Involuntary Bankruptcy: A Powerful Weapon, But Use Extreme Caution!

by Susan Heath Sharp and Matthew B. Hale

Susan Heath Sharp and Matthew Hale are attorneys at Stichter, Riedel, Blain & Postler, P.A. in Tampa, Florida. They represent debtors, creditors, trustees, purchasers, and other parties in all aspects of bankruptcy and insolvency proceedings.

Under the right set of circumstances, filing an involuntary bankruptcy petition can be a powerful tool for creditors attempting to recover claims against a debtor, but there are significant risks if the petitioning creditors are unsuccessful. An involuntary bankruptcy petition should not be used as substitution for traditional collection efforts or as a litigation tactic because of the potential of doing great harm to an alleged debtor, such as public embarrassment, loss of credit standing, and inability to transfer assets and carry on business as usual. Because it is such a severe remedy against an alleged debtor, the Bankruptcy Code and rules include numerous requirements and restrictions to curtail misuse and to ensure that an involuntary bankruptcy is sought only in appropriate circumstances. In order to avoid injustice and abuse of the process, bankruptcy courts carefully scrutinize such filings. As a result, involuntary bankruptcy cases make up only a small portion of the total number of bankruptcy cases filed each year.

The serious consequences for filing an involuntary bankruptcy are on full display in the continuing saga of an involuntary bankruptcy filed against business person Maury Rosenberg by DVI Receivables XIV and five affiliates in November 2008 (hereinafter called the "petitioning creditors"). While the facts of the case are convoluted, the important takeaway is that the petitioning creditors were not eligible creditors, thus the involuntary petition was dismissed. The bankruptcy court retained jurisdiction to award Rosenberg damages and attorney's fees under § 303(i)[1] of the Bankruptcy Code[2]. After multiple unsuccessful appeals to the Eleventh Circuit, in 2017 a final judgment was entered against the petitioning creditors in the amount of $6,120,000 for punitive and compensatory damages—the petitioning creditors' claims against Rosenberg totaled $5,363,361.56. In addition, the Eleventh Circuit upheld an award for Rosenberg's legal fees totaling $574,771 comprising fees incurred in connection with the dismissal of in the involuntary prosecution of the "bad faith" claims against the petitioning creditors and appellate fees for defending the dismissal of the involuntary petition on appeal.

The Rosenberg damages award provides a sobering lesson that a creditor should thoroughly examine the risk associated with filing an involuntary bankruptcy before using it to collect an outstanding debt. To the creditor or its lawyer, if the goal is to use an involuntary bankruptcy to damage or destroy a debtor's reputation, intimidate a debtor into a settlement, undermine the debtor's business, or obtain a disproportionate advantage over other creditors' position, or if the case is essentially a two-party dispute with other available remedies, then a loud warning bell should go off in your head. But even for "good faith" creditors, issues such as the existence of a "bona fide dispute" and numerosity concerns should give pause.

With such financial exposure for a creditor, why would a creditor ever consider filing an involuntary petition? Legitimate reasons are varied but include preserving the assets of the debtor, ensuring equality of distribution among the debtor's creditors, preventing the debtor from fraudulently transferring assets, or preventing other issues that can arise when the management of a debtor's business is incompetent.

Statutory Requirements to Commence an Involuntary Bankruptcy

An involuntary bankruptcy involves a "petitioning" creditor or creditors and an "alleged" debtor. Section 303 of the Bankruptcy Code, which governs involuntary cases under Chapter 7 or 11, contains three requirements for commencing an involuntary bankruptcy: (1) there must be three or more petitioning creditors, unless the debtor has fewer than 12 creditors (then it only takes one creditor); (2) each petitioning creditor must hold a claim against the debtor that is not contingent as to liability or the subject of a bona fide dispute; and (3) the claims must aggregate at least $15,775 more than the value of liens on the debtor's property.[3] Alleged debtors often challenge several of these factors, which typically must be resolved by an evidentiary hearing.

Numerosity

The "numerosity" requirement refers to the number of creditors of the alleged debtor, which in turn dictates

the number of required petitioning creditors. The general rule is that the number of creditors is determined as of the date the involuntary petition is filed.[4] Although the numerosity rules set forth under §§ 303(b)(1) and (2) seem relatively simple to apply, they have resulted in considerable litigation. For example, certain groups of creditors are excluded, such as employees, insiders, and transferees of avoidable transfers.[5] Furthermore, a petitioning creditor whose claims are barred by the statute limitations should also be excluded.[6]

If the alleged debtor believes that an involuntary petition has been filed by less than the requisite number of creditors, the alleged debtor should file an answer as contemplated by § 303(d). The alleged debtor has 21 days after service of the summons to file an answer or other responsive pleading to the involuntary petition.[7] A list of creditors, the amount owed, and a brief statement of the nature of the creditor's claim must be filed with the answer.[8] If an involuntary petition is not timely opposed, the court "on the next day, or soon thereafter as practicable, shall enter an order for the relief requested in the petition."[9]

Although 11 U.S.C. § 303(b) contemplates that a single creditor may file if they have claims that aggregate at least $15,775, there is considerable disagreement between courts as to whether single-creditor petitions are permitted when the petitioning creditor is the debtor's only creditor. Those cases generally represent a two-party dispute that could implicate the petitioning creditor's good faith, particularly when they are attempting to gain leverage over an alleged debtor to resolve the dispute.

Petitioning Creditor's Claim

A petitioning creditor's claim against the alleged debtor cannot be contingent as to liability or the subject of a bona fide dispute as to liability or amount.[10] The phrase "bona fide dispute" is not defined in the Bankruptcy Code; however, the majority of courts apply an objective standard in deciding whether a bona fide dispute exists.[11] Simply stated, a bona fide dispute exists only when an alleged debtor raises "substantial factual and legal questions" to dispute the creditor's claim.[12] Whether a bona fide dispute exists in a particular case may be readily apparent in certain circumstances but not in others, thus a petitioning creditor should carefully analyze its claim before filing an involuntary petition. Generally, an unappealed, unstayed final judgment is not subject to a bona fide dispute.[13] Some courts have held that if the claimant establishes that its claim is well-grounded and that no defenses have been asserted in response to the creditor's claim, the claim may not be subject to a bona fide dispute.[14]

Dollar Requirement

Section 303(b) provides that noncontingent, undisputed claims of petitioning creditors must aggregate at least $15,775.[15] Counterclaims, setoff rights, rights of recoupment, and bona fide disputes as to liability or amounts may be asserted, thus reducing either the dollar amount of the claim or the number of creditors below the statutory minimum for involuntary relief.[16]

Alleged Debtor Not Paying Debts

Assuming that the above statutory requirements are met, the court will enter an order for relief if "the debtor is generally not paying such debtor's debts as such debts become due unless such debts are the subject of a bona fide dispute as to liability or amount."[17] While the Bankruptcy Code does not define the term "generally not paying," courts have used a multifactor test. The factors courts consider focus on (1) the number of unpaid claims, (2) the amount of the claims, (3) the materiality of nonpayment, (4) the overall conduct of the debtor's financial affairs, (5) the amount of delinquencies, and (6) the number of delinquencies. Which of these factors should take priority, however, depends on the circumstances of each case.[18]

Final Warning—Bad Faith Dismissal

Creditors beware—a court may still dismiss the petition for bad faith even if the petitioning creditors satisfy the statutory requirements. After considering § 303(i)(2), the Third Circuit Court of Appeals held in *In re Forever Green Athletic Fields Inc.* that "bad faith provides an independent basis for dismissing an involuntary petition."[19] *Forever Green* involved a two-party dispute between competitors—the petitioning creditor commenced the involuntary petition to avoid arbitration and had threatened to do so unless arbitration was canceled. Although the petitioning creditor met the statutory requirements, the bankruptcy court dismissed the petition as filed in bad faith because it was intended to frustrate Forever Green's efforts to litigate its claim against its competitor and to collect a debt. The court looked at policy considerations to support its holding, stating that "dismissal of bad-faith filings will encourage creditors to file petitions for the proper reasons such as to protect against the preferential treatment of other creditors or the dissipation of the debtor's assets."[20]

Conclusion

With so much to lose, like in the Rosenberg case, it's no wonder that so few creditors choose to join in filing an involuntary bankruptcy petition. Creditors should proceed with extreme caution to make sure that all of the requirements of an involuntary petition are satisfied prior to joining in the filing of the petition. At minimum, a petitioning creditor should consider obtaining a credit report, run a lien search, determine if the alleged debtor is being sued by any other creditors, send a written demand for payment, and wait to file an involuntary petition until the alleged debtor has filed an answer in pending litigation or completed discovery in aid of execution of a judgment. Failure to take the proper steps before filing an involuntary petition could prove costly. ⊙

Endnotes

[1] § 303(i) provides—

> If the court dismisses a petition under this section other than on consent of all petitioners and the debtor, and if the debtor does not waive the right to judgment under this subsection, the court may grant judgment—
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> (1) against the petitioners and in favor of the debtor for—
>
> (A) costs; or
>
> (B) a reasonable attorney's fee; or
>
> (2) against any petitioner that filed the petition in bad faith, for—
>
> (A) any damages proximately caused by such filing; or
>
> (B) punitive damages.

[2] Unless otherwise specified, all section references are to Title 11 of the United States Code, 11 U.S.C. § 101, *et seq.* (the "Bankruptcy Code").

[3] 11 U.S.C. § 303(b)(1).

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When asked about her legacy, Judge McMahon hopes that she will be remembered for having an impact on what she characterizes as the "astonishing group of young people who circulate through her chambers" as law clerks and interns. She hopes that the members of her "clerk family" believe they are better lawyers for having spent time working with her and that she arms them with the skills necessary to be really effective advocates and solid ethical professionals. Judge McMahon treasures her opportunity to influence these individuals, whom she believes will one day be leaders of the bar. ⊙

Endnotes

[1]*United States v. Santiago*, No. 13 Cr. 039(CM), 2013 U.S. Dist. LEXIS 180050 (S.D.N.Y. Dec. 19, 2013).
[2]*Hishon v. King & Spaulding*, 467 U.S. 69 (1984).
[3]*United States v. Windsor*, 133 S Ct. 2675 (2013).
[4]*United States v. Mitlof*, 165 F. Supp. 2d 558 (S.D.N.Y. 2001).
[5]*United States v. Cullen*, No. 04-CR-00878 (S.D.N.Y. Feb. 2, 2006).
[6]16 U.S.C. §4902.
[7]*Pippins v. KPMG LLP*, 921 F. Supp. 2d 26 (S.D.N.Y. 2012).
[8]29 U.S.C. § 201 et seq.
[9]*Shaw Family Archives LtD. v. CMG Worldwide Inc.,* 589 F. Supp. 2d 331 (S.D.N.Y. 2008).
[10]*New York Times Co. v. U.S. Dep't of Justice*, 915 F. Supp. 2d 508 (S.D.N.Y. 2013).
[11]Id. at 515-16.
[12]*New York Times Co. v. U.S. Dep't of Justice*, 752 F.3d 123 (2d Cir. 2014).
[13]*New York Times Company.,* 752 F.3d at 141.
[14]*See United States v. Cromitie*, 781 F. Supp. 2d 211 (S.D.N.Y. 2011) ("Cromitie I"); *United States v. Cromitie*, No. 09 Cr. 558(CM), 2011 U.S. Dist. LEXIS 71821 (S.D.N.Y. June 29, 2011) ("Cromitie II").
[15]Cromitie I, 781 F. Supp. 2d at 215-16.
[16]*Id.* at 220-21.
[17]*Id.* at 222.
[18]*United States v. Cromitie*, 727 F.3d 194 (2d Cir. 2013).
[19]*United States v. Brand*, 467 F. 3d 179 (2d Cir. 2006).
[20]*Jacobson v. United States*, 503 U.S. 540 (1992).
[21]*Cromitie*, 727 F. 3d at 227 (Jacobs, C.J., dissenting).
[22]*Cromitie*, 2011 U.S. Dist. LEXIS 71821 at *5.
[23]*Id.* at *13.
[24]*Cromitie*, 727 F. 3d at 209, 216.
[25]*United States v. Cromitie*, 135 S.Ct. 53 (2014).

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[4]*In re Agrawal*, 2017 WL 4913715, at *6 (Bankr. W.D. Okla. Oct. 30, 2017).
[5]11 U.S.C. § 303(b)(2).
[6]*In re F.R.P. Indus, Inc.,* 73 B.R. 309 (Bankr. N.D. Fla. 1987).
[7]Fed. R. Bankr. P. 1011(b). If the debtor's answer to the involuntary petition asserts that there are 12 or more creditors, then pursuant to Fed. R. Bank. P 1003(b) the petitioning creditor should request a reasonable time within which to join at least two other creditors. If the other creditors join, it is as if they were creditors from the commencement of the case, and the otherwise defective involuntary petition is considered cured. 11 U.S.C. § 303(c).
[8]Fed. R. Bankr. P. 1003(b).
[9]*Id.*
[10]11 U.S.C. § 303(b)(1).
[11]*In re Bimini Island Air*, 370 B.R. 408 (Bankr. S.D. Fla. 2007) (surveying the circuits).
[12]*In re Ransome Group Investors, I, LLP*, 424 B.R. 547 (Bankr. M.D. Fla. 2009).
[13]*In re Manhattan Indus, Inc.,* 224 B.R. 195 (Bankr. M.D. Fla. 1997).
[14]*In re Audio Visual Workshop, Inc.*, 211 B.R. 154 (Bankr. S.D.N.Y. 1997).
[15]The dollar amount is adjusted under § 104 of the Bankruptcy Code and may be readjusted effective April 1, 2019.
[16]*Georgia Jewelers, Inc. v. Bulova Watch Co*., 302 F2d.362 (5th Cir 1962); *see also Harris v. Capehart-Farnsworth Corp.,* 225 F.2d 268, 270 (8th Cir.1955) (permitting the debtor to establish set-offs and counterclaims to challenge the standing of a petitioning creditor's claim).
[17]11 U.S.C. § 303(h)(1).
[18]*In re Food Gallery at Valleybrook*, 222 B.R. 480 (Bankr. W.D. Penn. 1998).
[19]*In re Forever Green Athletic Fields, Inc.,* 804 F.3d 328 (3d Cir. 2015).
[20]*Id.* at 335.