

**ISSUES IN APPLYING THE AUTOMATIC STAY
TO PENDING LITIGATION**

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11 U.S.C. § 362(a) creates a stay of –

- (1) The commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title.

There are actually three stays of action—against the debtor, against the debtor’s property, and against estate property. Pending litigation primarily implicates the first.

A. Purpose of Stay

The automatic stay has two primary purposes: To give the debtor a “breathing spell” from creditors and to protect creditors by averting a scramble for the debtor’s assets and promoting, instead, an orderly liquidation or other distribution procedure. Farley v. Henson, 2 F. 3d 273, 274 (8th Cir. 1993). Some courts apply these purposes in determining whether a particular action violates the stay.

B. What is stayed?

- (1) Actions or proceedings
 - *any* judicial or administrative action or proceeding against the debtor that could have been commenced before the case. See, In re Panayotoff, 140 B.R. 509, 511 (Bankr. D. Minn. 1992); In re Joe DeLisi Fruit Co., 11 B.R. 694, 695 (Bankr. D. Minn. 1981).
 - Including civil contempt actions. In re Atkins, 176 B.R. 998, 1006 (Bankr. D. Minn. 1994).
- (2) Against the debtor—How can you tell?
 - Whether an action is against a debtor (as opposed to by a debtor) is determined by the debtor’s status at the time the action was begun. In re Berry Estates, Inc., 812 F. 2d, 67, 71 (2nd Cir. 1987).
 - The automatic stay’s effect on judicial proceedings against the debtor does not depend upon whether the court finds for or against the debtor. Ellis v. Consolidated Electric Corp., 894 F. 2d 371, 373 (10th Cir. 1990).
 - Actions by the debtor usually produce recovery for the estate (or leave its value unaffected). In Matter of Mahurkar Double Lumen Hemodialysis

Chatheter Patent Litigation, 140 B.R. 969, 976 (D. N. D. Ill. 1992) (hereafter Mahurkar).

- The primary purpose of § 362 is not applicable to offensive actions by the debtor in possession or bankruptcy trustee. In re Merrick, 175 B.R. 333, 337 (9th Cir. BAP 1994); In re White, 186 B.R. 700, 704 (9th Cir. BAP 1995).
- There is no stay of action against non-debtor parties to litigation. Teachers Ins. & Annuity Assn. v. Butler, 803 F. 2d 61, 65 (2nd Cir. 1986). This is true even if those other parties are in a similar legal or factual nexus with the debtor. Seiko Epson Corp. v. Nu-Kote International, Inc., 190 F. 3d 1360, 1364 (Fed. Cir. 1999).
- Examples of action stayed and not stayed –
 - Court dismissal of action commenced by debtor not stayed. In re Way, 229 B.R. 11, 13 (9th Cir. BAP 1998) (non-debtor party may continue to defend state court action commenced by debtor, as long as other party does not raise counterclaims.)
 - Court may dismiss debtor's counterclaim in action originally brought against debtors. First Wisconsin National Bank v. Grandlich Development Corp., 565 F. 2d 879, 880 (5th Cir. 1978).
 - Debtor's cross-claim against co-defendant for contribution is not stayed. Boone v. Beacon Bldg. Corp., 613 F. Supp. 1151, 1155 (D.N.J. 1985).
 - Debtor may not appeal adverse ruling in action commenced by non-debtor party without obtaining relief from stay. Farley v. Henson, 2 F. 3d 273, 275, (8th Cir. 1993).
 - Violation of stay to dismiss claim against the debtor, when court must first decide other related issues. Dean v. TransWorld Airlines, Inc., 72 F.3d 754, 756 (9th Cir. 1995).

(3) “Disaggregation”

- “All proceedings in a single case are not lumped all 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 and cross claims and third-party claims are treated independently when determining which of their respective proceedings are subject to the bankruptcy stay.” Maritime Electric Company, Inc. v. United Jersey Bank, 959 F. 2d 1194, 1204 (3d Cir. 1992).

C. Counterclaims

- (1) Not in bankruptcy court.
 - Pursuit of pre-petition counterclaims or counterclaims raised in a court other than bankruptcy court requires relief from stay. Action Drug Co. v. Overnite Transportation Co., 724 F. Supp. 269 (D. Del. 1989); Merrick, 175 B.R. at 336.
 - Normally a creditor will be allowed relief from stay to pursue a counterclaim in response to the offensive action of a debtor. “Out of fairness, the defendant should be allowed to defend himself from attack and the automatic stay should not tie the hands of the defendant while the plaintiff debtor is given free rein to litigate. White, 186 B.R. at 705; In re Rogers, 251 B.R. 626, 629 (Bankr. Fla. 2000); In re Millsap, 141 B.R. 732 (Bankr. D. Idaho 1992).
- (2) In bankruptcy court.
 - Post-petition counterclaims in bankruptcy court do not require relief from stay. The early case of In re Lessig Const., Inc., 67 B.R. 436 (Bankr. E.D. Pa. 1986) suggested that a defendant must obtain relief from the automatic stay before asserting a counterclaim against the debtor in an adversary proceeding brought by the debtor in bankruptcy court. This suggestion has more recently been rejected by courts holding that a non-debtor may file a counterclaim that is directly related to the claim against that party. See, In re Briarwood Hills Assoc. L. P., 237 B.R. 479, 480 (Bankr. W. D. Mo. 1999).
 - Newer cases hold that the automatic stay does not apply to proceedings within the bankruptcy court having jurisdiction over the debtor. In re North Coast Village, Ltd., 135 B.R. 641, 643, (9th Cir. B.A.P. 1992), In re Atrius Enterprises, Ltd., 120 B.R. 341, 346 (Bankr. S.D.N.Y. 1990); In re Washington Manufacturing Co., 118 B.R. 555, 561 (Bankr. Tenn. 1990).
 - Other courts reason that suits against the debtor in bankruptcy court or counterclaims in bankruptcy court can be considered the functional equivalent of filing a proof of claim against the bankruptcy estate, In re J.T. Moran Financial Corp., 124 B.R. 931, 940 (S.D.N.Y. 1991); or the equivalent of requesting relief from the automatic stay. In re F.R.G., Inc., 121 B.R. 710, 714 (Bankr. E.D. Pa. 1990).

D. Discovery

- (1) Discovery from debtor in action against debtor.
 - Pursuing discovery against a debtor in a state court action filed prior to the bankruptcy case is “continuation” of the state court action and requires relief from the automatic stay.” In re Manown, 213 B.R. 411, 412 (Bankr. N.D. Ga. 1997); but, see, America Online, Inc. v. C.N. Productions, Inc., 272 B.R. 879 (D.E.D. Va. 2002)(debtor must respond to discovery request in action against him for civil contempt.)

- (2) Discovery against debtor to defend claim by debtor or third party.
- A non-debtor party to litigation may obtain relief from stay to defend itself against the debtor's counterclaim in non-bankruptcy litigation. In re Bailey, 11 B.R. 199, 201 (Bankr. E.D. Va. 1991).
 - Similarly, a party may obtain relief from the automatic stay to depose a debtor to defend against a third party's action. In re Bradley, 2000 WL 33710900 (D. Utah 2000.)
- (3) Discovery from debtor as witness.
- The automatic stay does not apply to discovery sought from the debtor regarding claims by or against a non-debtor party, even where that information could adversely affect the debtor. In re Miller, 262 B.R. 499, 505 (9th Cir. BAP 2001); In re Hillsborough Holdings Corp., 130 B.R. 603, 605 (Bankr. M.D. Fla. 1991).
 - Because related litigation goes on without the debtor, the debtor is obligated to participate in discovery to the extent it would be as a non-party. Mahurkar, 140 B.R. at 977.
 - Courts disagree on whether the automatic stay even applies to debtor as a third-party witness only. Early courts, like Johns-Manville assumed it did and established a test for when the discovery request should be allowed. This puts the burden on the party seeking discovery to come in for relief from stay. More recent cases suggest that the burden ought to be on the debtor to seek protection from overly burdensome discovery, instead.
- (4) Standards for obtaining discovery from the debtor.
- Bankruptcy courts are generally protective of debtors and will not allow discovery to proceed involving a debtor to the extent that it would significantly distract from the debtor's attempts at reorganization so as to prejudice reorganization efforts. In re Towner Petroleum Co., 48 B.R. 182 (Bankr. W.D. Okla. 1985).
 - The two Johns-Manville cases set out the general standard courts use in determining whether litigation-related discovery is unduly burdensome. See, Johns-Manville Corporation v. Asbestos Litigation Group, 40 B.R. 219 (S.D.N.Y. 1984) and Occidental Chemical Corp. v. Johns-Manville Corp., 41 B.R. 926, 927 (S.D.N.Y. 1984).

E. Which Court Decides?

- (1) Court where litigation is pending may construe the automatic stay. It is well settled that both the bankruptcy court and the court in which the other litigation is pending may determine whether the automatic stay applies and the extent to which it applies. Mahurkar, 140 B.R. at 973; Picco v. Global Marine Drilling Co., 900 F.2d 846, 850 (5th Cir. 1990).

- (2) Only the bankruptcy court has the power to release or modify the automatic stay. Mahurkar, 140 B.R. at 974. See also Maritime Electric Company, Inc., 959 F.2d at 1204; Cathey v. Johns-Manville Sales Corp., 711 F.2d 60, 62-63 (6th Cir. 1983), cert denied, 478 U.S. 1021, 92 L.E.D. 2d 740 (1986).
- (3) In light of the Eighth Circuit's interest in the Rooker-Feldman doctrine, the party concerned about determining the scope of the stay—whether seeking to go forward with an action or to be free from an action—should get to the court of its choice for a decision.

F. Who Goes to Court First?

“There is all the difference in the world between a litigant who barges ahead as if the bankruptcy filing never took place and the litigant who conscientiously brings the filing to the attention of the court and asks for interpretation and instruction.” Judge Easterbrook in Mahurkar, 140 B.R. at 974.

Early courts, as in the Johns-Manville cases, assumed that the automatic stay applied to all discovery involving the debtor. More recent decisions distinguish between whether the case is still against the debtor or whether the debtor can more accurately be characterized as a third-party witness. The safer course is to seek relief from the automatic stay in all cases or, if representing the non-debtor litigant, to ask the trial court for a determination that the stay does not apply to discovery sought against a non-party debtor.

G. A Violations—Void or Voidable?

In the Eighth Circuit, as in the majority of other circuits, acts in violation of the automatic stay are considered void *ab initio*. In re Vierkant, 240 B.R. 317, 325 (8th Cir. BAP 1999). A party may, however, request that the court annul the automatic stay. This is a statutory exception to the general operation of the stay, and allows an action taken in apparent violation of the stay to stand. In re Hoffinger Industries, Inc., 2002 WL 337425 (Bankr. E.D. Ark. 2002); In re Harris, 268 B.R. 199 (Bankr. W.D. Mo. 2001). One court has even held that the temporary suspension of an action against a debtor (in that case a foreclosure sale) does not violate the automatic stay as long as the other party merely preserves the status quo and intends to immediately seek relief from the stay. Taylor v. Slick, 178 F.3d 698 (3rd Cir. 1999). This seems a notable extension of the bank “administrative freeze” concept of Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 116 S. Ct. 286 (1995), although the Taylor court did not cite Strumpf. Instead, the Circuit Court analyzed it as a debtor's due process question, concluding that the “confirmation” of the foreclosure sale simply preserved the status quo—not a concept previously recognized as a primary purpose of the automatic stay. Thus, the law evolves. Stay tuned.