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## Modification of Automatic Stay to Permit Litigation to Proceed Remains Possible

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In *The SCO Group Inc.*, 2007 WL 4224407, No. 07-11337 (KG) (Bankr. D. Del. Nov. 27, 2007), the U.S. Bankruptcy Court for the District of Delaware reminded us that litigation against a debtor may proceed notwithstanding its bankruptcy. Creditors and other parties in interest, especially parties to litigation, should be cognizant that while the automatic stay generally protects a debtor and its estate from litigation, the stay is not absolute. Under certain circumstances, it may be modified “for cause, including the lack of protection of an interest in property of such party in interest.” Cause, however, is not defined in the Bankruptcy Code. Accordingly, courts generally conduct a fact-intensive test on a case-by-case basis to determine whether sufficient cause exists to lift the automatic stay. If cause exists, a court may conclude that it should modify the automatic stay to be lifted to permit litigation to proceed against the debtor. This is what occurred in the chapter 11 case of *The SCO Group Inc.*

### The SCO Case

The SCO Group Inc. is a provider of Linux software for certain systems, SCO Open-Server for certain businesses and companies, and UnixWare and SCO Mobile Serve for enterprise applications and digital network services. Pursuant to an asset-purchase agreement between Novell Inc. and SCO's predecessor, The Santa Cruz Operation Inc., Novell transferred all of its UNIX SVRX software licenses to Santa Cruz. Subsequently, SCO entered into a licensing campaign, which was based

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on those licenses.

On Jan. 20, 2004, SCO commenced a lawsuit against Novell in Utah State Court that was ultimately removed to the U.S. District Court for the District of Utah. In the lawsuit, SCO asserted: (1) claims for slander of title and interference with the UNIX copyrights and (2) claims for copyright infringement, unfair cooperation and breach of a technology licensing agreement. Novell counterclaimed against SCO, asserting that: (1) it retained all UNIX copyrights under the asset purchase agreement and (2) SCO's retention of funds from certain SCO

### The Court's Analysis

As an initial matter, the bankruptcy court noted that in analyzing whether cause exists to determine whether litigation should be allowed to proceed against a debtor, most courts apply an “equitable balance test.” In particular, Delaware courts consider the following three factors in determining whether to lift the stay:

- whether any great prejudice to either the bankruptcy estate or the debtor will result from continuation of the civil suit;
- whether the hardship to the nonbankrupt party by maintenance of the stay considerably outweighs the hardship to the debtor; and
- the probability of the creditor prevailing on the merits.

This test embodies the following 12 general principles previously outlined by the Second Circuit Court of

## Claims Chat

Source licenses constituted breaches of fiduciary duty and contract, and conversion.

Subsequently, the district court dismissed several of SCO's claims against Novell and scheduled a trial for Sept. 17, 2007, to consider (1) the amount of the royalties to which Novell is entitled from certain licenses and whether SCO had the authority to enter into certain licensing agreements and (2) the amount of funds held by SCO that are subject to a constructive trust. On Sept. 14, 2007, SCO filed a voluntary petition for relief under chapter 11 of the Code. On Oct. 4, 2007, Novell filed a motion for relief from the automatic stay so that the lawsuit could proceed.

### Appeals:

- whether said relief would result in a partial or complete resolution of the issues;
- lack of any connection with or interference with the bankruptcy case;
- whether the other proceeding involves the debtor as a fiduciary;
- whether a specialized tribunal with the necessary expertise has been established to hear the cause of action;
- whether the debtor's insurer has assumed full responsibility for defending it;
- whether the action primarily involves third parties;
- whether litigation in another

forum would prejudice the interests of other creditors;

- whether the judgment claim arising from the other action is subject to equitable subordination;
- whether the moving party's success in the other proceeding would result in a judicial lien avoidable by the debtor;
- the interests of judicial economy and the expeditious and economic resolution of litigation;
- whether the parties are ready for trial in the other proceeding; and
- impact of the stay on the parties and the balance of the harms.

After applying the three-part balancing test, the bankruptcy court concluded that it should modify the automatic stay to permit the lawsuit to proceed. In particular, the court concluded that modifying the automatic stay would not prejudice SCO. While SCO argued that allowing the lawsuit to proceed would cause its management to turn its attention to the lawsuit and away from SCO's reorganization efforts, the court concluded, however, that was not the case. Indeed, SCO had separate counsel that was fully prepared to go forward with the lawsuit. Moreover, the court concluded that the continued and indefinite enjoining of the lawsuit would unduly prejudice Novell (and SCO). Indeed, the court noted that until Novell's rights are determined, "the debtors simply cannot file a confirmable plan of reorganization." As such, the modifying of the automatic stay "will assist the debtors, not burden them." Thus, a further delay of the lawsuit would prejudice both sides, and therefore modifying the automatic stay would satisfy the first two prongs on the three-part test.

Under the three-part test, the court had to consider the probability of Novell prevailing on the merits. The court noted that "[e]ven a slight probability of success on the merits may be sufficient to support lifting an automatic stay in the appropriate case." SCO contended that Novell had failed to demonstrate that (1) it had prevailed on the license issues and (2) the amount of funds that are subject to a constructive trust. The bankruptcy court, however, held that while the license issues could be heard by the district court, the constructive-trust issue would be decided by the court. Indeed, the effect of a constructive trust on a bankruptcy case was "profound"

and would affect the bankruptcy court's determination of what is property of the estate. Based on the evidence presented, including the district court's earlier decision dismissing several of SCO's claims, the bankruptcy court concluded that there was sufficient evidence to support a finding of reasonable probability of success on the merits and modified the automatic stay to allow the district court to consider the license issues.

## **Conclusion**

Parties to litigation against a debtor should not assume that litigation will be stayed indefinitely or that the bankruptcy court will be the ultimate adjudicator of all the issues raised in litigation. Under appropriate circumstances, a bankruptcy court may modify the automatic stay, in whole or in part, to allow litigation (or certain aspects thereof) to be adjudicated by another court. Whether a court will modify the automatic stay will depend on the court's consideration of certain facts, including (1) the status of litigation, (2) whether the litigation is pending before a special tribunal and (3) whether the tribunal has extensive knowledge of the relevant facts and issues on made findings. ■

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chapter 13 cases with regard to claims secured by certain types of collateral has no counterpart in chapter 11.

<sup>3</sup> "Domestic support obligation" is a new term defined in §101(14A). In general, it broadly encompasses a debtor's obligations for alimony, maintenance or support to a spouse, former spouse or child of the debtor.

<sup>4</sup> A class accepts a plan if the plan is accepted by creditors holding at least two-thirds in amount and a majority in number of the claims held by creditors in the class who vote. §1126(c).

<sup>5</sup> Generally, §522(q) limits exemptions in certain property to \$125,000 if

the debtor has been involved in certain criminal activity or owes debts arising from violation of securities laws or criminal, intentional or willful or reckless conduct resulting in serious physical injury or death to another. How and whether the statute accomplishes its objectives is beyond the scope of this discussion. Suffice it to say that the same issues exist in all chapters.

<sup>1</sup> References are to the Bankruptcy Code, title 11 of the U.S. Code.

<sup>2</sup> BAPCPA does not change valuation of collateral in chapter 11 cases as it does in chapter 13 cases. The new requirement in §506(a)(2) for use of replacement value with respect to personal property securing an allowed claim applies only in chapter 7 and 13 cases. The so-called "hanging paragraph" of §1325(a) that eliminates §506(a) bifurcation in

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<sup>6</sup> The question does not arise in the case of an entity because anything the entity acquires after the filing of the petition must of necessity come from assets that existed when the petition was filed. As such, any acquisition of post-petition property must be proceeds of property of the estate that is included as property of the estate under §541(a)(6).

<sup>7</sup> Property that a debtor acquires post-petition that is not property of the estate must be distinguished from post-petition income, rent or other proceeds that are property of the estate under §541(a)(6). Thus, a car that the debtor buys with cash from his exempt savings account is not property of the estate, whereas interest on a nonexempt savings account is property of the estate.

<sup>8</sup> This type of post-petition property differs from proceeds of property of the estate, which have always been included as property of the estate under §541(a)(6).

<sup>9</sup> Because the post-petition property would not be an asset of the chapter 13 debtor's estate if it were liquidated on the confirmation date, the issue does not arise in a chapter 13 case. See §1325(a)(4).

<sup>10</sup> Williams, Jack F. and Todres, Jacob L., "Tax Consequences of Post-Petition Income as Property of the Estate in an Individual Debtor Chapter 11 Case and Tax Disclosure in Chapter 11," 13 Am. Bankr. Inst. Law

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Rev. 701, 702-11 (2005) (collecting cases). The article summarizes the pre-BAPCPA state of the law as follows, *id.* at 705 (footnotes omitted); Before enactment of the 2005 Act, courts had taken three different positions on whether an individual chapter 11

