th Cir 1986) 779 F2d 1068. "Several, but not all, of the following conditions usually exist," the court wrote (779 F2d at 1072) in giving its description of the circumstances that amount to a bad faith filing. The "conditions" took on a life of their own, and the subsequent citation history for *Little Creek* is almost measureless. If *Little Creek* is now out of date, then it has been replaced by other opinions on the subject containing even more lists of factors. See, e.g., *Duvar Apt., Inc. v FDIC (In re Duvar Apt., Inc.)* (BAP 9th Cir 1996) 205 BR 196 (seven-point test for bad faith filing).

There are many subjects in bankruptcy on which appellate courts have given multi-part tests or factors. For example, the court in *Kuske v McSheridan (In re McSheridan)* (BAP 9th Cir 1995) 184 BR 91 volunteered an often-cited "three part test" for the definition of rent under 11 USC §502(b)(6)(A). The Code itself contains nonexclusive "lists of factors," perhaps the most prominent lying in the definition of "insider" (11 USC §101(31)), which is most often interpreted to mean that you *are* an insider if any of the factors applies, but you *may be* an insider anyway, even if none of the factors fits. Or consider the factors that "may" constitute adequate protection, under 11 USC §361, or the many other places in the Code and bankruptcy case law where "best interests" and "good faith" standards obtain.

This situation arises because it is essential for good case administration in bankruptcy that courts employ two jurisprudential systems: equity, in which rules are subordinate to good conscience, and statutory law, in which the meaning of words selected by legislators is paramount. Skillful and experienced bankruptcy practitioners have a sense of how these systems intermix. Their answers to a client's question is, so often, "Not necessarily," or "In some cases"; and it is rarely, "That's impossible." We find "lists of factors," such as those given by the BAP in *Fjeldsted*, at those junctures where appellate judges detect a policy in favor of greater predictability, or wish to guide results in a more certain direction, which always comes at some cost of flexibility in the original proceeding.