

## **Automatic Stay**

In most instances the filing of a bankruptcy petition, whether voluntary or involuntary, acts as an immediate but temporary injunction under 11 USC §362 against the commencement or continuation of any action or proceeding against the debtor or the debtor's estate. The purpose of the stay is twofold:

1. It allows for a fair and efficient administration of the debtor's estate by preventing one creditor from getting paid before their counterparts; and
2. It provides the debtor with some breathing room by maintaining the status quo until such time as the bankruptcy court can evaluate the debtor's position.

In the legislative history to the 1978 version of the Code, the House of Representative's report describes the purpose of the automatic stay as follows:

The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization, or simply to be relieved of the financial pressures that drove him into bankruptcy.

(See, H.R. Rep. No. 95-595, 95th Cong. 1st Sess. 340 (1977).

### **Length of Stay**

Once a bankruptcy petition is filed the automatic stay goes into effect the instant the petition has been filed. The automatic stay provisions are found in Section 362(a) and the exceptions to the automatic stay can be found in Section 362(b) as referenced below. The automatic stay pertains to all property of the bankruptcy estate and unless lifted or modified by the an order of the court, the stay will remain in effect until the sought after property is no longer part of the bankruptcy estate or the case has been dismissed or closed. While a discharge will also operate to lift the stay as to the debt so discharged, it is replaced on a permanent basis by Section 524 which gives the debtor the ultimate relief sought in bankruptcy. Creditors can no longer pursue the debtor for discharged debts although it does not protect the debtor from in rem execution actions by secured creditors whose liens were not avoided in an Adversary Proceeding.

Unless the Court issues and Order to the contrary, there are two exceptions that impact the length of the stay:

- a) If a second bankruptcy is filed within one year of a previously filed and dismissed bankruptcy, the automatic stay will terminate 30 days after the date the second petition is filed; and
- b) If there were two petitions filed within the previous year, the automatic stay never goes into effect.

See, 11 USC §362(c)(3) and (4).

To underwrite a transaction in which the 30 day stay under §362(c)(3) is applicable, it is important to (1) independently verify that another bankruptcy proceeding was dismissed within the one year period immediately preceding the current filing; and (2) review the docket of the current bankruptcy proceeding to determine that no action to extend the stay was filed within 30 days of the date the current petition was filed. If two petitions were filed within the previous year so that under §362(c)(4) there is no automatic stay, the Court must enter an Order to that effect upon the request of a party - presumably a creditor. A similar Order is unlikely to be entered where there was only one prior filing.

Actions taken in violation of the automatic stay are generally treated as "void" and not merely "voidable". Furthermore, if there is a willful violation of the automatic stay which contemplates knowledge of the automatic stay being in place, the violator is subject to punitive damages and an award of attorneys' fees, as discussed in more detail below.

### **Exceptions to the Stay**

Although §362 is specifically designed to prevent the commencement or continuation of any action or proceeding against the debtor or the debtor's estate, §362(b) enumerates 28 types of actions that are expressly exempt from the effects of the stay. The real estate related exceptions include the following:

- An act to perfect or to continue perfection of an interest in property. §362(b)(3);
- Foreclosure actions by the Secretary of HUD to foreclose a mortgage or deed of trust insured under the National Housing Act and covering five or more living units. §362(b)(8);
- An act by a lessor of nonresidential real property to evict the debtor if the lease has terminated, either pre-petition or post-petition, by the expiration of its stated term. §362(b)(10);
- The creation or perfection of a statutory lien for ad valorem property tax if such tax comes due post-petition. §362(b)(18);
- An act to enforce a lien on real estate if, within the past two years, a bankruptcy court found the debtor took part in a scheme to defraud creditors by transferring the real estate in question without creditor consent or by multiple bankruptcy filings. §362(b)(20);
- An act to enforce a lien on real estate if the debtor violated a prior bankruptcy court order barring the debtor from further bankruptcy filings. §362(b)(21);
- An action by a lessor of residential real property to enforce a pre-bankruptcy judgment of eviction against the debtor, unless the debtor certifies in bankruptcy court that the debtor will cure a default and deposits one month's rent with that court. In that case, eviction is stayed for 30 days. §362(b)(22); and
- An action to evict the debtor from residential real property if the lessor certifies to the bankruptcy court that the tenant has endangered the property or allowed use of illegal controlled substances thereon within 30 days prior to the certification. §362(b)(23).

Other exceptions to the automatic stay include actions relating to things such as:

- Criminal Proceedings;
- Child Support;
- Divorce;

- Spousal support
- Paternity actions
- Child custody or visitation
- Domestic violence
- Collection of taxes that are not dischargeable; and
- The interception of a tax refund

### **Actions Against Co-Debtors**

In general, the protections of the automatic stay do not extend to co-debtors. Consequently, in most cases, a creditor can proceed against a co-debtor without being in violation of §362. It is worth noting that although limited in scope to the collection of consumer debts, the Code's automatic stay provisions do extend to co-debtors in Chapter 12 and 13 filings. (See, §§ 1201 and 1301, respectively). This co-debtor stay, however, only remains in place until such time as the court lifts or modifies the stay or until the bankruptcy case is closed, dismissed, or converted to a Chapter 7. Once the debtor's bankruptcy case has been closed, dismissed or converted to a Chapter 7 or the debtor has received a discharge, the creditors are then free to pursue whatever causes of action they may have against the co-debtor. It is also worth noting that although the debtor may have received a discharge, §524(e) prevents that discharge from extending to the co-debtor.

Although actions against commercial co-debtors do not, in and of themselves, violate the automatic stay any joint action taken against both a debtor and a co-debtor that the Court considers to be a "substantial step" toward furthering a creditor's claim against the debtor potentially makes the entire action null and void. See, *In re Ebadi*, 448 B.R. 308 (Bankr. E.D.N.Y. 2011), a copy of which is attached. The Court in *Ebadi* held that a foreclosure action against both the debtor and co-debtor was a violation of the automatic stay even though the debtor had no ownership interest in the mortgaged property and the filing of the bankruptcy petition was done, in the Court's opinion, "solely to prevent the foreclosure sale, with no legitimate intent to reorganize [the debtor's] financial affairs, to obtain a discharge, or to comply with his duties as a Chapter 13 debtor."

Consequently, when insuring any post foreclosure title where the original underlying action included both the mortgagor and one or more guarantors, the names of all defendants need to be checked for any bankruptcy petitions filed prior to the foreclosure sale. If a bankruptcy filing is found, it is important to ascertain whether or not the foreclosing lender postponed the sale until after a lift of the stay had been granted, or if the bankruptcy debtor was dismissed from the underlying action by the lender. If the lender continued with the sale without dismissing the bankruptcy debtor, under *Ebadi*, it is likely that the foreclosure, as well as any transfers resulting from that foreclosure, will be considered void.

It may be argued that §549(c) provides an exception to the automatic stays for transfers made to good faith purchasers for value without knowledge of the bankruptcy filing. Although this section does provide some protection against the trustee's avoidance powers for post petition transfers made by the debtor, it is generally not considered applicable to transfers made by a creditor. When the §549(c) argument has been raised by a creditor, courts that hold §362 violations to be void also find §549(c) to be inapplicable. The reasoning is fairly

straightforward: If the transfer is void *ab initio*, §549(c) cannot be used to protect a transfer to a good faith buyer because no valid transfer occurred. See e.g., *In re Richardson*, 497 B.R. 546 (Bankr. S.D. IN. 2013) and *In re Abusaad*, 309 B.R. 895 (Bankr. N.D. TX. 2004).

## **Violations**

The penalty for violating the automatic stay can be severe and include both monetary and equitable remedies. §362(k) provides that an "individual" injured by any willful violation of a stay shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may even recover punitive damages. Although some circuits construe the term "individual" to include corporations, trustees or other types of legal entities, the majority limits the meaning to natural persons. Nevertheless, the court has broad powers under §105 to impose sanctions on those who violate the stay even when the debtor is not an individual.

Additionally, the courts consider a "willful" violation of the automatic stay to be any act done with knowledge of the bankruptcy as well as a failure to undo any act taken prior to knowledge of the bankruptcy once such knowledge is obtained. Penalties have been imposed even in situations where the court itself has found a "good faith" violation of the automatic stay. See, *In re Ebadi*, *supra*.

More importantly, from a title insurance perspective, is whether an act done in violation of the stay is void *ab initio* or merely voidable. If it's void then any action taken is invalid and anyone claiming title as a result of that act takes nothing. Although the U.S. Supreme Court determined in 1940 that such actions taken under the Bankruptcy Act in place at that time were void (See, *Kalb v. Feuerstein*, 308 U.S. 433 (1940)) they have yet to address the issue under the current incantation of the Act and at present, the Circuit Courts are divided on the issue. The majority of jurisdictions, however, hold such acts to be void. Until such time as the U.S. Supreme Court resolves the current void vs. voidable split in the circuits, when insuring any transaction with a potential stay violation in the chain of title, it is Old Republic's position that the act is void an appropriate exception must be taken.

## **Enforcement by Creditors**

In addition to a debtor's ability to bring an action for violation of the automatic stay, Courts have also recognized the ability of a creditor who is harmed by such a violation to bring such an action. See, *In re Watson*, 505 B.R. 634 (Bankr. M.D. PA. 2014); and *St. Paul Fire & Marine Ins. Co. v. Labuzan*, 579 F.3d 533 (5th Cir. 2009). The rationale for allowing a creditor to bring such an action is based on the §362 objective of equally treating all creditors within the same class. Although creditors can bring an action for violation of the automatic stay, most courts have limited those actions to injunctive or other equitable actions rather than allow a suit for money damages.

## **Perfection and Enforcement of Mechanic's Liens**

The act of perfecting a mechanic's lien claim is not stayed by the filing of a bankruptcy petition so long as pertinent non-bankruptcy law provides that the mechanic's lien relates back and is effective as of the date of a pre-petition event, such as the first visible of improvement to the

project. (See, 11 USC §§ 362(b)(3) & 546 (b)). Where the perfection of a contractor's lien is not subject to the automatic stay, the lien perfection period is not tolled and failure to timely perfect such claims will not be excused by the bankruptcy filing. In contrast, the enforcement of a mechanic's lien is automatically stayed by Code § 362(a) if the time period for commencing suit under the mechanic's lien statute is construed as a statute of limitations rather than one of duration. If enforcement is stayed, the limitation period is extended under Code § 108(c) to the later of the expiration of the statute of limitations or 30 days after notice is given of the expiration or termination of the automatic stay.

### **Conclusion**

Violations of the automatic stay, whether intentional or unintentional, can have serious consequences for title insurers up to and including a complete failure of title. Extreme care should be taken whenever a title search reveals that a foreclosure or other transfer of title continued unabated through the course of a debtor's bankruptcy, even if done with the consent of the debtor, without a corresponding court order lifting the stay.