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Isabella Benchetrit

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**Exceptions to the Rule: When Non-Debtor Entities are Protected by the Automatic Stay**

**Isabella Benchetrit, J.D. Candidate 2024**

Cite as: *Exceptions to the Rule: When Non-Debtor Entities are Protected by the Automatic Stay*,  
15 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 4 (2023).

**Introduction**

In most cases, the automatic stay, under section 362 of title 11 of the United States Code (the "Bankruptcy Code"), stays all creditors from pursuing litigation against debtors.

Nonetheless, non-debtor entities can obtain the protection afforded to debtors by the automatic stay in limited circumstances. There are two primary ways of staying litigation against a non-debtor. First, through demonstrating that there are exceptional circumstances to extend section 362 to a non-debtor. Second, through satisfying the standard for an injunction pursuant to section 105 of the Bankruptcy Code.

This Article considers the circumstances by which a non-debtor entity may receive the protection of the automatic stay under section 362. Part I discusses the general standard under section 362 — that the automatic stay only extends to debtors. Part II analyzes the main exceptions to the general rule, whereby the automatic stay may be extended to non-debtors. Part III sets forth the injunction standard under section 105, which may be utilized to enjoin actions against a non-debtor.

**I. The Plain Language of Section 362 Limits the Automatic Stay Only to Debtors**

Section 362's text refers exclusively to the protection of debtors.<sup>1</sup> Filing a bankruptcy petition "operates as a stay . . . of the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor . . . ." <sup>2</sup> Filing a bankruptcy petition stays "any act to collect, assess, or recover a claim against the debtor . . . ." <sup>3</sup> Many courts have interpreted the "plain language" of section 362 to find that only debtors are protected by the automatic stay.<sup>4</sup> Sections 362(a)(1) and (1)(6) "specifically and in plain language refer to the stay of actions *against the debtor*."<sup>5</sup> Section 362 stays actions against the debtor and no other entity.<sup>6</sup>

The Bankruptcy Code's purpose "is to grant a 'fresh start' to 'the honest but unfortunate debtor.'" <sup>7</sup> The automatic stay is a "fundamental" debtor protection which gives the debtor a "breathing spell."<sup>8</sup> This "breathing spell" provides debtors the opportunity "to attempt to reorganize or simply be relieved of the financial pressures that led to the bankruptcy."<sup>9</sup> The legislative history of section 362 demonstrates that there is a clear distinction between the treatment of debtors and non-debtors.<sup>10</sup> Applying the automatic stay to a non-debtor distorts the congressional purpose of section 362, which is to protect the insolvent debtor and its creditors.<sup>11</sup>

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<sup>1</sup> See *In re Diocese of Rochester*, No. 19-20905-PRW, 2022 WL 1638966, at \*4 (Bankr. W.D.N.Y. May 23, 2022).

<sup>2</sup> 11 U.S.C. § 362(a)(1) (2018).

<sup>3</sup> 11 U.S.C. § 362(a)(6) (2018).

<sup>4</sup> See *In re Diocese of Rochester*, 2022 WL 1638966, at \*4; *Wedgeworth v. Fibreboard Corp.*, 706 F.2d 541, 544 (5th Cir. 1983).

<sup>5</sup> See *In re Diocese of Rochester*, 2022 WL 1638966, at \*4.

<sup>6</sup> *Lynch v. Johns-Manville Sales Corp.*, 710 F.2d 1194, 1197 (6th Cir. 1983). In one narrow exception, a stay in bankruptcy can be extended to codebtors. The codebtor stay is limited to the consumer context under 11 U.S.C. § 1301. If there are codebtors and one files for bankruptcy, a secured creditor may not pursue compensation from the other codebtor.

<sup>7</sup> *In re Rhodes*, 563 B.R. 380, 382 (Bankr. M.D. Fla. 2017) (citing *Grogan v. Garner*, 498 U.S. 279, 286–87 (1991)).

<sup>8</sup> S. Rep. No. 95–989, 95th Cong., 2d Sess. 54–55 (1978), as reprinted in 1978 U.S.C.C.A.N. 5787, 5840.

<sup>9</sup> *In re Cole*, 552 B.R. 903, 911 (Bankr. N.D. Ga. 2016).

<sup>10</sup> See *Wedgeworth v. Fibreboard Corp.*, 706 F.2d 541, 544 (5th Cir. 1983).

<sup>11</sup> *Lynch v. Johns-Manville Sales Corp.*, 710 F.2d at 1197.

Non-bankrupt co-defendants do not receive the protection of the automatic stay.<sup>12</sup> When a limited partnership files for bankruptcy, and individual general partner defendants do not declare bankruptcy, the automatic stay does not apply to those individual general partner defendants.<sup>13</sup> The automatic stay does not extend to "the debtor's liability insurers" and no "provision of § 362 grant[s] the insurer an automatic stay."<sup>14</sup> A suit against a debtor's insurer does not *per se* lead to a hit on the debtor's assets.<sup>15</sup> Ultimately, section 362 "provides a narrow protection directed at the debtor and its estate."<sup>16</sup>

## **II. The Automatic Stay can be Extended to a Non-Debtor in Certain Circumstances**

There are two exceptional situations where the automatic stay may extend to non-debtor entities. The first special circumstance is the "unusual situation" that arises when a judgment against the third-party defendant will essentially be a judgment against the debtor. The second special circumstance is when a claim against the non-debtor will have an "immediate adverse economic consequence" for the debtor's estate.

### *A. The Automatic Stay can be Extended to a Non-Debtor Where the Non-Debtor's Liability is Imputed to the Debtor*

The automatic stay can be extended to a non-debtor in the "unusual circumstance" where there is an inextricable link between debtor and non-debtor for purposes of liability.<sup>17</sup> An "unusual situation" arises "when there is such 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."<sup>18</sup> For example, an "unusual circumstance" may arise when there is "a suit against a third-party who is

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<sup>12</sup> Tchrs. Ins. & Annuity Ass'n of Am. v. Butler, 803 F.2d 61, 65 (2d Cir. 1986).

<sup>13</sup> *Id.*

<sup>14</sup> *Wedgeworth*, 706 F.2d at 547.

<sup>15</sup> *See id.*

<sup>16</sup> *Id.* at 547.

<sup>17</sup> *See A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 1000 (4th Cir. 1986).

<sup>18</sup> *Id.*

entitled to absolute indemnity by the debtor on account of any judgment that might result against them in the case . . . ." <sup>19</sup> That is because, "[t]o refuse application of the statutory stay . . . would defeat the very purpose and intent of the statute." <sup>20</sup> Although the intent behind section 362 is to safeguard debtors, "[w]here . . . a debtor and a non-debtor are so bound by statute or contract that the liability of the non-debtor is imputed to the debtor by operation of law, then the Congressional intent to provide relief to debtors would be frustrated by permitting indirectly what is expressly prohibited in the Code." <sup>21</sup> Therefore, courts consider the "unusual circumstances" of a non-debtor's liability being imputed to the debtor when deciding whether to extend the automatic stay to a non-debtor.

*B. The Automatic Stay can be Extended to a Non-Debtor to Avoid "Immediate Adverse Economic Consequences."*

The automatic stay can also be extended to a non-debtor when a claim against the non-debtor will have an "immediate adverse economic consequence for the debtor's estate." <sup>22</sup> The "fundamental question" a court must ask to decide if a claim against a non-debtor will cause a debtor to suffer immediate economic harm is "whether the determination of the claims against the Non-Debtor will or will not effect [sic] the Debtor's assets and/or liabilities as they existed at the date of the petition . . . ." <sup>23</sup> Whether claims against the non-debtor will have economic consequences for the debtor depends on if "the outcome of the proceeding could conceivably have any effect upon" the debtor's estate. <sup>24</sup>

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<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *In re Metal Center, Inc.*, 31 B.R. 458, 462 (Bankr. D. Conn. 1983).

<sup>22</sup> *Residential Cap., LLC v. Fed. Hous. Fin. Agency*, No. 11 CIV. 6188 DLC, 2013 WL 4056195, at \*1 (S.D.N.Y. Aug. 12, 2013).

<sup>23</sup> *In re U.S. Air Duct Corp.*, 8 B.R. 848, 851 (Bankr. N.D.N.Y. 1981).

<sup>24</sup> *Id.*

The debtor has the burden of proof under section 362(a)(3) to demonstrate that litigation against the non-debtor entities would adversely affect property of the debtor's estate.<sup>25</sup> The debtor must show that its reorganization efforts are threatened by an action against the non-debtor.<sup>26</sup> For instance, "a claim to establish an obligation of which the debtor is a guarantor," or "a claim against the debtor's insurer[.]"<sup>27</sup> The debtor can meet its burden by showing that litigation against the non-debtor would "erode collective insurance coverage" shared by the debtor and the non-debtor entities.<sup>28</sup> In the insurance context, the debtor needs to show that a specific claim brought against the non-debtor entities would impact a specific policy of insurance in such a way that would result in materially adverse economic consequences for the debtor.<sup>29</sup>

### **III. If there will be Irreparable Harm Absent the Issuance of an Injunction, a Bankruptcy Court may Enjoin a Creditor's Action Against a Non-Debtor**

Pursuant to its equitable powers, a bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."<sup>30</sup> A bankruptcy court may grant an injunction that extends the automatic stay to non-debtor entities. To obtain a preliminary injunction, a movant must demonstrate the following: (1) the likelihood of success on the merits; (2) the likelihood of irreparable harm to the movant absent the injunction issuing; (3) that the balance of hardships tips decidedly in favor of the movant; and (4) that the issuance of injunction is in the public interest.<sup>31</sup> "Likelihood of success on the merits" is interpreted by bankruptcy courts as "likelihood of successful reorganization."<sup>32</sup> "Irreparable harm" is the key

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<sup>25</sup> *In re Diocese of Rochester*, No. 19-20905-PRW, 2022 WL 1638966, at \*5 (Bankr. W.D.N.Y. May 23, 2022).

<sup>26</sup> *Residential Cap., LLC v. Fed. Hous. Fin. Agency*, 2013 WL 4056195, at \*2.

<sup>27</sup> *Queenie, Ltd. v. Nygard Intern.*, 321 F.3d 282, 287 (2d Cir. 2003).

<sup>28</sup> *In re Diocese of Rochester*, 2022 WL 1638966, at \*5.

<sup>29</sup> *Id.*

<sup>30</sup> 11 U.S.C. § 105(a) (2018).

<sup>31</sup> *Winter v. Natural Resources Defense Council, Inc.*, 555 U.S. 7, 20 (2008).

<sup>32</sup> *In re Diocese of Rochester*, 2022 WL 1638966, at \*6 (citing *In re Calpine Corp.*, 365 B.R. 401, 409 (S.D.N.Y. 2007)).

element necessary to justify the grant of an injunction.<sup>33</sup> A debtor seeking "to enjoin a creditor's action against a non-debtor" must present evidence that there will be "[i]rreparable harm to the bankruptcy estate if the stay is not extended[.]"<sup>34</sup>

A bankruptcy court's discretion to grant an injunction extending the automatic stay to a non-debtor is generally limited to situations where enjoining an action protects the debtor and furthers the debtor's goal of rehabilitation.<sup>35</sup> A preliminary injunction is a powerful remedy which requires the movant to carry a heavy burden of proof.<sup>36</sup> Although a bankruptcy court may use its "general equity powers" to extend the automatic stay to non-bankrupt entities, the courts' broad discretionary power "to stay proceedings in the interest of justice and in control of their dockets . . . is not unbounded."<sup>37</sup> A judge cannot issue an injunction to stay actions against a non-debtor if the request for injunction stems from "bad faith" efforts by "non-bankrupt co-defendants in order to escape . . . liability."<sup>38</sup>

Section 105 provides a workaround for non-debtor entities to seek bankruptcy protection to stay actions that are not subject to section 362.<sup>39</sup> Bankruptcy courts have the power under section 105 to stay actions that "threaten the integrity of a bankrupt's estate."<sup>40</sup> The injunction standard is in some ways antithetical to the purpose of section 362. Nevertheless, "[s]everal courts have held that under specific circumstances non-debtors may be protected by the automatic stay—even though such protection may be temporary—if it contributes to the debtor's

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<sup>33</sup> *In re Diocese of Rochester*, 2022 WL 1638966, at \*6.

<sup>34</sup> Soo Y. Kang, *To Extend or Not Extend: The Dilemma of the Non-Debtor and the Automatic Stay*, 52 *ADVOCATE* 19, 19 (2009).

<sup>35</sup> *Tchrs. Ins. & Annuity Ass'n of Am. v. Butler*, 803 F.2d 61, 65 (2d Cir. 1986).

<sup>36</sup> *In re Diocese of Rochester*, 2022 WL 1638966, at \*6.

<sup>37</sup> *Tchrs. Ins. & Annuity Ass'n of Am.*, 803 F.2d at 65; *Wedgeworth v. Fibreboard Corp.*, 706 F.2d 541, 544–45 (5th Cir. 1983).

<sup>38</sup> *Tchrs. Ins. & Annuity Ass'n of Am.*, 803 F.2d at 65–66.

<sup>39</sup> *See In re Excel Innovations, Inc.*, 502 F.3d 1086, 1093 (9th Cir. 2007).

<sup>40</sup> *See id.* (Citing *Canter v. Canter*, 299 F.3d 1150, 1155 (9th Cir. 2002)).

efforts to achieve rehabilitation."<sup>41</sup> Therefore, section 105 provides an escape valve in cases where despite the fact that the non-debtor cannot be protected by the automatic stay under section 362, actions against the non-debtor can still be stayed due to the threat against the debtor's estate.<sup>42</sup>

## **Conclusion**

Under section 362 of the Bankruptcy Code, the automatic stay only extends to debtors. However, there are a couple of exceptions to this general rule that allow for the automatic stay to extend to non-debtors. As courts of equity, under the right circumstances, bankruptcy courts can extend the automatic stay to non-debtors. It is within a bankruptcy court's jurisdiction to extend the automatic stay to a non-debtor if there is an issue whereby the debtor's estate will be adversely affected by a judgment against the non-debtor. While the debtor has a heavy burden to show that equity calls for a bankruptcy court to stay litigation against a non-debtor, it is possible.

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<sup>41</sup> *Tchrs. Ins. & Annuity Ass'n of Am.*, 803 F.2d at 65.

<sup>42</sup> *See In re Excel Innovations*, 502 F.3d at 1093 (citing *Canter v. Canter*, 299 F.3d at 1155).