Foreclosure Sale on Property After Tenant Filed for Bankruptcy Violated the Automatic Stay, Second Circuit Rules

*By Mark S. Edelstein and Theresa A. Foudy**

The authors examine a recent decision by the U.S. Court of Appeals for the Second Circuit that they believe potentially raises troubling roadblocks to a lender's ability to foreclose upon real property in New York.

In New York, it is a standard practice to name all tenants residing in a building when foreclosing upon the property. That is because Section 1311 of the New York Real Property Actions and Proceedings Law ("RPAPL") states that the necessary defendants in a foreclosure action include anyone "whose interest is claimed to be subject and subordinate to the plaintiff's lien," including "[e]very person having an estate or interest in possession, or otherwise, in the property as tenant in fee, for life, by the courtesy or for years." Thus, New York courts have held that "tenants are necessary parties to a foreclosure action."[1]

As a result, a recent decision by the U.S. Court of Appeals for the Second Circuit holding that the automatic stay precludes a foreclosure sale from being conducted when a tenant of the property files for bankruptcy potentially raises troubling roadblocks to a lender's ability to foreclose upon real property in New York - a process that could already be time-consuming and filled with potential potholes along the way.

Going forward, if a tenant of a property is in a bankruptcy proceeding prior to the filing of a foreclosure action, or files for bankruptcy during the pendency of the foreclosure action, a lender seeking to foreclose will need to either: (i) forgo naming the tenant - or dismiss an already-named tenant - and accept that the lease will remain unaffected by the foreclosure, or (ii) seek relief from the automatic stay from the bankruptcy court.

However, neither of these options ensures that the foreclosure action will be able to proceed.

With respect to the first option, even if a lender is content to have the lease remain in place, because tenants are necessary parties

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to a foreclosure action under New York law, failing to name a bankrupt tenant risks the foreclosure action being dismissed for failure to name a necessary party or the court ordering that the tenant be named in lieu of dismissal.

With respect to the second option, there is no guarantee that the bankruptcy court will grant relief from the stay.

BACKGROUND

On July 6, 2022, the Second Circuit decided *Bayview Loan Servicing LLC v. Fogarty (In re Fogarty)*,[2] in which the court held that a lender had willfully violated the automatic stay by proceeding with a foreclosure sale after having been informed that the property's tenant, a named defendant in the foreclosure action, had filed for bankruptcy.

In *Fogarty*, Eileen Fogarty held a 99% interest in 72 Grandview LLC (the "LLC"), an entity that owed money pursuant to a Note and Mortgage secured by an interest in real property (the "Property"), in which Fogarty was a tenant. After the LLC ceased making payments on the Mortgage and Note, Bayview Loan Servicing LLC, the owner and holder of the Note and Mortgage (the "Lender"), obtained a judgment in a state court foreclosure action (the "Foreclosure Action"), which authorized the Lender to conduct a foreclosure sale (the "Sale").

Four days prior to the scheduled Sale, Fogarty filed a Chapter 7 bankruptcy case in the Eastern District of New York, and her counsel notified the Lender of the filing and Fogarty's position that the ability to proceed with the Sale was subject to the automatic stay. Taking the position that the LLC alone owned the Property and that only a bankruptcy by the LLC would stay the Sale, the Lender proceeded with the Sale as scheduled.

Following the Sale, Fogarty sought sanctions against the Lender, arguing that the Lender had willfully violated the automatic stay. Although the bankruptcy court denied Fogarty's request for sanctions, the district court reversed, finding that because Fogarty was a debtor in bankruptcy and a named defendant in the Foreclosure Action, the Sale violated the automatic stay. In addition, because the Lender knew of the bankruptcy petition when it proceeded with the Sale, the district court found that the stay violation was willful and granted sanctions.

THE SECOND CIRCUIT'S DECISION

On appeal, in what the Second Circuit Court of Appeals described as "a matter of first impression," the court agreed with the district court, finding that two of the Bankruptcy Code's automatic stay provisions, 11 U.S.C.A. § 362(a)(1) and (a)(2), were violated by the foreclosure sale of a property when the debtor is a named party in the foreclosure proceedings, "even if the debtor's direct interest in the property is only possessory."

The Second Circuit likewise agreed with the district court that, because the Lender was aware of the bankruptcy filing at the time it conducted the Sale, the violation of the automatic stay was willful and warranted sanctions. The court reasoned that, by the plain language of Section 362(a) of the Bankruptcy Code, the continuation of the Foreclosure Action and Sale was subject to the automatic stay.

In particular, Section 362(a)(1) stays the "commencement or continuation . . . of a

judicial, administrative, or other action or proceeding against the debtor," and Section 362(a)(2) stays the "enforcement" of a judgment against the debtor or against property of the estate.

Because the debtor Fogarty was a named defendant in the Foreclosure Action, the Second Circuit found that the Foreclosure Action was a judicial proceeding against the debtor stayed by operation of Section 362(a)(1) and that the foreclosure Sale itself was a "continuation" of that judicial proceeding and thus was also stayed under Section 362(a)(1).

In addition, because the judgment of foreclosure authorizing the Sale had been previously entered, the Second Circuit found that the Sale "enforce[d]" a judgment "against the debtor" in violation of Section 362(a)(2). The Second Circuit reasoned that Sections 362(a)(1) and (a)(2) apply to any action in which a debtor is named as a defendant - regardless of whether the action affected property of the bankruptcy estate and regardless of the capacity in which the debtor is named or even if the debtor were merely a "nominal" defendant.

In short, the court concluded that Section 362(a)'s "language demands a bright-line rule that, 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."

Although *Fogarty* involved a residential building with a residential tenant, the reasoning would seem to apply equally to commercial and other types of real estate.

In addition, although the tenant/debtor in *Fogarty* also happened to own 99% of the borrower/owner of the building, that fact does not appear to have factored into the Court's analysis. As a result, the *Fogarty* decision appears to open the door to arguments that the bankruptcy of any tenant - even if the tenant leases only a newspaper stand in a large commercial building - stays a foreclosure suit from continuing if that tenant is named as a defendant in the foreclosure action (as RPAPL 1311 appears to require).

CONCLUSION

If a tenant of a building in New York on which a lender is seeking foreclosure files for bankruptcy, the lender will be left with two less-than-perfect options.

First, the lender could choose not to name a bankrupt tenant or to dismiss from the action a tenant who files for bankruptcy.

One consequence of that will be that the lease will come through the foreclosure unaffected.[3]

Another consequence is that there is a risk that, if the borrower/owner moves to dismiss the foreclosure action for failure to name a necessary party, the court will grant the dismissal or order that the tenant be named, which the lender will not be able to do without violating the automatic stay.[4]

If a lender wants to terminate the lease of the bankrupt tenant or is unwilling to chance the possibility of its foreclosure action being dismissed for failure to name a necessary party, the Lender will need to petition the bankruptcy court for relief from the automatic stay in order to commence or continue its foreclo-

sure action. Needless to say, there are no guarantees that such relief will be granted. However, presumably, the odds of stay relief being granted will be higher where the lender is willing to allow the lease to remain in effect than if the lender is seeking to terminate a lease that may have value to the bankruptcy estate.

Given the complications caused by the bankruptcy of a tenant, lenders should expect that borrowers may try to use the bankruptcy of a tenant as leverage in negotiations and to demand additional compensation for delivering a deed in lieu. Lenders should consider whether modifications to their loan documentation should be made to guard against a scenario in which the borrower's sponsor or affiliate has a lease in the building and seeks to use a bankruptcy by such affiliate as a delay tactic. If a "bad boy" guarantee is being put in place, a lender may want to ensure that a bankruptcy by a tenant-affiliate of the borrower is a triggering event for liability under the guarantee.

NOTES:

[1] *1426 46 St., LLC v. Klein*, 60 A.D.3d 740, 876 N.Y.S.2d 425 (2d Dep't 2009).

[2] *In re Fogarty*, 39 F.4th 62, 71 Bankr. Ct. Dec. (CRR) 179 (2d Cir. 2022).

[3] *See 71-21 Loubet, LLC v. Bank of America, N.A.*, 208 A.D.3d 736, 174 N.Y.S.3d 400 (2d Dep't 2022) (" 'The absence of a necessary party in a foreclosure action leaves that party's rights unaffected by the judgment and sale, and the foreclosure sale may be considered void as to the omitted party.' " *(quoting 6820 Ridge Realty LLC v. Goldman*, 263 A.D.2d 22, 26, 701 N.Y.S.2d 69 (2d Dep't 1999))).

[4] *See, e.g., Toiny LLC v. Gill*, 2022 WL 4118520 (E.D. N.Y. 2022) (dismissing foreclosure action for failure to name all interested and necessary parties); *Dime Sav. Bank of New York, FSB v. Johneas*, 172 A.D.2d 1082, 569 N.Y.S.2d 260 (4th Dep't 1991) (where defendant moved to dismiss foreclosure action because plaintiff failed to name a tenant as a defendant, court ruled that "proper remedy for nonjoinder was not to dismiss the action" but to direct that tenant be joined as defendant).