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Be Wary of Using Involuntary Bankruptcy as a Collection Tool: An Update

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In our prior client alert, "Be Wary of Using Involuntary Bankruptcy as a Collection Tool," we were reminded to use the involuntary bankruptcy petition as a collection tool only after careful consideration of both the language and the spirit of the law. A recent case emphasizes that rule: *In re TV Azteca, S.A.B. de C.V.*, 23-10385 (Bankr. S.D.N.Y. Nov. 20, 2023).

Five years ago we discussed the case *State of Montana Department of Revenue v. Blixseth*, 581 B.R. 882 (D. Nevada 2017), where four creditors ran afoul of this advice when trying to collect taxes owed by a debtor.[1]

11 U.S.C. Section 303 lays out the basic requirements to file an involuntary petition, forcing a debtor into bankruptcy court. Among those requirements are that:

1. Three or more petitioners are needed if the debtor has 12 or more creditors (otherwise only 1 petitioner is required).
2. The debtor must generally be failing to pay its debts as they become due.
3. The debts owed to the petitioners must not be subject to a bona fide dispute.

Beyond the "letter of the law," the "spirit" underlying its presence in the Bankruptcy Code is to provide a method to bring to the bar a distressed and troubled situation for the general good, not a private right of action. This section was not provided as a substitute for litigation.

It is critical to meet the requirements of the statute. Should the debtor contest the involuntary, sanctions can be imposed. Moreover, if there is a finding of bad faith, sanctions will also include penalties which can be severe. When we consult with our Cullen and Dykman LLP clients, we remind them that filing an involuntary is akin to a lawsuit where they are plaintiffs and the debtor is a defendant.

The debtor has an opportunity to fight back and, if it wins, the results can be painful. Indeed, the two most problematic portions of the requirements are the phrases "generally failing to pay its debts as they become due" and "not subject to bona fide dispute." In this case, the issue was whether the debts were subject to dispute.

The United States District Court for the District of Nevada found that, if any portion of the debt owed to a petitioning creditor was in dispute, the creditor did not qualify to petition.

In the recent case, *In re TV Azteca, S.A.B. de C.V.*, Bankruptcy Judge Lisa G. Beckerman granted a debtor's motion to dismiss holding that Section 303(b)(1) disqualifies an involuntary petitioner if there is a dispute as to even part of the creditor's claim. In this case, several noteholders of the debtor made a demand on the indenture trustee. The indenture trustee filed suit in the federal district court in New York seeking judgment for principal, interest, and other sums due including a redemption premium. Meanwhile, several noteholders filed an involuntary chapter 11 petition in the bankruptcy court, but only claimed the debts for principal and interest, and not the disputed redemption premium. Therefore, Judge Beckerman stated that "there is a dispute as to whether the holders of the notes are entitled to the redemption premium."

Judge Beckerman referred to the case *In re Koffee Kup Bakery, Inc.*, and agreed with Vermont Bankruptcy Judge Colleen A. Brown who stated that "the First, Fifth and Eleventh Circuits 'have concluded that a creditor whose claim is the subject of a bona fide dispute as to liability or amount lacks standing to be a petitioning creditor under § 303(b)(1), even if a portion of their claim amount is undisputed.'"

Furthermore, Judge Beckerman found that these suits arose from the same notes and indentures, and the indenture trustee was acting on behalf of the noteholders in seeking recovery for the redemption premium. Judge Beckerman continued to explain that when creditors hold the same claim, "[a creditor] cannot voluntarily disclaim their entitlement to a redemption premium so that their claims are not subject to a bona fide dispute."

These two cases teach us a general rule: be careful! There is no absolute measure and different courts may find differing nuances in the language. Indeed, as Justice Potter Stewart once said, this may be a case where precise definition escapes us, and where you "know it when you see it."

Consult consul. Let her worry about doing it right and protecting you!

Please note this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and the recipient. If you have any questions regarding the provisions discussed above, or any other aspect of bankruptcy law, please contact Michael H. Traison (mtraison@cullenllp.com) at 312.860.4230.

Footnotes

[1] *State of Montana Department of Revenue v. Blixseth*, 581 B.R. 882 (D. Nevada 2017) was affirmed in part and remanded in part in *Department of Revenue v. Blixseth*, 942 F.3d 1179, 1181 (9th Cir. 2019). The Court "affirmed the decisions of the bankruptcy and district courts that the Montana Department of Revenue lacked standing to file the involuntary Chapter 7 bankruptcy petition against Timothy L. Blixseth." *Id.* However, the Court remanded the case to the bankruptcy court "to determine whether [the] case should be dismissed under 11 U.S.C. § 303(j)(3)"

because “all other petitioning creditors have withdrawn from the proceedings.” *Id.*

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