Applicability Of Automatic Stay — Who Decides?

by Scott H. Bernstein, Hunton & Williams LLP

Whenever a defendant in multiparty litigation before a state court files for bankruptcy protection, questions over jurisdiction will inevitably arise. This is particularly the case when determining whether the bankruptcy court or the state court has authority regarding the automatic stay provided to the debtor under section 362 of the United States Bankruptcy Code.

Does the bankruptcy court have jurisdiction to review the decision of the state court as to whether the automatic stay bars prosecution of the state court action? And, do the nondebtor defendants have standing to assert that the continuation of the state court action violates the automatic stay?

The courts are divided on how to answer these questions. However, several relatively recent decisions provide some answers that may provide guidance to attorneys in New York bankruptcy courts. The most often cited decision on this issue, until recently, was In re Ivani, 308 B.R. 132 (Bankr. E.D.N.Y. 2004) (B.J., Strong).

In this case, the debtor’s former wife had obtained a postpetition decree from a New York state court holding the debtor in contempt for violation of a divorce judgment requiring the payment of child support and the equitable distribution of material property. The debtor, in turn, sought an order from the bankruptcy court holding the debtor and her attorney in contempt for violation of the automatic stay.

The bankruptcy court denied the debtor’s motion because it concluded that it lacked jurisdiction to collaterally review a state court’s determination that the automatic stay did not apply. It extended the holding of Baldwin-United that federal courts have concurrent jurisdiction with the bankruptcy court to determine the applicability of the automatic stay to state courts.

The court reasoned that 11 U.S.C. § 1334(b) grants bankruptcy courts original but not exclusive jurisdiction over determining whether the automatic stay applies in civil proceedings arising under the Bankruptcy Code.

Furthermore, the court held that under the Rooker-Feldman doctrine (which provides that lower federal courts lack subject matter jurisdiction over a case if their actions would result in the reversal or modification of the state court judgment), bankruptcy courts lack jurisdiction to collaterally review a state court determination on this issue. The bankruptcy court also stated that the same holding may be reached under doctrines of res judicata and collateral estoppel.

The court in In re Ivani held that the debtor’s proper remedy was to appeal through the state court system and, ultimately, to the United States Supreme Court. Having lost on the applicability of the automatic stay in the state court, the In re Ivania court would not allow the debtor to seek collateral review in a lower federal court.
A more recent decision takes a starkly different view of this issue. In *Mokuba N.Y. LLC v. Pitts (In re Pitts)*, 2009 Bankr. LEXIS 4023 (Bankr. E.D.N.Y. Dec. 8, 2009), prior to the date the debtor’s bankruptcy petition was filed, the plaintiffs commenced an action in the Supreme Court of the State of New York, New York County, against a number of corporate defendants, including the debtor, for fraud and breach of contract.

Upon being advised that the debtor filed for bankruptcy protection, the state court judge entered an order severing the debtor from the state court action, declined extending the automatic stay to the nondebtor defendants, and entered judgment by default on all issues of liability against the corporate defendants. The plaintiffs then sought to have certain debts allegedly owed by the debtor deemed nondischargeable by the bankruptcy court.

In response, the debtor filed a motion requesting that the bankruptcy court declare the state court judgment entered postpetition against the corporate defendants deemed void ab initio as a violation of the automatic stay in the debtor’s case.

In ruling on the case, Bankruptcy Judge Robert E. Grossman observed that the automatic stay, which is a self-executing injunction issued by the bankruptcy court, is effective upon the filing of the bankruptcy petition and must be obeyed until it is modified or reversed. In addition, he observed that any action taken in violation of the stay, even a judicial proceeding, is void, of no force and effect and not entitled to full faith and credit in federal courts.

Judge Grossman recognized the state court’s inherent right to decide its own jurisdiction, and that federal courts have the authority to determine whether an automatic stay applies to a pending prepetition action.

Nevertheless, he determined that bankruptcy courts have the jurisdiction to review state court decisions and make their own determinations as to whether the automatic stay in the debtor’s case applies to any portion of a state court action. He found this to be consistent with the bankruptcy court’s power to enforce its own injunctions under the Supremacy Clause of the United States Constitution.

Judge Grossman found that the state court judge correctly found that section 362 of the Bankruptcy Code did not apply to the nondebtor corporate defendants. In sum, *Mokuba N.Y. LLC v. Pitts (In re Pitts)* dictates that state courts have only provisional jurisdictional to decide whether the automatic stay applies to pending prepetition litigation.

Bankruptcy Judge Grossman also found that the state court judge correctly decided to not extend the automatic stay to the corporate defendants, but did not comment on whether the state court judge had the jurisdiction to extend the automatic stay to the nondebtors.

*Straney v. GMC*, 2006 U.S. Dist. LEXIS 76940 ( E.D. Mich. Oct. 6, 2006) (C.J., Friedman) is an example of a decision wherein the presiding nonbankruptcy judge held that the bankruptcy court presiding over the debtor’s case has the sole authority to extend the automatic stay to a nondebtor defendant in prepetition litigation.

court in separate litigations considered whether nondebtors have standing to complain about violations of the automatic stay in a debtor’s case.

In *Taberna Capital Mgmt. LLC v. Dunmore*, the defendants moved to dismiss the claims against them on the grounds that the causes of action brought against them by the plaintiff sought recovery of the assets of the bankruptcy estate and were therefore subject to the automatic bankruptcy stay.

In denying the motion to dismiss and applying Ninth Circuit law, the Taberna court reasoned that the nondebtors do not have standing to assert violations of the stay since the automatic stay is for the benefit of the debtor.

Likewise, in *In re Fiber Optek Interconnect Corp.*, the bankruptcy court, when finding that a creditor and former officer of the debtor lacked standing to move for a declaration that another creditor was in violation of the automatic stay and in contempt of court, held that the debtor is the only party with standing to complain about stay violations.

These cases are significant as they adopt the majority rule in the jurisdictions that have considered standing under the automatic stay provision to the Southern District of New York when holding that section 362 of the Bankruptcy Code is intended to solely benefit the debtor’s estate and only the debtor may challenge acts purportedly in violation of the stay.

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[1] In *Erti v. Pain Webber Jackson & Cutis Inc. (In re Baldwin-United Corp. Litigation)*, 765 F.2d 343, 347 (2nd Cir. 1985), the Court of Appeals for the Second Circuit held that federal courts have jurisdiction to decide whether the automatic stay applies to the nonbankruptcy action, but suggested that the nonbankruptcy court should defer to the bankruptcy court for this determination. While Baldwin-United dealt with another federal court, other lower courts in the Second Circuit have applied its reasoning when holding that state courts have jurisdiction to decide whether the automatic stay applies to prepetition litigation.