

Second Circuit's Bright-Line Rule Spells Trouble for Unwary Lenders

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Over the Summer, the Second Circuit Court of Appeals answered the open question of whether the Bankruptcy Code's automatic stay provisions are violated by the foreclosure sale of a property when the debtor is a named defendant in the foreclosure proceeding, even if the debtor's interest in the property is only possessory, in the affirmative. In reaching its decision, the Second Circuit set forth a new bright-line rule making the automatic stay applicable to the continuation of an action and/or the enforcement of a judgment rendered in that action whenever the debtor is a named party in the action. Under the Second Circuit's new rule, whenever a defendant in a foreclosure proceeding files a bankruptcy petition, the automatic stay is triggered, halting the action. If a lender proceeds without first obtaining relief from the bankruptcy court, it will be found to have violated the automatic stay. In light of the Second Circuit's decision, lenders and their counsel should exercise caution whenever they receive notice of a bankruptcy filing. Failure to do so could result in sanctions.

In *Bayview Loan Servicing LLC v. Fogarty* (In re Fogarty), 39 F.4th 62 (2d Cir. 2022), the debtor resided at the mortgaged property, which was owned by a limited liability company ("LLC") that was essentially wholly owned by the debtor. In January 2010, the LLC defaulted in making monthly payments under the mortgage note, and the lender commenced a foreclosure proceeding against the LLC in early 2011. However, the debtor was not named as a party defendant. In October 2014, the lender obtained an order of reference from the state court which included, as is typical in foreclosure cases, an order substituting the debtor as a party defendant in place of one of "John Doe" defendants named in the complaint. In January 2018, the state court issued a judgment of foreclosure and sale. Thereafter, the lender scheduled a foreclosure sale of the property on April 17, 2018.

On April 13, 2018, just four days before the sale, the debtor filed a chapter 7 bankruptcy petition in the United States Bankruptcy Court for the Eastern District of New York. On April 16, counsel for the debtor contacted counsel for the lender by phone and e-mail conveying his opinion that the automatic stay was in effect and the sale should be cancelled. Counsel for the lender responded the next morning dismissing the debtor's warning and proceeded with the sale.

In May 2011, the debtor moved for sanctions against the lender arguing that the sale violated the automatic stay. The lender opposed the motion and cross-moved for sanctions against the debtor. The bankruptcy court denied both motions, finding that the debtor could not be held liable for the LLC's debt on the mortgage note. Because the debtor could not be held liable for the mortgage debt, the bankruptcy court reasoned that the foreclosure proceeding was solely an in rem proceeding not subject to the automatic stay. The debtor appealed to the United States District Court for the Eastern District of New York.

The district court reversed the bankruptcy court's order for two reasons. First, the district found that because the debtor was a named defendant in the foreclosure action, and the foreclosure action was the basis for the sale, the lender violated the stay by proceeding with the sale. Second, the district court reasoned that the foreclosure sale interfered with the debtor's possessory interest in the property because it lessened the barriers

to her eviction. Since the debtor had a possessory interest in the property, that interest was part of her bankruptcy estate, and thus protected by the stay. Finally, the district court determined that the lender willfully violated the stay and awarded sanctions to the debtor. The lender appealed to the Second Circuit Court of Appeals.

On appeal to the Second Circuit, the lender conceded that the debtor's bankruptcy filing triggered an automatic stay and that the debtor's possessory interest in the property was part of her bankruptcy estate and protected by the stay. However, it vigorously argued that the stay did not apply to the foreclosure sale because the proceeding was solely in rem. The debtor argued that the stay applied because the sale constituted both a continuation of the foreclosure proceeding and enforcement of a judgment against the debtor.

In determining whether the stay applied, an issue of first impression, the Second Circuit began its analysis by reviewing the statutory text. Based on a plain meaning reading of the Bankruptcy Code's stay provisions, the Court found that the automatic stay operates as a stay of both the commencement or continuation of a proceeding and the enforcement of a judgment against the debtor or against property of the estate.

In applying the law to the facts, the Court found that the foreclosure sale in this case constituted both a continuation of the foreclosure action and enforcement of a judgment against the debtor. The Court reasoned that because the judgment of foreclosure and sale was entered against the debtor before her bankruptcy petition was filed, and the debtor remained a defendant when the property was sold after her bankruptcy filing, the sale amounted to both a continuation of the action and enforcement of a judgment against the debtor. Thus, the Second Circuit held that the lender violated the stay in both respects and affirmed the district court's decision. It also affirmed the district court's award of sanctions to the debtor finding that by proceeding with the sale after being notified of the bankruptcy filing, the lender willfully violated the stay.

Crucial to the Second Circuit's analysis was the fact that the debtor was a party defendant before the judgment was issued and remained a defendant when the property was sold pursuant to the judgment. The debtor's role as a party to the action was so critical to the Court's determination, that it set forth a bright-line rule centered on the debtor's party status to avoid ambiguity going forward. 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.

Based on the Second Circuit's decision, lenders and their counsel should exercise caution whenever they receive notice of a bankruptcy filing. If the debtor is a named defendant in a foreclosure action, the lender must seek relief from the bankruptcy court before proceeding. The debtor defendant's interest in the mortgaged property, no matter how attenuated, is irrelevant. If the debtor is a named defendant, the lender must halt the foreclosure action and seek relief from the bankruptcy court. Failure to do so could result in sanctions.