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Introduction

When a corporation files for bankruptcy, it is entitled to an automatic stay of any action that has been filed against it pursuant to section 362(a)(1) of title 11 of the United States Code (the "Bankruptcy Code").[1] But today, litigation is often complex and involves more than one defendant. For example, I may commence an action against corporations X, Y and Z. Corporation X then files for bankruptcy and is entitled to an automatic stay. The question in these cases is whether the automatic stay applicable to the debtor corporation (Corporation X) also applies to the non-debtor corporations (Corporations Y and Z).

This was precisely the issue that was addressed in *Pavers & Road Builders District Council Welfare Fund v. Core Contracting of NY, LLC*.[2] Here, the District Court for the Eastern District of New York exercised its discretion with regard to automatic stays in its holding that a corporation's alter ego status does not permit an automatic stay for non-debtors.[3] In *Pavers & Road Builders District Council Welfare Fund*, administrators of an Employee Retirement Income Security Act ("ERISA") pension fund brought suit against four related corporate defendants for

[1] 11 U.S.C. §362(a)(1).
[2] No. 15 Civ. 0207, 2015 WL 4925351 (E.D.N.Y. August 18, 2015).
[3] *Id*. at *5.

"delinquent contributions and shifting of assets to avoid having to pay workers."[4] Canal Asphalt, the defendant-debtor, filed a voluntary petition for chapter 11 relief in the Southern District of New York. Thus, the cause of action was automatically stayed against the debtor, pursuant to section 362(a)(1) of the Bankruptcy Code.[5] The other defendants argued in a letter to the District Court of the Eastern District of New York that because the non-debtor corporations are alter egos of one another, the automatic stay arising in the debtor's case should prevent the action from proceeding against all defendants.[6] The District Court disagreed and instead, issued an order stating that the automatic stay only enjoined actions against debtors or their property.[7]

I. Background of Section 362(a)(1)

Under 11 U.S.C. §362(a)(1), "a petition filed [for voluntary bankruptcy]…operates as a stay, applicable to all entitles, of the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding *against the debtor*…or to recover a claim *against the debtor* that arose before the commencement of the case under this title."[8] The stay is triggered when "a petition is filed under section 301, 302 or 303, or when an application is filed under section 5(a)(3) of the Securities Investor Protection Act of 1970."[9]

"The legislative history of the provision reveals that Congress enacted §362 to provide protection for bankrupt debtors and to facilitate the orderly distribution of debtors' assets among

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[4] *See id.* at *1, 4.
[5] 11 U.S.C. §362(a)(1); *See* Pavers & Road Builders District Council Welfare Fund v. Core Contracting of NY, LLC, 2015 WL 4925351, at *1.
[6] *See id.*
[7] *See id.*
[8] 11 U.S.C. §362(a)(1) (emphasis added).
[9] COLLIER ON BANKRUPTCY 362.03, p. 1 (15th 2015).

their creditors."[10] Thus, its purpose is to provide "the debtor with relief from the pressure and harassment of creditors seeking to collect their claims."[11] This purpose works to promote bankruptcy's overarching goal of "equality of distribution."[12]

To achieve the goal of "equality of distribution" the drafters made the scope of section 362(a)(1) broad. The section covers "all types of legal proceedings" and is subject only to limited exceptions found in section 362(b).[13] However, the broad scope of the stay has traditionally been interpreted to apply only to the debtor. Therefore, "[t]he stay of litigation does not protect non-debtor parties who may be subjected to litigation for transactions or events involving the debtor."[14]

II. When Does an Automatic Stay Apply to Non-Debtors?

A. Existing Relationship between Debtor and Non-Debtor

Courts can apply a fact-specific analysis to determine whether the section 362 stay applies to non-debtors as well as debtors. For example, in cases involving general partnerships, courts have relied on the facts that partners can be held jointly and severally liable for their

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[10] Credit Alliance Corp. v. Williams, 851 F.2d 119 (4th Cir. 1988).

[11] *Id*. Providing the debtor with this stay allows them to retain their property and assets "that may be necessary for the debtor's fresh start" and "provides breathing space to permit the debtor to focus on rehabilitation." *Id*.

[12] *Id. See also* H.R. Rep. No. 595, 95th Cong., 1st Sess. 340 (1977):

> 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.

Id.

[13] COLLIER ON BANKRUPTCY, 362.03[3], p. 2 (15th 2015) ("[The stay] even covers actions or proceedings against when the debtor acts solely in a fiduciary capacity…[and] proceedings on both dischargeable and non-dischargeable debt.").

[14] *Id.* ("[A] suit against a codefendant is not automatically stayed by the debtor's bankruptcy filing.").

individual actions.[15] Therefore, the court will determine whether the action proceeding against the partner arose out of the partner acting in an individual capacity. For example, the court in *Patton v. Bearden* held that the automatic stay does not protect a partner of a partnership.[16] On the other hand, courts have determined that it is appropriate, in some cases, to extend the automatic stay to debtor's insurers because those insurance policies are part of the debtor's estate.[17]

Furthermore, the court in *Credit Alliance Corp v. Williams* looked to the intent of Congress in drafting the automatic stay provision and determined that to apply the stay to guarantors would negate Congress' intentions for the Bankruptcy Code.[18] The court held "[n]othing in § 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

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[15] *See* Credit Alliance Corp v. Williams, 8 F.3d 343, 346 (6th Cir.1993).

[16] Credit Alliance Corp v. Williams, 8 F.3d at 346. The court reasoned "a partnership may file a petition in bankruptcy even though its partners have not." *Id*. at 349. Therefore, because the partner is not a debtor and can be held jointly and severally liable, the partner is responsible for individual actions against him. *Id*. The stay does not apply. *Id*. This same reasoning applies to corporate shareholders. An action may be brought against the corporate shareholders of a corporation, despite the applicability of a stay to the corporation. *Collier on Bankruptcy* 362.03[3], p. 5 (15th 2015).

[17] *See* MacArthur Co. v. Johns-Manville Corp., 837 F.2d 89, 92 (2d Cir. 1988), *cert. denied,* 488 U.S. 868, 109 S. Ct. 176, 102 L. Ed. 2d 145 (1988). Under certain circumstances, courts will apply the automatic stay to an action against a debtor's insurers. *Collier on Bankruptcy* 362.03[3], p. 5 (15th 2015). If the court finds that the debtor's insurance policies are property of the estate, the court will stay the action to recover on those policies. *Id*. For example, in *MacArthur Co. v. Johns-Manville Corp.,* the court found "that [the] insurance policies and their proceeds were 'substantial property of the [] estate which will be diminished if and to the extent that third party direct actions against the insurance carriers result in plaintiffs' judgments.'" 837 F.2d at 92 (2d Cir. 1988) (citing Johns-Manville Corp., 26 B.R. 420, 435 (Bankr. S.D.N.Y. 1983)).

[18] 851 F.2d 119, 121 (4th Cir. 1988) ("A reading of § 362 restricting a creditor's ability to proceed against its guarantor would eliminate the protection of assured creditors contemplated by the Bankruptcy Code.")

guaranty the debt," and therefore the automatic stay does not apply to guarantors under section 362.[19]

B. Identity of Interest

Aside from analyzing the nature of the relationship between debtor and non-debtor, whether it is a partnership or insurance relationship, courts will also analyze the closeness of the relationship between debtor and non-debtor.[20] Courts have held that in "unusual circumstances," like when the debtor and non-debtor's interests are very closely related, the automatic stay can extend to the non-debtor party.[21] Therefore, the non-debtor must prove that its interests are so closely related to the debtor party's by demonstrating that "there is such identity between the debtor and the non-debtor that the debtor may be said to be the real party defendant and that a judgment against the non-debtor will in effect be a judgment or findings against the debtor."[22]

The court in *A.H. Robins Co.* attempted to define what "unusual circumstances" were sufficient for a court to find an identity of interest.[23] However, the only guidance the court

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[19] *Id.*

[20] *See In re* Divine Ripe, L.L.C., 538 B.R. 300, 302 (Bankr. S.D.Tex. 2015). "Courts recognize that a § 362 stay may apply to an action against non-debtor defendants depending on their relationship to the debtor." *See also* A.H. Robins Co. v. Piccinin, 788 F.2d 994, 999 (4th Cir. 1986) ("[A] bankruptcy court may invoke § 362 to stay proceedings against nonbankrupt codefendants where 'there is such an 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.'").

[21] *See In re* Union Trust Philadelphia, LLC, 465 B.R. 765, 770 (Bankr. E.D.Penn. 2011). "Unusual circumstances exist when 'there is such identity between the debtor and 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.'" *Id.; see also In re* Bidermann Industries U.S.A., Inc., 200 B.R. 779 (Bankr. S.D.N.Y. 1996) ("The case law indicates that 'unusual circumstances' exist where the claim clearly arises out of the defendant's actions in his capacity as the debtor's officer, and he is undisputedly entitled to indemnity.")

[22] *In re* Xenon Anesthesia of Texas, PLLC, 510 B.R. 106, 111–12 (Bankr.S.D.Tex.2014). "The burden of proof to show that the automatic stay is applicable to a non-debtor is on the party invoking the stay." *Id*. at 111.

[23] *See* 788 F.2d at 999.

provided was that the relationship between the debtor and non-debtor must be "something more than the mere fact that one of the parties to the lawsuit has filed [for bankruptcy]."[24] For example, "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" would constitute a relationship between debtor and non-debtor where the court could find an identity of interest. [25]

III. Applying the Automatic Stay to Non-Debtor In Addition to the Debtor under *Pavers & Road Builders District Council Welfare Fund*

The court in *Pavers & Road Builders District Council Welfare Fund* developed a two-tier analysis to determine whether the section 362 stay should apply to non-debtor parties. First, a court should determine whether the debtor and non-debtor corporations are alter egos. If the corporations are alter egos, the bankruptcy court must then determine if their interests are so intertwined that the automatic stay must also apply to the non-debtor corporations.

In developing this two-step analysis the court held that it is no longer enough for corporations to be alter egos. In other words, the court will no longer apply the stay solely because corporations are alter egos, the corporations' interests must also be comingled, such that the stay would not protect the debtor unless it also applied to the non-debtor.

A. Alter Ego Status

For a court to consider two corporations "alter egos" of each other, they must demonstrate a relationship that is more than "mere majority or complete stock control."[26] Corporations are only granted alter ego status upon a showing that one company "totally dominates and controls" the other.[27]

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[24] *Id.*
[25] *Id.*
[26] U.S. v. Jon–T Chemicals, Inc. 768 F.2d 686, 691 (5th Cir. 1985).
[27] *Id*. The court has determined a "laundry list of factors" that help to determine whether corporations are alter egos.

The bankruptcy court in *In re Adler*[28] expanded upon the holding in *Queenie, Ltd. v. Nygard Int'l*,[29] which stated that "when a claim against the non-debtor will have an immediate adverse economic consequence for the debtor's estate," the automatic stay applies to alter egos.[30] The *In re Adler* court held:

> [I]f two judicial determinations have been made—(1) one or more non-debtor corporations has been found liable for a prepetition debt on a cause of action asserted in a post-petition proceeding, and (2) the veil between these corporate alter egos and the non-party debtor has been pierced—the § 362(a)(1) stay was violated by the post-petition proceeding.[31]

Therefore, under this holding, if a non-debtor is liable for debt but that non-debtor is the alter ego of the debtor corporation, the automatic stay extends to the non-debtor.

It is important to note though that the court in *Pavers & Road Builders District Council Welfare Fund* held that a corporate defendant's status as an alter ego was not enough to intermingle debtor and non-debtor interests, such that the automatic stay would be applied to the

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> (1) the parent and the subsidiary have common stock ownership; (2) the parent and the subsidiary have common directors or officers; (3) the parent and the subsidiary have common business departments; (4) the parent and the subsidiary file consolidated financial statements and tax returns; (5) the parent finances the subsidiary; (6) the parent caused the incorporation of the subsidiary; (7) the subsidiary operates with grossly inadequate capital; (8) the parent pays the salaries and other expenses of the subsidiary; (9) the subsidiary receives no business except that given to it by the parent; (10) the parent uses the subsidiary's property as its own; (11) the daily operations of the two corporations are not kept separate; and (12) the subsidiary does not observe the basic corporate formalities, such as keeping separate books and records and holding shareholder and board meetings.

Id. at 691-692.

[28] 494 B.R. 43 (Bankr. E.D.N.Y. 2013).

[29] 321 F.3d 282 (2d Cir. 2003).

[30] *Id.* at 287 (citing A.H. Robins Co., Inc. v. Piccinin, 788 F.2d 994, 999 (4th Cir. 1986)).

[31] 494 B.R. at 281.

non-debtor.[32] The court pointed out, "[j]ust because two entities are *alter egos* does not make them both debtors under the Bankruptcy Code."[33]

B. Intertwined Interests

The *Pavers & Road Builders District Council Welfare Fund* court concluded the debtor could make a motion to the bankruptcy court to enjoin a district court from proceeding in the action against the non-debtor on the grounds that it would "prejudice other creditors of the debtor in a way that the Bankruptcy Court would consider unfair."[34] Under this approach, the Bankruptcy Court would have discretion as to whether to grant the motion.[35] If the Bankruptcy Court does not issue an injunction, however, the district court could resolve the pending litigation against the non-debtor.[36]

Under *Pavers & Road Builders District Council Welfare Fund* a bankruptcy court will issue an injunction if it "is necessary to protect the debtor's estate or to effectuate its reorganization."[37] Therefore, extending the stay to non-debtors should only be done in cases where it serves to protect the debtor.[38] For example, "it may be necessary to extend the automatic stay…to protect the non-debtor entities, for not only may they be *alter- egos*, but they may be holding the assets that should be used to satisfy all of the debtor's creditors."[39]

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[32] *See generally* Pavers & Road Builders District Council Welfare Fund v. Core Contracting of NY, LLC, 2015 WL 4925351, at *5.
[33] *Id*. at *2.
[34] *See id.* at *4.
[35] *See id.*
[36] *See id*.
[37] *Id.* at *3. ("It is the protection of the debtor, not the non-debtors (who receive the benefit only collaterally) that furnishes the rationale for extending the automatic stay to include those non-debtors").
[38] Pavers & Road Builders District Council Welfare Fund, 2015 WL 4925351, at *3.
[39] *Id.*

Therefore, "[w]hile an alter ego finding might make debtor and non-debtors liable for each other [sic] debts, it did not make them all bankruptcy 'debtors,' and if the non-debtors desired the protections of the automatic stay, they needed to file their own bankruptcy petitions."[40] The court's analysis must not end with a determination as to a corporation's alter ego status. Instead, the court must continue in its analysis to determine whether the interests of the debtor and non-debtor corporations are so intertwined such that a refusal to apply the section 362 stay to non-debtor corporations will harm the debtor.

C. Similarities between Intertwined Interests and Identity of Interest

This language in *Pavers & Road Builders District Council Welfare Fund*, which requires a stay to be issued if it is necessary to protect the debtor, mirrors the language found in *A.H. Robins Co.*, which also required the court to issue a stay to protect the debtor from judgment. Both holdings work to achieve bankruptcy's overarching goal of "equality of distribution" by protecting the interest of the debtor. [41]

IV. The Lack of a Bright-Line Rule

The analysis that the court developed in *Pavers & Road Builders District Council Welfare Fund* does not set a practical standard that can be applied in future cases. Instead, courts are left to use their discretion as to whether they believe that the debtor and non-debtor interests are so intertwined that the stay must apply to both parties.

Another recent case, *In re Divine Ripe, L.L.C.,* also focuses on the discretion of the court.[42] The *In re Divine Ripe* court held that:

> To extend the Automatic Stay to a non-debtor, a court must find an identity of interest between the debtor and the non-debtor, and then evaluate whether the

[40] *Stay Did Not Protect Alleged Alter Egos*, 09-23-15 West's Bankr. Newsl. 7
[41] *See supra* n. 11 and accompanying text.
[42] 538 B.R. 300 (Bankr. S.D.Tex. 2015).

> circumstances warrant exercising the "general discretionary power ... to stay proceedings in the interest of justice and in control of their dockets.[43]

This allows the court to exercise its discretion to refuse to apply the stay, even if it finds an identity of interest.

These discretionary analyses will lead to more complex and costly litigation caused by a lack of consistency in the application of the analysis to subsequent cases. *Pavers & Road Builders District Council Welfare Fund* and *In re Divine Ripe, L.L.C.* leave non-debtors with a precedent that can be applied discretionarily and does not provide these non-debtors with any guidance on how to obtain stays absent filing a bankruptcy petition for relief as well.

Conclusion

Although the application of a section 362 stay to non-debtors is discretionary, one thing is clear from the case law: stays will only be granted to non-debtors if it is in the best interest of the debtor. From earlier cases, such as *A.H. Robins Co.*, we saw that the court's primary focus is to protect debtors from falling victim to the judgments of their non-debtor co-defendants. This agenda is carried out even in later cases. And as we saw in *Pavers & Road Builders District Council Welfare Fund*, even corporations that are alter-egos of one another will endure scrutiny by the court to ensure that stays are only extended to the non-debtor when it is required to protect the interests of the debtor corporation.

Therefore, even though the applicability of section 362 stays are discretionary, if an argument can be made that extending the stay would serve to protect the debtor in some way, the stay may be granted.

[43] *Id*. at 309 (citing Wedgeworth v. Fibreboard Corp., 706 F.2d 541, 545 (5th Cir. 1983)).