

# Financial Restructuring & Bankruptcy Advisory

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July 2011

## Bankruptcy Court Holds Individual Guarantor's Bankruptcy Petition Stays Foreclosure Sale of Corporate-Owned Property

In a case of first impression, the Bankruptcy Court for the Eastern District of New York recently held that a mortgage lender's foreclosure sale was a violation of the automatic stay when the lender obtained its foreclosure judgment pre-petition and the debtor was not an owner of the mortgaged property. While this decision was filed several months ago, there has been little discussion about its implications. But the case is noteworthy because it is a gotcha, as evidenced by the court's decision not to award punitive damages against the lender. *In re Ebadi*, 2011 WL 1257211 (Bankr. E.D.N.Y. Mar. 30, 2011).

In that case, Lings Property, LLC ("Lender") was the holder of a mortgage securing repayment of a loan made to CBC Media Retail (the "Borrower"). The loan was secured by the mortgage on property owned by the Borrower and a guaranty of the Borrower's principal, Madjid Ebadi (the "Debtor"). The Debtor did not have an ownership interest in the mortgaged property. Upon Borrower's default, Lender commenced a foreclosure action, naming Debtor as a defendant — a requirement under New York law to preserve the lender's deficiency claim. Lender obtained a foreclosure judgment, which provided that the Lender was authorized to seek a deficiency judgment against Debtor after the sale.

Hours before the foreclosure sale was to take place, the Debtor filed a bankruptcy petition under chapter 13 of the Bankruptcy Code and immediately notified the Lender of the filing. Operating under the general rule that the automatic stay does not prevent a creditor from pursuing collection of a debt from a non-filing co-obligor or guarantor, Lender proceeded with the sale and was the successful bidder at auction. The Debtor did not continue with the bankruptcy case and the case was ultimately dismissed for failure to comply with filing requirements.

Months after the foreclosure sale took place and after the bankruptcy case was closed, Lender sought to evict Borrower from the premises. The following month, the Debtor filed a motion with the bankruptcy court requesting that the court (1) reopen the bankruptcy case, (2) vacate the foreclosure sale as a violation of the automatic stay and (3) award actual and punitive damages to the Debtor for the stay violation.

The Bankruptcy Court held that the foreclosure sale was conducted in violation of the automatic stay and therefore was void. The court's holding was based on the premise that the sale was a "substantial step" toward obtaining a deficiency judgment against the Debtor and therefore was an "act to collect, assess, or recover a claim against the debtor" under Section 362 of the Bankruptcy Code. The Debtor's lack of ownership interest in the mortgaged property was irrelevant; the key was that the foreclosure suit was, in part, an *in personam* action against the Debtor to obtain a deficiency judgment and the sale was a continuation of that action.

The court noted that Lender could have dismissed the Debtor from the foreclosure action and removed him from the judgment to avoid the effect automatic stay, or alternatively could have sought relief from the automatic stay. However, since the Lender continued with the sale despite its knowledge of the bankruptcy case, actual damages were appropriate.

The Court declined the Debtor's request for punitive damages, holding that although Lender's conduct was certainly a knowing violation of the stay, it was due to a mistake of law rather than a malicious intention or even a "callous disregard" for the automatic stay. Further, the court hesitated to award punitive damages to a debtor who "clearly filed [the] bankruptcy solely to prevent the foreclosure sale, with no legitimate intent to reorganize his financial affairs, to obtain a discharge, or to comply with his duties as a Chapter 13 debtor."

The holding of *In re Ebadi* is a powerful tool that borrowers may use to stall foreclosure sales. It's holding will likely reach beyond New York and may be persuasive in any case where a guarantor has been named as a defendant in a foreclosure action — regardless of whether the guarantor was included as a defendant on account of legal requirements or on account of a lender's election.

Even if lenders obtain foreclosure judgments pre-petition, after *In re Ebadi* a single-purpose, eleventh-hour bankruptcy petition from a guarantor may force the lender to adjourn the sale and seek stay relief or face an action for damages for violation of the automatic stay.

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