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To Trade and Secured Creditor Clients: Measure Twice, Cut Once and Don't Violate the Automatic Stay!

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In a recent decision on a matter of first impression, the Second Circuit Court of Appeals reminds us of the importance of the automatic stay, which arises immediately upon the filing of a case under the United States Bankruptcy Code (the "Code").

The basic rule is that, once a debtor files a bankruptcy petition, actions against the debtor must cease immediately. If a creditor wants to pursue its claims against a debtor, it must seek bankruptcy court approval. A creditor may then pursue its claims in bankruptcy court or, if it had already commenced an action in another forum, the lifting of the automatic stay can enable the creditor to continue its proceeding where it was pending as of the petition date.

But the automatic stay can create unexpected results for the unwary. Violations of the stay have been the subject of many of our prior client alerts, including those dealing with prepetition seizures and failure to release collateral, refusal to release student transcripts, and other related topics, all of which created a violation of the automatic stay issue. (Beware of the Automatic Stay! Bankruptcy Court Sanctions Law Firm and Client for "Willful" Violation of the Automatic Stay; Automatic Stay Violators and Prepetition Seizures; The Automatic Stay: Even Pre-Petition Seizures May Be Covered; Questioning Willful Violations of the Automatic Stay: Third Circuit Gives University the Third Degree; Purdue Pharma: Is Protection of Third Parties by the Automatic Stay an Oxymoron?)

In *Bayview Loan Servicing LLC v. Fogarty* (*In re Fogarty*), the Second Circuit unanimously adopted a bright-line rule for application of the automatic stay where the debtor is a named party in an action pending as of the petition date. *See In re Fogarty*, No. 20-2187, 2022 WL 2443388 at *1 (2d Cir. July 6, 2022). In *In re Fogarty*, the individual debtor held a 99% interest in a non-debtor LLC, which in turn was the sole owner of a residential property that the individual debtor occupied as her primary residence. *Id.* at *1.

The LLC defaulted on its mortgage loan and, in 2011, the lender initiated a foreclosure action in the Supreme Court of the State of New York, Suffolk County. Although the individual was the 99% owner of the LLC, she was neither a maker or co-maker of the mortgage note, nor a guarantor of the debt. The lender named the LLC, the New York State Department of Taxation and Finance, and "John Doe 1-50" as defendants in the foreclosure action, the latter being standard practice to cover persons or entities unknown that may have a claim or interest, possessory or otherwise, in the mortgaged property. *Fogarty*, 2022 WL 2443388 at *2. Although the individual had no liability on the loan, the lender later moved to substitute the individual in place of John Doe #1 because it had determined she was a tenant of the premises.

The lender obtained a judgment in the foreclosure action, and a foreclosure sale was scheduled for April 17, 2018. Four days before the scheduled sale, the individual debtor filed a chapter 7 petition, triggering the automatic stay. The debtor gave notice of the bankruptcy filing to the lender and asserted that continuation of the sale would violate the automatic stay. The lender argued that the automatic stay was inapplicable because the property was owned by the LLC, not the debtor. The lender proceeded with the foreclosure sale and the property was purchased by a third party.

The individual debtor then sought sanctions against the lender, arguing that the lender willfully violated the automatic stay.[1] The bankruptcy court held that the individual debtor was not liable on the indebtedness and that the foreclosure was an action against the property "solely *in* rem." *Fogarty*, 2022 WL 2443388 at *3. Thus, the lender did not violate the automatic stay by naming the debtor. The debtor appealed to the United States District Court for the Eastern District of New York.

The district court reversed the bankruptcy court's order identifying two reasons for its ruling. First, because the individual debtor was a named party in the foreclosure action and that was the basis of the sale, the lender was in violation of the automatic stay by proceeding with the sale. Second, because the sale interfered with the individual debtor's property interest and that interest was part of the debtor's bankruptcy estate, it was protected by the automatic stay. *See Bayview Loan Servicing LLC v. Fogarty* (*In re Fogarty*), 18-cv-3324, 2020 WL 13442114 (E.D.N.Y. July 1, 2020). That decision was appealed to the Second Circuit Court of Appeals.

The Second Circuit found that the automatic stay under Section 362(a)(1) and 362(a)(2) of the Code is "violated by the foreclosure sale of a property when the debtor is a named party in the foreclosure proceeding, even if the debtor's direct interest…is only possessory." *Fogarty*, 2022 WL 2443388 at *4. In other words, the stay was violated because the debtor's ability to remain in the premises was disturbed.

The Court relied on the "plain text" of Sections 362(a)(1) and (a)(2). *Fogarty*, 2022 WL 2443388 at *3. For Section 362(a)(1) specifically, the Court reasoned that the sale represented a "continuation…of a judicial…or other action or proceeding against the debtor." *Id.* Additionally, Section 362(a)(1) provides that actions "against the debtor" or

"to recover a claim against the debtor" are subject to the automatic stay. *Id.* Because the individual was a named defendant in the foreclosure action, the action was thus "against the debtor" and therefore subject to the automatic stay. *Id.*

As for Section 362(a)(2), because the individual remained a defendant in the foreclosure proceeding at least through the sale, the sale enforced a judgment "against the debtor." *Id*. at *5. Thus, the sale violated the automatic stay imposed by Section 362(a)(2), providing that the stay is applicable to "the enforcement, against the debtor or against the property of the estate, of a judgment obtained before the commencement of the case."

Paying attention to certain basic rules can avoid such a result. First, and less expensive than multiple appeals, a creditor can file a motion in the bankruptcy court to lift the stay.

Another option is to file a motion in state court to sever claims of a debtor defendant. In cases where only one named defendant has filed for bankruptcy and the proceeding is still pending in state court, it may be possible to sever and continue with the proceeding of the defendant that is not protected by the stay, as long as they are not an indispensable party.[2] While this would not have been a plausible route for the lender in *Fogarty* because a judgment had already been entered, the Second Circuit commented that if the debtor "had been dismissed from the case as a defendant before the Sale occurred…the sale might not have violated the automatic stay." *Id*. at *8.

Courts, including the Second Circuit, have recognized that the ultimate decision of whether the automatic stay applies to a non-bankruptcy action lies primarily with the bankruptcy court, not with a creditor or its attorney. Simply put, bankruptcy court is not the place to act first and seek forgiveness later.

Please note that this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient. If you have questions regarding these provisions, or any other aspect of bankruptcy law, please contact Michael H. Traison (mtraison@cullenllp.com) at (312) 860-4230 or Elizabeth Usinger (eusinger@cullenllp.com) at (516) 357-3869.

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Footnotes

[1] The District Court determined that the stay was willfully violated, explaining that the relevant inquiry is only whether the lender intended to take the action that violated the automatic stay. The lender did not challenge this conclusion on appeal.

[2] *Teachers Ins. and Annuity Ass'n of America v. Butler*, 803 F.2d 61, 65 (2d Cir. 1986); LG *37 Doe v. Nail*, No. 1:20-cv-00217-FPG, 2021 WL 164285 at *4 (W.D.N.Y. Jan. 19, 2021) ("Courts in similar circumstances have found that failure to sever claims against a bankruptcy party would be unjust, unless it is an indispensable party to the action.").

Practices

- Bankruptcy and Creditors' Rights

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