

**SCOPE OF THE AUTOMATIC STAY
IN SUSPENDING MULTI-PARTY LITIGATION**

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In construction related litigation, it is not uncommon to have multiple defendants, and it is also not uncommon for one of the defendants to file bankruptcy at some stage of the litigation. We all know that the bankruptcy filing gives rise to an automatic stay of section 362 of the Bankruptcy Code, protecting the debtor and prohibiting in most circumstances continuation of the litigation against that debtor party, absent an order modifying the automatic stay to allow litigation to proceed as against that debtor party. But, does the filing of bankruptcy by just one of several parties to the litigation bring the entire lawsuit to a screeching halt? And, what court determines whether the automatic stay in favor of the debtor will suspend the entire litigation?

In the typical case, the plaintiff has filed its lawsuit seeking a money judgment against the debtor and others in the state court, and less frequently in the federal district court. Those trial courts certainly have an interest in the scope of the automatic stay once it is invoked by one of the parties (typically one of the defendants) filing bankruptcy. Once the bankruptcy is filed, the bankruptcy court takes jurisdiction over the assets and affairs of the debtor, and it also has an interest in the scope of the automatic stay. Within the jurisdiction of the Federal Court of Appeals for the Fifth Circuit, where the bankruptcy courts and the federal district courts in Texas reside, the first step of an appeal from a ruling of a bankruptcy court concerning the automatic stay or any other matter is to the federal district court in the district where that bankruptcy court is located. The next step of the appeal process would be to the Fifth Circuit Court of Appeals. Consequently, the state and federal trial courts, the state courts of appeal (including the state Supreme Court), the bankruptcy court, and the federal district court, as well as the Fifth Circuit Court of Appeals all have an interest in the scope of the automatic stay in pending litigation. With the exception of the trial courts, which do not issue written opinions, each of these courts have issued opinions on the issue, and for the most part, the opinions are consistent.

The General Rule

As recently as 2005, the Texas Court of Appeals held that the automatic stay generally only applies to actions against the debtor. *Lisanti v. Dixon*, 147 S.W.3d 638 (Tex.App.– Dallas 2005, pet. denied). Thus, under state law the automatic stay generally encompasses only claims against the debtor. The Texas Supreme Court reached the same conclusion in *In re Southwestern Bell*, 35 S.W.3d 602 (Tex. 2000). The Court held that the automatic stay does not apply to non-debtors or even co-debtors, co-tortfeasors, or co-defendants. Moreover, the Court held that express severance of the debtor from the case was not required for the case to move forward as to the other parties.

The Texas bankruptcy courts reached the same conclusion in *Tierra Petroleum, Inc. v. Walker*, 232 B.R. 889 (Bankr. E.D.Tex. 1999), as has the Federal District Court for the Southern District of Texas in *Carway v. Progressive*, 183 B.R. 769 (S.D. Tex. 1995). The Fifth Circuit Court of Appeals agrees. In *Wedgeworth v. Fibreboard*, 706 F.2d 541 (5th Cir. 1983) the Court

stated that the language of the automatic stay contained in 11 U.S.C. § 362(a) only stays action against a debtor. *Id.* at 544. The Court added that the purpose set forth by the statute would not be furthered by application of the stay to co-defendants. *Id.*

Thus, the courts that govern our litigation here in Texas have held that the automatic stay that arises in favor of a debtor who is a party to litigation is not so broad as to suspend the entire case.

Exceptions to the General Rule

The general rule described in the preceding paragraphs apply to Chapter 7 and Chapter 11 bankruptcy cases. The result may be entirely different in a Chapter 13 case which is known as “Adjustment of Debts of an Individual with Regular Income” or frequently referred to by its more informal name, “Wage Earner Plan”. Chapter 13 contains specific statutory wording creating a “co-debtor stay”. 11 U.S.C. § 1301. This section of the Bankruptcy Code expressly creates a stay in favor of a co-debtor who has not filed bankruptcy. A co-debtor can be a guarantor, a co-signor, an indemnitor, or someone otherwise jointly liable for one or more of the debtor’s obligations. By way of example, in a case where a surety has filed suit against its principal to recover for losses on a bond, and has also sued multiple indemnitors that signed a general indemnity agreement, if the principal or one of the indemnitors files a Chapter 13 bankruptcy proceeding then presumably the other indemnitors are “co-debtors” and the litigation is stayed against them as well.

Apart from the co-debtor stay there are other, infrequent circumstances in which the automatic stay will be deemed to extend to other litigants that have not filed bankruptcy. For example, the automatic stay may be extended to apply to third parties when the assets of the bankruptcy estate will be jeopardized if the litigation is allowed to continue as against the non-debtor parties. 147 S.N. 3d at 641. The Houston 1st District Court of Appeals recognized this exception and extension of the automatic stay in favor of non-debtor parties in litigation in *Greenberg v. Fincher*, 753 S.W.2d 506 (Tex.App.– Houston [1st Dist] 1988, no pet.). In *Greenberg*, the non-debtors seeking extension of the automatic stay were alter egos of the debtors. *Id.* at 507.

In the *Carway* case, discussed above, the Federal District Court for the Southern District of Texas recognized that the automatic stay may be extended to non-debtor parties in cases where the litigation, if continued, would have a significant impact on the debtor’s ability to reorganize. 183 B.R. at 775. The Court noted that extending the stay in that fashion would be allowed only where the non-debtor’s interest is so intertwined with the debtor’s interest that it is considered to be a real party in interest. The Court also noted that this type of connection is difficult to prove and will be absent in most cases. *Id.* at 744. This ruling is consistent with the statement of the Fifth Circuit Court of Appeals in *Reliant Energy Svcs. v. Enron Canada Corp.*, 349 F.3d 816 (5th Cir. 2003) that the stay may be extended in favor of third parties when the identity between the third party and the debtor is so close as to make the debtor a real party defendant, and where a judgment against the third party would in effect be a judgment against the debtor. *Id.*

Conclusion

A typical case in which this issue involving the scope of the automatic stay arises involves a single plaintiff suing multiple defendants for money damages, with one of the defendants filing bankruptcy at some point in the proceedings. Generally, the other defendants are not co-debtors as that term is used in the Bankruptcy Code and they are not the alter egos of the defendant that filed bankruptcy. In most of the cases, proceeding against the non-debtor defendants will have no impact on the debtor's bankruptcy estate. In the vast majority of cases, the automatic stay, therefore, will suspend prosecution of the case against the debtor party but does not operate as a prohibition against continuation of the litigation against the non-debtor parties. The result should be the same for multi-party arbitrations.

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