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APPLYING THE AUTOMATIC STAY TO NON-DEBTORS

Raff Ferraioli

Introduction

The automatic stay provision of the Bankruptcy Code is regarded as one of the most essential protections the Code offers to debtors.¹ Section 362(a) provides that the filing of a bankruptcy petition “operates as a stay [of] action[s] or proceeding[s] against the debtor.”² Thus, when an entity files for bankruptcy, an automatic stay is created that prevents creditors from taking any action to collect or enforce a debt, including among other things, continuing ongoing litigation.³

Practically, the automatic stay enables all claims against a debtor to be brought in a single forum.⁴ Simultaneously, it also preserves “what remains of the debtor’s solvent estate and [provides] for a systematic and equitable liquidation procedure for all creditors.”⁵ Aside from its benefit to debtors, the automatic stay also incidentally benefits creditors by fostering an orderly and organized resolution of all pending claims against the debtor’s estate.⁶

¹ See *In re Diamond*, 346 F.3d 224, 227 (1st Cir. 2003); see also *Hillis Motors, Inc. v. Hawaii Auto. Dealers' Ass'n*, 997 F.2d 581, 585 (9th Cir. 1993) (“The automatic stay plays a vital and fundamental role in bankruptcy.”); *Eskanos & Adler, P.C. v. Leetien*, 309 F.3d 1210, 1214 (9th Cir. 2002).

² 11 U.S.C. § 362(a) (2006).

³ See *id.*

⁴ See *Leetien*, 309 F.3d at 1214 (noting Congress’ intent to have all proceedings against a debtor in a resolved single forum).

⁵ *United States v. Sayres*, 43 B.R. 437, 439 (W.D.N.Y. 1984).

⁶ See *Pursifull v. Eakin*, 814 F.2d 1501, 1504 (10th Cir. 1987) (stating that the purpose of the automatic stay is to protect the debtors and her creditors by ensuring an “orderly resolution of all claims”).

Traditionally, courts have limited the application of the automatic stay to debtors and property of the estate,⁷ adhering to a strict interpretation of the language of section 362.⁸ Some courts, however, have expanded the application of the automatic stay to non-debtor entities under certain circumstances.⁹ This expansion is significant because it affords the protections of a bankruptcy to entities that have not filed and thus are not within the bankruptcy court's jurisdiction.

This Article will survey the different standards applied by circuit courts when determining whether the automatic stay should be expanded to cover non-debtor entities. Part I will analyze the "strict interpretation" of section 362, Part II will consider the "unusual circumstances" standard, Part III will evaluate the "immediate adverse economic consequence" standard, and Part IV will examine the nuances between the standards. Although two different models may justify expanding the application of the automatic stay provision to non-debtor entities, their nuances are important to note, especially when considering the implications that expansion will have on the debtor, its creditors, and the bankruptcy system as a whole. This is especially evident when compared to the strict interpretation of section 362. Moreover, while the expansion of section 362 may broaden its reach, non-debtor parties still must meet the stringent requirements of those standards in order to be afforded the protections of the automatic stay.

⁷ See 11 U.S.C. § 362(a) ("a stay [of] action[s] or proceeding[s] against the debtor"); see also *McCartney v. Integra Nat. Bank N.*, 106 F.3d 506, 510 (3d Cir. 1997) (noting that Section 362(a) clearly uses language that precludes non-debtor entities).

⁸ See 11 U.S.C. § 362(a) ("a stay [of] action[s] or proceeding[s] against the debtor"); see also *McCartney*, 106 F.3d at 510 (noting that Section 362(a) clearly uses language that precludes non-debtor entities).

⁹ See, e.g., *A.H. Robins Co., Inc. v. Piccinin*, 788 F.2d 994, 999 (4th Cir. 1986) (expanding the application of the automatic stay provision to non-debtor entities).

I. Strict Interpretation

Adhering to a “strict interpretation” of the automatic stay provision, some courts will not apply the automatic stay to non-debtors.¹⁰ This standard focuses on the plain language of section 362.¹¹ The pertinent language of the statute does not reference non-debtor entities; instead, it states that a bankruptcy filing “operates as a stay [of] action[s] or proceeding[s] against the debtor.”¹² Thus, the language of section 362 indicates that it seeks to protect debtors, but fails to mention third parties. Therefore, drawing a distinction between the debtor’s estate and pending actions outside of the bankruptcy proceeding is critical in strictly construing section 362 to apply only to the debtor. This distinction, however, ignores the potential impact that other actions may have on the debtor’s estate.

For example, in *In re Advanced Ribbons & Office Products, Inc.*,¹³ the Ninth Circuit concluded that the automatic stay applies only to the debtor.¹⁴ The relevant issue in that case was “[w]hether the sale of [stock] in the debtor pursuant to [a] pledge agreement violated the automatic stay when the stock was pledged to secure a debt of the debtor and [the stockholder] had no personal liability on the debt.”¹⁵ The court held that because the stay only protects the debtor, or property within the debtor’s estate, such an action did not fall within the protections of section 362.¹⁶

¹⁰ *Credit Alliance Corp. v. Williams*, 851 F.2d 119, 121 (4th Cir. 1988) (“Nothing in [section] 362 suggests that Congress intended that provision to strip from the creditors of a bankrupt debtor the protection they sought and received when they required a third party to guaranty the debt.”).

¹¹ *See* 11 U.S.C. § 362; *see also* *McCartney*, 106 F.3d at 510 (noting that Section 362(a) clearly uses language that precluded non-debtor entities).

¹² 11 U.S.C. § 362(a) (emphasis added).

¹³ 125 B.R. 259 (Bankr. 9th Cir. 1991).

¹⁴ *See id.* at 263 (“Thus, section 362(a) does not stay actions against guarantors, sureties, corporate affiliates, or other non-debtor parties liable on the debts of the debtor.”).

¹⁵ *Id.* at 262.

¹⁶ *See id.* at 263, 264.

Likewise, in *AAA Nevada Insurance Company v. Chau*, the court strictly interpreted section 362 to confine the automatic stay to debtors.¹⁷ In that case, the defendant-debtors filed for bankruptcy after an insurance company commenced an action to recover attorney’s fees.¹⁸ The insurance company’s action arose from a car accident and subsequent wrongful death action.¹⁹ The United States District Court for the District of Nevada, citing *Advanced Ribbons*, opined that the automatic stay does not protect non-debtor entities or their property.²⁰ Thus, the court held that the automatic stay did not apply to the action to recover attorney’s fees because it did not concern the debtor’s property.²¹

II. Immediate Adverse Economic Consequences

One standard courts use to determine whether to extend the automatic stay beyond the plain language of section 362 to apply to non-debtor entities is the “immediate adverse economic consequences” standard.²² Under this standard, a court will only expand the stay when the claim against the non-debtor entity will have an “immediate adverse economic consequence [on] the debtor’s estate.”²³

For example, in *Queenie, Ltd. v. Nygard International*, the debtor wanted the automatic stay to apply to himself, his wholly owned non-debtor corporation, and to another group of non-debtor appellants.²⁴ The Second Circuit held that the automatic stay applied to the non-debtor corporation because “adjudication of a claim against the [non-debtor] corporation [would] have

¹⁷ 2:08-CV-00827-RCJ, 2013 WL 496064, *3 (D. Nev. Feb. 7, 2013) (applying the strict interpretation of section 362).

¹⁸ *See id.* at *2.

¹⁹ *See id.* at *1.

²⁰ *See id.* at *3.

²¹ *See id.* (“Plaintiff’s motion for attorney’s fees . . . seeks fees and costs against Intervenors only, and does not concern property of the debtor. For that reason, the automatic stay does not apply to the motion . . . or any other proceedings or claims concerning Intervenors without involving Defendants, the debtors in bankruptcy.”).

²² *See* 321 F.3d 282, 287 (2d Cir. 2003) (enumerating the immediate adverse economic consequences standard).

²³ *See id.*

²⁴ *See id.*

an immediate adverse economic impact on [the debtor].”²⁵ However, the court did not expand the automatic stay to the other non-debtor appellants because avoiding a potential offensive use of collateral estoppel did not amount to an immediate adverse economic consequence.²⁶

Residential Capital, LLC v. Federal Housing Finance Agency,²⁷ is a prominent and recent case that illustrates how courts apply the immediate adverse economic consequences standard. In that case, the District Court for the Southern District of New York refused to extend the automatic stay to apply to a group of non-debtors being sued by the Federal Housing Finance Agency (“FHFA”) because the court found that the FHFA litigation against those non-debtors would not have an immediate adverse economic consequence on the debtors’ estate.²⁸ There, the FHFA brought an action against the debtors and a group of non-debtor defendants alleging that they made material misstatements concerning mortgage-backed securities purchased by Freddie Mac.²⁹ While that suit was pending, the debtors filed for bankruptcy.³⁰ Despite the petition, the FHFA continued to prosecute its claims against the non-debtor defendants.³¹

Initially, the district court held that the automatic stay could not apply to the non-debtors because they were not in bankruptcy.³² The court never considered whether FHFA’s pending suit would have immediate adverse economic consequences on the debtor’s estate.³³ On appeal, the Second Circuit remanded the case and instructed the district court to consider whether the

²⁵ See *id.* at 288.

²⁶ See *id.* 287–88.

²⁷ 2013 WL 4056195 (S.D.N.Y. Aug. 12, 2013) (applying the immediate adverse economic consequence standard on remand from the Second Circuit).

²⁸ See *id.* at *1.

²⁹ See Brief for Appellee at 1, *In Re Residential Capital, LLC*, Fed. Appx., 2013 WL 3491311 (2d Cir. July 15, 2013) (No. 12-3342); Brief for Appellants at 2, *In Re Residential Capital, LLC*, 2013 WL 3491311 (2d Cir. July 15, 2013) (No. 12-3342); 2012 WL 6053220 (2d Cir.) (Appellate Brief).

³⁰ See Brief for Appellee at 2–3, *In Re Residential Capital, LLC*, Fed. Appx., 2013 WL 3491311 (2d Cir. July 15, 2013) (No. 12-3342).

³¹ *In re Residential Capital, LLC*, 2012 WL 3249641 (Bankr. S.D.N.Y. Aug. 7, 2012).

³² See *In re Residential Capital, LLC*, 12-3342, 2013 WL 3491311 (2d Cir. July 15, 2013).

³³ See *id.*

suit would have immediate adverse economic consequences on the debtor's estate.³⁴ On remand, analyzing the scope of the alleged adverse economic consequences, the district court held that the shared insurance policies between the estate and non-debtors would not have an immediate and adverse effect on the debtors' estates because (1) there was a provision in the debtors' plan that relinquished to the non-debtor defendants all rights and proceeds under the relevant insurance policies; (2) the non-debtor defendants would have failed to meet the twenty-five million dollar threshold under the insurance policies; and (3) the time table for litigation, which was not scheduled to begin until January 2015, provided no immediate threat to the debtors since the effective date of the debtors' plan was anticipated be in October 2013.³⁵

Aside from the shared insurance policies, the district court also held that the indemnification agreement would not have immediate adverse economic consequences on the debtor's estate.³⁶ Under the Plan, a non-debtor agreed to release the debtor from all indemnification claims.³⁷ At that time, the debtor had not made any payments pursuant to the agreement.³⁸ Regardless, the debtor argued that the court should ignore the insurance and indemnification agreements because determining whether to extend the automatic stay depends only on facts present at filing.³⁹ The court disagreed and noted that determining whether there are immediate adverse economic consequences should not be grounded on "a purely theoretical basis, without reference to the current factual situation."⁴⁰ Therefore, based on the facts before

³⁴ See *In re Residential Capital, LLC*, 529 F. App'x 69, 71 (2d Cir. 2013).

³⁵ See *Residential Capital, LLC v. Fed. Hous. Fin. Agency*, 2013 WL 4056195, at *2. (S.D.N.Y. Aug. 12, 2013).

³⁶ See *id.*

³⁷ See *id.*

³⁸ See *id.*

³⁹ See *id.* at *3

⁴⁰ *id.*

it, the court held that the indemnification obligation did not and would not have an immediate adverse economic impact on the debtor's estate.⁴¹

III. Unusual Circumstances

Another prominent standard, the unusual circumstances standard, was announced in *A.H. Robins Company, Inc. v. Piccinin*.⁴² In that case, the Fourth Circuit held that in order for the automatic stay to apply to a non-debtor, there must be “unusual circumstances.”⁴³ The *A.H. Robins* court identified an unusual circumstance as one that “arises when there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the third-party defendant will in effect be a judgment or finding against the debtor.”⁴⁴

In *A.H. Robins*, the debtor filed for bankruptcy after “an avalanche of actions” by plaintiffs who sustained injuries due to a defective contraceptive device that the debtor manufactured.⁴⁵ The directors and officers of the debtor company were also sued, and the debtor petitioned the court to extend the automatic stay to apply to suits pending against these individuals.⁴⁶ Based on the “unusual circumstances” arising from those individuals’ relationships with the debtor, the Fourth Circuit affirmed the lower court’s expansion of the stay⁴⁷ because “continuation of litigation in [those] civil actions threatened property of [the debtor’s] estate, burdened and impeded [its] reorganization effort, contravened the public interest, and rendered any plan of reorganization futile.”⁴⁸

⁴¹ See *id.* at *2.

⁴² 788 F.2d 994, 999 (4th Cir. 1986) (enumerating the unusual circumstances standard).

⁴³ See *id.*

⁴⁴ See *id.*

⁴⁵ See *id.* at 996.

⁴⁶ See *id.*

⁴⁷ See *id.* at 1016.

⁴⁸ *Id.* at 997.

Similarly, the Eighth Circuit also applied the unusual circumstances standard to determine whether to extend the automatic stay to apply to non-debtors.⁴⁹ In *In re Panther Mountain Land Development, LLC*, the debtors owned parcels of land that were included within property-owners' improvement districts formed under state law.⁵⁰ After the debtors filed for bankruptcy, a secured creditor sought a determination that a proposed state court action against the improvement districts, alleging that the districts were formed without the constitutionally required notice that the secured creditors would be included in the districts, would not violate the automatic stay.⁵¹ The bankruptcy court held that the automatic stay applied to the secured creditor's action because the court found that a state court action against the improvement districts would inevitably interfere with the real estate—an asset of the bankruptcy estate, and would adversely affect the debtor's ability to reorganize.⁵² The Bankruptcy Appellate Panel for the Eighth Circuit affirmed.⁵³

On appeal, the United States Court of Appeals for the Eighth Circuit reversed, noting that the automatic stay does not generally extend to third parties, and the unusual situations that would permit such an exception are rare.⁵⁴ The Eighth Circuit found that the circumstances in *Panther Mountain Land Development* did not meet the requirements of the *A.H. Robins* standard

⁴⁹ See generally *In re Panther Mountain Land Dev., LLC*, 686 F.3d 916, 921 (8th Cir. 2012) (acknowledging that the automatic stay generally only applies to debtors, but may apply to non-debtor entities where unusual circumstances are present).

⁵⁰ *Id.* at 917.

⁵¹ See *id.* at 917–18.

⁵² See *id.* at 918; *In re Panther Mountain Land Dev., LLC*, 446 B.R. 282, 286 (B.A.P. 8th Cir. 2011), *rev'd*, 686 F.3d 916 (8th Cir. 2012).

⁵³ *In re Panther Mountain Land Dev., LLC*, 446 B.R. at 290 (“Since the Bank's collateral—the real estate—is an asset of the bankruptcy estate, the Improvement Districts are barred from placing any liens on that collateral unless they first obtain approval of the Bankruptcy Court”).

⁵⁴ See *In re Panther Mountain Land Dev., LLC*, 686 F.3d at 921 (“The unusual circumstances in which the bankruptcy court can stay cases against non-debtors are rare.”) (citing *Ritchie Capital Mgmt., L.L.C. v. Jeffries*, 653 F.3d 755, 762 (8th Cir. 2011)).

because the improvement districts were separate from, and not controlled by, the debtor.⁵⁵ The court reasoned that the secured creditor's action could have potentially impacted the value of the estate, but in an undetermined and indirect manner.⁵⁶ Moreover, the secured creditor did not attempt to gain control or possession over any of the estate property, and nothing suggested that the action would diminish the property's value.⁵⁷ Thus, the alleged impact on the estate was not substantial enough to justify an extension of the automatic stay.⁵⁸

IV. Protecting the Debtor—A Common Goal

While both standards that expand the application of the automatic stay are fact intensive, under the strict interpretation standard, the application of the automatic stay is confined to the plain language of section 362. As such, the application of the strict interpretation standard is predictable. Regardless, it may hinder the protections that would otherwise be afforded to non-debtors in order to protect the estate. Strict interpretation ensures that parties who have not participated in the initial bankruptcy filing will not benefit from the bankruptcy. However, it is contemporaneous that non-debtors are protected by the expansion of section 362. The purpose of expanding the rule is to protect the debtor's estate, which echoes the policy behind section 362.⁵⁹ Therefore, strict interpretation may solve theoretical problems with expanding the automatic stay provision to apply to non-debtor entities, while possibly ignoring the practical benefits of expansion, namely, protecting the debtor's estate.

⁵⁵ *See id.* at 922 (“[W]e believe the present situation falls short of the type of ‘rare’ and unusual circumstance that might justify extension of the automatic stay. Here, not only are the Improvement Districts legal entities separate from the [d]ebtor, they are not controlled by the [d]ebtor.”).

⁵⁶ *See id.* at 918.

⁵⁷ *See id.*

⁵⁸ *See id.* at 926.

⁵⁹ *See id.*

Despite the language of the automatic stay provision limiting its application to debtors, as explicated above, some courts have expanded the automatic stay provision to apply to non-debtor entities. When determining whether to expand the automatic stay, these courts consider if unusual circumstances exist or if the non-debtor may suffer from immediate adverse economic consequences due to the bankruptcy proceeding. Although these standards broaden the scope of the automatic stay beyond the plain language of section 362, both standards are strict, and a mere economic relationship between a non-debtor entity and the debtor, without more, will not amount to an immediate adverse economic consequence or an unusual circumstance. Instead, a party needs to demonstrate urgent and detrimental consequences in order for a non-debtor entity to be afforded the benefit of the automatic stay.⁶⁰ Accordingly, under either standard, the automatic stay will not be expanded to cover a non-debtor in the absence of dire circumstances.

Although the standards are articulated differently, they are essentially the same. That is to say, if a party can meet one of the standards, it can also likely meet the other. For example, the unusual circumstance in *A.H. Robbins*, “a suit against a third-party who is entitled to absolute indemnity by the debtor on account of any judgment that might result against them in the case,”⁶¹ could foreseeably have immediate adverse economic consequences on the parties involved. Also, in *Queenie*, the court cited to *A. H. Robbins* when identifying when it is appropriate to extend the automatic stay, thus using the rationale for the unusual circumstances standard to explain the immediate adverse consequences standard.⁶² Therefore, the two standards are essentially congruent despite their facial differences.

⁶⁰ See, e.g., *See Residential Capital, LLC v. Fed. Hous. Fin. Agency*, 2013 WL 4056195, at *3. (S.D.N.Y. Aug. 12, 2013).

⁶¹ *A. H. Robbins*, 788 F.2d at 999.

⁶² See *Queenie*, 321 F.3d at 288 (“there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant”) (citing *A. H. Robbins*, 788 F.2d at 999).

Even though both standards may ultimately lead to the same result, the court's focus under each standard is different. The immediate adverse economic consequences standard focuses on the potential harm to the debtor's estate, while the unusual circumstances standard focuses on the relationship between the parties. Irrespective of these nuances, the central concern may still be avoiding situations that would impair the debtor and its estate.⁶³

Conclusion

Based on the three different standards elucidated above, even where courts have applied the automatic stay broadly, there are limitations. For instance, a court may apply the automatic stay to non-debtors, but the debtor must offer factual evidence, not theoretical assertions, to demonstrate that there will be an immediate adverse economic consequence to its estate, or that there are unusual circumstances surrounding the other actions. Ultimately, if a non-debtor can demonstrate that allowing the litigation against the non-debtor will have an immediate economic adverse consequence on the debtor, or that there are unusual circumstances surrounding the bankruptcy, the non-debtor may be able get the benefits of a bankruptcy without filing.

⁶³ Lynch v. Johns-Manville Sales Corp., 710 F.2d 1194, 1197 (6th Cir. 1983) (“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 plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.”).