

# CREDITOR RIGHTS: PREPETITION CREDITORS HAVE STANDING TO SUE FOR VIOLATIONS OF THE BANKRUPTCY CODE'S AUTOMATIC STAY

BY SCOT PIERCE, Brackett & Ellis, P.C.



Contrary to popular belief, one of the guiding principles behind bankruptcy law is protecting creditors. Bankruptcy law is intended to provide an orderly mechanism to handle situations in which companies or individuals cannot fully and timely pay their debts. The intent is not only to allow a debtor an opportunity for a fresh start but also to provide an orderly liquidation procedure and prevent unequal treatment of creditors. One of the Bankruptcy Code's primary tools to accomplish this purpose is the automatic stay provided in 11 U.S.C. § 362. When a debtor files for bankruptcy protection, section 362 prevents creditors from continuing most collection activities.

Sometimes, however, the world turns upside down, and a creditor violates the automatic stay against a debtor who has little incentive to object. For example, a piece of property may be subject to a genuine dispute about lien priorities between two creditors. If one of the creditors violates the stay and takes the property—to the other creditor's detriment—a debtor who has no equity in the property may have little incentive to object.

In August of this year, the Fifth Circuit Court of Appeals issued an opinion that will help provide aggrieved creditors with an option to sue for damages for violation of the automatic stay when a situation like the above arises. *St. Paul Fire & Marine Ins. Co. v. Labuzan*, 579 F.3d 533 (5th Cir. 2009). In *Labuzan*, an insurance company sued the principals of Contractor Technology, Ltd., a construction company that had filed for bankruptcy protection. The insurance company sued to hold the principals liable in order to indemnify the insurance company for any losses as a result of issuing performance bonds. As an affirmative defense and by way of a separate adversarial proceeding, the principals claimed that the insurance company willfully violated the Bankruptcy Code's automatic stay.

The United States district court held that the principals lacked standing to file a claim or assert an affirmative defense for violation of the automatic stay. The Fifth Circuit Court of Appeals vacated and remanded the case, holding that the principals, as creditors, had standing to pursue damages for violation of the automatic stay under 11 U.S.C. § 362(k).

The facts of the case are insightful. The principals owned almost 100% of the ownership interests in Contractor Technology, Ltd., the debtor. St. Paul Fire & Marine Insurance Company provided performance bonds for a number of the debtor's projects. The principals issued personal indemnities to the insurance company for any payments that St. Paul would make on the performance bonds. Shortly after the debtor filed for Chapter 11 bankruptcy protection, St. Paul contacted the owners of several ongoing projects and advised them that if the project owners made payments directly to the debtor and St. Paul was later required to pay on the performance bonds, St. Paul would reduce its liability to the project owners by the amounts that were paid to the debtor. The principals claimed that this action not only caused the company's Chapter 11 bankruptcy to be unsuccessful but it also caused them significant personal damage because of the increased amounts that they became obligated to pay on the indemnities.

Not surprisingly, St. Paul sued the principals. The principals raised the violation of the automatic stay as an affirmative defense. They also sued St. Paul in an adversarial proceeding in bankruptcy court for damages arising from violation of the automatic stay. The United States district court consolidated St. Paul's lawsuit and the principals' adversarial proceeding into one action in the district court.

In a case of first impression for the Fifth Circuit, the court reasoned that the principals had both constitutional and prudential standing to qualify for protection under 11 U.S.C. § 362(k). Section 362(k)

states that an individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages." Constitutional standing requires that the aggrieved party "show (1) an injury in fact (2) that is fairly traceable to the actions of the defendant and (3) that likely will be redressed by a favorable decision." *Labuzan*, 579 F.3d at 539. Prudential standing asks "(1) whether a plaintiff's grievance arguably falls within the zone of interests protected by the statutory provision invoked in the suit, (2) whether the complaint raises abstract questions or a generalized grievance more properly addressed by the legislative branch, and (3) whether the plaintiff is asserting his or her own legal rights and interests rather than the legal rights and interests of third parties." *Id.*

The court concluded that the language and intent behind section 362(k) were not to restrict solely to debtors or trustees causes of actions for violations of the automatic stay. The court held that the principals in this matter had both constitutional and prudential standing. A key factor in the decision was the court's finding that the principals suffered injuries separate from the injuries that the bankruptcy estate suffered. Thus, the court held that the principals had standing as prepetition creditors, but not as owners or equity holders, to assert violations of the automatic stay.

This case opens the door in the Fifth Circuit to a potentially powerful cause of action for creditors. Although creditors may have other causes of action available to remedy these types of wrongs, this decision provides a mechanism that is consistent with the Bankruptcy Code's intent to prevent unequal treatment of creditors. Evolving case law will further clarify the limits of when courts will allow creditors to recover damages for violations of automatic stays. In the meantime, parties should be wary of self-help remedies when a debtor is in bankruptcy, even if the debtor does not object.