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Feature

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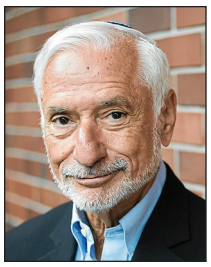
Be Wary of Using Involuntary Bankruptcy as a Collection Tool



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When reflecting on several recent court decisions cautioning against the use of involuntary bankruptcy as a litigation tactic or debt-collection device, creditors are reminded to use involuntary bankruptcy proceedings only after careful consideration of both the language and the "spirit" of the law. Much like the proverbial barking dog who chased the car and caught it, petitioning creditors should consider what could happen after filing the involuntary petition. Involuntary bankruptcy creditors assume various risks, including:

- paying all costs and attorneys' fees incurred by the debtor;
- sanctions with severe monetary penalties;
- lawsuits in a separate state court action under business tort theories; and
- lawsuits by the subsequently appointed debtor in possession or trustee under avoidance theories for preferences or fraudulent conveyances.

Section 303 of the Bankruptcy Code[1] lays out the statutory requirements to file an involuntary petition to force a debtor into bankruptcy court. These requirements include (1) three or more petitioners are needed if the debtor has 12 or more creditors (otherwise only one petitioner is required); (2) the debtor must generally be failing to pay its debts as they become due; and (3) the debts owed to the petitioners must not be subject to *bona fide* dispute.

Beyond the "letter of the law," the "spirit" underlying the involuntary bankruptcy procedure 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. It is not intended to be used as a substitute for litigation nor for use as a private debt-collection tool.

It would be wise for attorneys to remind their creditor clients that filing an involuntary bankruptcy is akin to a lawsuit, where they are the plaintiff and the debtor is the defendant. The debtor has an opportunity to fight back, and if it wins, the results can be painful. For example, in *In re TPG Troy LLC*,[2] the Second Circuit found that a presumption exists that costs and attorneys' fees will be awarded to an alleged debtor when an involuntary petition is dismissed, regardless of whether there is a finding of bad faith. The court reasoned that awarding fees and costs both serves to discourage the use of filing involuntary petitions to force debtors to pay on disputed debt while also keeping whole the putative bankruptcy estate.[3] Moreover, if there is a finding of bad faith, a court may also impose sanctions, which can include severe penalties.

To avoid these penalties, it is imperative for a creditor to comply with the strict requirements of the Bankruptcy Code. Typically, the two most problematic involuntary bankruptcy statutory phrases are "generally failing to pay its debts as they become due" and "not subject to *bona fide* dispute."[4]

When tasked with evaluating whether a debt is subject to a *bona fide* dispute, the Second Circuit in *TPG Troy LLC* held that a court must determine "whether there is an objective basis for either a factual or a legal dispute as to the validity of the debt."[5] While not dispositive, the court found that the existence of pending litigation over a claim "strongly suggests" the existence of a *bona fide* dispute.

And in *Montana Department of Revenue v. Blixseth*,[6] a Nevada district court found that if any portion of the debt owed to a petitioning creditor was in dispute, the creditor could not file an involuntary petition against the debtor. In this case, four

1 11 U.S.C. § 303 (West).

2 793 F.3d 228, 235 (2d Cir. 2015).
3 *Id.*
4 11 U.S.C. § 303 (West).
5 793 F.3d at 234 (internal citations omitted).
6 581 B.R. 882 (D. Nev. 2017).

taxing-authority creditors failed to adequately consider the risks associated with an involuntary filing when they attempted to collect taxes owed to them by the debtor. The court found that a *bona fide* dispute existed as to the amount of the creditors' claims and could not join in the involuntary petition. The State of Montana appealed the district court's order and asked the Ninth Circuit to consider whether a creditor with a partial undisputed claim could be a petitioning creditor under § 303(b) of the Bankruptcy Code. However, the Ninth Circuit has yet to consider rendering a decision, and the appeal is still pending.

The second issue surrounds how to measure "generally failing to pay debts as they become due." Does a creditor look at the number of debts or the amount of debt owed? If a debtor is paying 99 percent of its creditors, but the remaining 1 percent is owed 99 percent of the debtor's total indebtedness, does it fall within the language of § 303? While there is no absolute measure, and different courts might find differing nuances in the language, courts often consider, among other things, (1) the number of unpaid claims; (2) the amount of unpaid claims; (3) the materiality of the nonpayment; and (4) the nature and conduct of the debtor's business.[7] As Justice Potter Stewart once said, this might be a case where precise definition escapes us, and where you'll "know it when you see it."

The very subjective nature of this issue can be quicksand for the unwary. In *In re Rosenberg*,[8] the Eleventh Circuit found that beneficiaries of a loan guarantee were not "petitioning creditors" for purposes of an involuntary bankruptcy. Here, the debtor guaranteed his company's debts to an agent for three institutional lenders. The three lenders petitioned for an involuntary bankruptcy against the debtor, and the court disqualified them as creditors because they did not hold the guarantee, even though they were its beneficiaries. The case contains a useful compendium of many things that can go wrong in an ill-considered filing, resulting in millions of dollars of sanctions and penalties, and even tort damages in a state court action.

Creditors should make reasonable efforts to engage in negotiations with a debtor before filing an involuntary petition. However, they should be cautious not to threaten the involuntary bankruptcy, as this might raise unnecessary questions about bad faith. In *In re Forever Green Athletic Fields Inc*.,[9] the Third Circuit held that bad faith provides an independent basis for dismissing an involuntary petition, even where the statutory requirements have been satisfied and the debtor is admittedly not paying its debts as they become due. In this case, the court treated the filing requirements of § 303(b)(1) as pleading requirements for a *prima facie* case, but observed that the court has discretion to dismiss an involuntary petition as a bad-faith filing based on an analysis of the totality of the circumstances.

It is important to consider that, after being subjected to the filing of an involuntary bankruptcy filing, some putative debtors might offer to settle with one or more of the petitioning creditors. Yet, a petition may not be withdrawn, even with the debtor's consent, without court approval on notice to all creditors. These cautionary words should remind us that 11 U.S.C. § 303 is in the nature of a "citizen's arrest" as a vehicle for the public good entrusted to the care of three or more creditors acting on behalf of their fellow creditors, not to be misused for a creditor's self-serving purpose.

Even if a creditor succeeds in avoiding these and other involuntary bankruptcy pitfalls, keep in mind that it is likely that a trustee will likely be appointed to look to chapter 5 avoidance actions as a way of making creditors as whole as possible. And the trustee will likely examine payments made to creditors, including the petitioning creditors who may have received avoidable preferential transfers. abi

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7 2 *Collier on Bankruptcy* ¶ 303.31[2] (Alan N. Resnick & Henry J. Sommer eds., 16th ed.).
8 779 F.3d 1254, 1257 (11th Cir. 2015), *cert. denied*, 136 S. Ct. 805 (2016).
9 804 F.2d 328, 330 (3d Cir. 2015).