

Second Circuit Finds Willful Stay Violation in Foreclosure Sale of Non-Debtor's Real Property

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On July 6, 2022, the Court of Appeals for the Second Circuit (the Circuit Court), in analyzing an issue of first impression, entered a decision clarifying the expansive applicability of the automatic stay provision of the Bankruptcy Code. In *Bayview Loan Servicing LLC v. Fogarty (In re Fogarty)*, No. 20-2187, 2022 U.S. App. LEXIS 18515 (2d Cir. July 6, 2022), the Circuit Court was tasked with determining whether the automatic stay provision of Bankruptcy Code section 362(a) was violated by the foreclosure sale of real property when the debtor was a named defendant in the underlying foreclosure proceedings, even if the debtor's direct interest in the property was merely possessory. In affirming the decision of the District Court for the Eastern District of New York (the District Court), which reversed an earlier decision of the Bankruptcy Court for the Eastern District of New York (the Bankruptcy Court), the Circuit Court held that the foreclosure sale was a willful violation of the automatic stay.

Factual Background and Procedural History

Eileen Fogarty (the Debtor) held a 99% interest in 72 Grandview LLC (Grandview), which was the sole owner of residential real property located in Shirley, New York (the Property), which was also Debtor's primary residence. Bayview Loan Servicing LLC (Bayview) commenced a foreclosure action (the Foreclosure Action) against the Property in early 2011 in the New York State Supreme Court, County of Suffolk (the State Court). Initially, Bayview named, among others, Grandview and John Does #1-50, but not Debtor, as defendants in the Foreclosure Action. However, in October 2014, Bayview requested that Debtor be substituted in as a party defendant in place of John Doe #1 as "co-tenant in possession of a portion of the" Property.[1] In early 2018, the State Court entered a *Judgment of Foreclosure and Sale*, naming Debtor as among the defendants, and Bayview scheduled a foreclosure sale of the Property for April 17, 2018.

On April 13, 2018, four (4) days before the scheduled foreclosure sale of the Property, Debtor filed a petition for Chapter 7 relief in the Bankruptcy Court. Debtor's counsel subsequently notified Bayview's counsel that: (i) Debtor had filed for Chapter 7 protection; (ii) continuation of the foreclosure sale would violate the automatic stay of Bankruptcy Code section 362(a); and (iii) Debtor would seek costs, fees, and sanctions for any such stay violation. Bayview's counsel responded that as non-debtor Grandview, and not the Debtor, was the legal owner of the Property, and is legally distinct from Debtor, the automatic stay was inapplicable. Bayview then proceeded with the foreclosure sale as scheduled.

Debtor subsequently moved for sanctions against Bayview in the Bankruptcy Court, asserting willful violations of Bankruptcy Code sections 362(a)(1) and (a)(2), and seeking actual damages, costs, fees, and punitive damages. In denying the motion, the Bankruptcy Court held that because Debtor could not be held liable under the subject loan documents, executed solely by Grandview, the Foreclosure Action was solely *in rem* and Bayview did not violate the automatic stay in proceeding with the sale. Upon Debtor's appeal, the District Court reversed the Bankruptcy Court, holding that Bayview had willfully violated the automatic stay because: (i) Debtor was a named defendant in the Foreclosure Action; and (ii) the sale interfered with Debtor's possessory interest in the Property, which interest was property of the Debtor's Chapter 7 estate. Bayview appealed to the Circuit Court.

The Circuit Court's Rationale

A debtor's filing of a bankruptcy petition "operates as a stay, applicable to all entities" of, among other things: (i) the continuation of a judicial action "against the debtor" that was commenced before the bankruptcy case;^[2] and (ii) "the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under" the Bankruptcy Code.^[3]

In analyzing these two (2) provisions of the Bankruptcy Code, the Circuit Court noted first that actions "against the debtor," as used in section 362(a)(1), must naturally encompass actions where the debtor is a named defendant.^[4] Consequently, as Debtor was substituted as a party defendant in the Foreclosure Action, the Circuit Court could "only conclude that the Foreclosure Action was 'against the debtor' and therefore covered by Section 362(a)(1)."^[5] The Circuit Court further noted that Debtor remained as a named party defendant in the Foreclosure Action from her substitution therein up to the sale of the Property, as reflected by the caption in pleadings filed in the State Court.^[6] It follows that the foreclosure sale was the "continuation" of a pre-bankruptcy action against the Debtor and, thus, was subject to the automatic stay.^[7]

As to Bankruptcy Code section 362(a)(2), the Circuit Court noted that as the foreclosure judgment was entered on February 14, 2018, and Debtor filed for Chapter 7 protection on April 13, 2018, the judgment was undoubtedly "obtained before the commencement of" the Debtor's Chapter 7 case.^[8] Furthermore, the sale of the Property was the "enforcement, against the [D]ebtor . . . of a judgment . . ." ^[9] Specifically, the foreclosure judgment authorized the sale of the Property by a court-appointed referee, the judgment bound all defendants thereunder, and the Debtor was a party defendant to the Foreclosure Action up to at least the sale.^[10] The Circuit Court concluded its analysis of section 362(a) by stating that its language "demands a bright-line rule that, so long as the debtor is a named party in a proceeding or action, the automatic stay applies to the continuation of that proceeding, and to the enforcement of, a judgment rendered in that proceeding."^[11]

In addressing the Bankruptcy Court's decision, the Circuit Court also dismissed Bayview's argument that, because the Foreclosure Action was an *in rem* proceeding and Debtor was only named as a party defendant as an "interested party," there was no effect in Debtor's Chapter 7 estate.^[12] The Circuit Court noted that Bankruptcy Code section 362(a) does not draw a distinction between *in rem* and *in personam* proceedings, nor does it inquire as to *why* a debtor is named as a defendant in legal proceedings.^[13] Rather, its plain text clearly stays the "continuation . . . of a judicial . . . action or proceeding against the debtor that was . . . commenced before the commencement of the case" under the Bankruptcy Code.^[14]

Conclusion

Counsel to creditors and other parties-in-interest to a bankruptcy proceeding should take great efforts to heed the warnings that: (i) "the automatic stay . . . is all-powerful and exempt from compromise";^[15] and (ii) "[w]hen in doubt . . . file a motion for relief from the stay . . ."^[16] As demonstrated in *Bayview*, a willful violation of the automatic stay most often results in significant, and almost always preventable, monetary penalties against the offending party. Indeed, under Bankruptcy Code section 362(k), a party found to have willfully violated the automatic stay is not only liable for a debtor's actual damages, including costs and counsel fees, but, in some circumstances, punitive damages as well.^[17] As such, oftentimes it is in a party's best interest to seek stay where applicability of the stay is in question. "Put bluntly, the system requires that a creditor ask for permission not forgiveness."^[18]

If you have questions or would like additional information, please contact Travis Powers (powerst@whiteandwilliams.com; 212.868.4837).

[1] *Fogarty*, 2022 U.S. App. LEXIS 18515, at *5.

[2] 11 U.S.C. § 362(a)(1).

[3] 11 U.S.C. § 362(a)(2).

[4] *Fogarty*, 2022 U.S. App. LEXIS 18515, at *13.

[5] *Fogarty*, 2022 U.S. App. LEXIS 18515, at *13.

[6] *Fogarty*, 2022 U.S. App. LEXIS 18515, at *13.

[7] *Fogarty*, 2022 U.S. App. LEXIS 18515, at *13-14.

[8] *Fogarty*, 2022 U.S. App. LEXIS 18515, at *14 (*quoting* 11 U.S.C. § 362(a)(2)).

[9] *Fogarty*, 2022 U.S. App. LEXIS 18515, at *14.

[10] *Fogarty*, 2022 U.S. App. LEXIS 18515, at *14.

[11] *Fogarty*, 2022 U.S. App. LEXIS 18515, at *15.

[12] *Fogarty*, 2022 U.S. App. LEXIS 18515, at *17-18.

[13] *Fogarty*, 2022 U.S. App. LEXIS 18515, at *18.

[14] *Fogarty*, 2022 U.S. App. LEXIS 18515, at *18. The Circuit Court summarily dispensed with the remainder of Bayview's arguments: (i) that the foreclosure sale was merely a ministerial act (ii) that Bayview was not a party in interest and, therefore, could not seek stay relief, and (iii) that equity demanded that the Circuit Court reverse the District Court.

[15] *Off. Cmtee. Of Unsec. Creditors v. Provident Nat Bank (In re Un. Church of the Ministries of God)*, 74 B.R. 271, 275 (Bankr. E.D. Pa. 1987).

[16] *Top Roofing, Inc. v. Roy Kirby & Sons, Inc. (In re Top Roofing, Inc.)*, No. 12-00041, 2013 WL 5636628, at *37 (Bankr. D.Md. Oct. 15, 2013).

[17] 11 U.S.C. § 362(k).

[18] *In re Stefani*, No. 18-00395-LT13, 2019 Bankr. LEXIS 481, at *43 (Bankr. S.D. Cal. Feb. 15, 2019).

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