

Foreclosure Sale of Non-Debtor's Property Voided as Violation of Automatic Stay

Paul Rubin*

A New York bankruptcy court voided the foreclosure sale of non-debtor property where the debtor filed for bankruptcy with no legitimate intent to reorganize. The case, the author notes, illustrates that lenders must be wary of the breadth of the automatic stay in bankruptcy cases and remember that sanctions may be assessed for violating the stay.

Lenders and mortgage holders may be surprised to learn that a New York bankruptcy court voided the foreclosure sale of non-debtor property where the debtor filed for bankruptcy with no legitimate intent to reorganize. This case of first impression, *In re Ebad*¹ addresses a common scenario: a foreclosure action against multiple parties, including a borrower not in bankruptcy and a guarantor in bankruptcy. Though one may question the court's reasoning, this case illustrates that lenders must be wary of the breadth of the automatic stay in bankruptcy cases and remember that sanctions may be assessed for violating the stay.

Background

An individual ("Debtor") guaranteed a loan made to a real property owner ("Borrower"), but he did not own any interest in the property. After Borrower defaulted, Lender obtained a foreclosure judgment, which provided that, if proceeds of the foreclosure sale were insufficient to satisfy Lender's debt,

Lender would recover the deficiency from Borrower and Debtor, provided a motion for a deficiency judgment is made.

Immediately before the foreclosure sale was scheduled to occur, Debtor filed a bankruptcy case and notified Lender of the filing. Lender still proceeded with the foreclosure sale because the property owner was not in bankruptcy. Debtor's bankruptcy case was dismissed within six weeks of its commencement because he failed to comply with basic disclosure requirements required under the Bankruptcy Code. Debtor thereafter sought to reopen the bankruptcy case in order to vacate the foreclosure sale and seek actual and punitive damages against Lender for its allegedly willful violation of the automatic stay.

The Bankruptcy Court's Ruling

The court framed the issue as one of first impression in the Second Circuit: "whether a foreclosure sale . . . in which a bankruptcy

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debtor has no ownership interest is a violation of the automatic stay, where the debtor is a guarantor of the underlying debt and a named defendant in a foreclosure judgment.” The court did not state that the automatic stay applicable in Debtor’s case also stayed litigation against Borrower. Rather, the court held that the foreclosure sale violated the automatic stay because it constituted both a continuation of a judicial action against Debtor and a continuation of a judicial action to recover a claim against Debtor, which are prohibited under the Bankruptcy Code.

The court stated that the foreclosure sale could have satisfied the prerequisite condition for collecting a deficiency from Debtor. Thus, it found the foreclosure sale represented a significant step in the process leading to the recovery of a claim against Debtor. The court vacated the foreclosure sale and awarded Debtor actual damages for what it called Lender’s willful violation of the stay. It held that the violation was willful even if Lender did not know that its proceeding with the sale would violate the stay. But the court declined to award Debtor punitive damages, finding that Lender’s actions likely resulted from a mistake of law and did not rise to the level of bad faith or maliciousness that would justify an award of punitive damages. The court also expressed significant concerns about awarding punitive damages to a debtor whom it said filed his bankruptcy case solely to delay a foreclosure sale without any legitimate intent to reorganize.

One might argue that the bankruptcy court could have reached a different conclusion because it was possible that Lender merely wanted to conduct the foreclosure sale but never intended to move for a deficiency against Debtor. Instead, the court viewed the foreclosure sale as “a substantial step in the

process that could lead to recovery of a deficiency judgment from Debtor,” and therefore enough to constitute an automatic stay violation.

Worth noting is the court’s observation that, had Lender dismissed Debtor from the foreclosure action and removed Debtor from the foreclosure judgment before conducting the foreclosure sale, Lender likely would have been able to proceed with the sale without violating the automatic stay in Debtor’s bankruptcy case.

What It Means

There are basic rules that a prudent foreclosing lender should follow if it learns that a party against whom it has sought a judgment in its foreclosure action has filed for bankruptcy protection. If there is a question whether proceeding with the sale would violate the automatic stay, a lender should seek relief from the stay from the bankruptcy court or a ruling that conducting the sale would not violate the stay. If the debtor does not own the mortgaged property but is a defendant named in the foreclosure judgment from whom a deficiency claim may be recovered, a lender should consider dismissing the debtor from the foreclosure action and removing the debtor from the foreclosure judgment. But the lender will have to evaluate whether it is worthwhile to waive the right to a deficiency claim against the debtor.

The threat of sanctions is very real where a lender has notice of a bankruptcy filing and decides to proceed with a foreclosure sale. Now that this decision has been rendered, a mortgagee situated similarly as Lender cannot use mistake of law as an excuse to avoid the imposition of punitive damages. The *Ebadi* court has delivered a warning that should not be ignored.

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NOTES:

¹*In re Ebadi*, 448 B.R. 308 (Bankr. E.D. N.Y. 2011).