

## Alert

### Second Circuit Rejects Use of Involuntary Bankruptcy Petition as Collection Tool

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A bankruptcy court properly dismissed a creditor’s involuntary bankruptcy petition “for cause” when it “would serve none of the Bankruptcy Code’s goals or purposes . . . and [when] the sole [petitioning] creditor is not substantially prejudiced by remedies available under state law,” held the U.S. Court of Appeals for the Second Circuit on Aug. 14, 2018. *In re Murray*, 2018 WL 3848316, \*7 (2d Cir. Aug. 14, 2018). In its view, the bankruptcy court “declined to serve as a ‘rented battle field’ or ‘collection agency’” for a single creditor. *Id.*, at \*7. The bankruptcy court had stressed that “bankruptcy is not a judgment enforcement device.” *In re Murray*, 543 B.R. 484, 494 (Bankr. S.D.N.Y. 2016).

#### Relevance

“Most bankruptcy filings are initiated as voluntary petitions,” and “[f]ar fewer are initiated as involuntary petitions by creditors, much less a single creditor,” explained the Second Circuit. *Id.*, at \*4,<sup>1</sup> citing Administrative Office of the United States Courts, Judicial Facts and Figures, tbl 7.2 (last visited Aug. 13, 2018). According to the bankruptcy court, “less than 1/10 of 1% of all bankruptcy cases” are involuntary. 543 B.R. at 497. In the view of the Third and Seventh Circuits, involuntary bankruptcy petitions have “serious consequences [for] the alleged debtor, such as loss of credit standing, inability to transfer assets and carry on business affairs, and public embarrassment.” *In re Forever Green Athletic Fields Inc.*, 804 F.3d 328, 335 (3d Cir. 2015), quoting *In re Reid*, 773 F.2d 945, 946 (7th Cir. 1985).

Even when creditors file an otherwise valid involuntary petition, “that doesn’t mean the bankruptcy court can’t dismiss the case.” *In re Forever Green*, 804 F.3d at 334. Because an involuntary bankruptcy petition is an extreme remedy, the Second Circuit stressed in *Murray* that “Congress provided bankruptcy courts with a variety of tools with which to police their use.” *Murray*, 2018 WL 3848316, at \*4.

#### Facts

A creditor obtained a \$19-million judgment against the debtor and assigned the judgment to its counsel (“W”) as part of a fee settlement, agreeing to split any recovery on a 70/30 basis. *Id.*, at \*1. The debtor was jobless, had no income and made no payments to satisfy the judgment. According to W, the debtor sold assets and transferred the sale proceeds “to an offshore asset-protection trust.” *Id.*

The debtor’s sole remaining asset was a \$4.6-million residential cooperative apartment in Manhattan, the shares of which the debtor held with his wife as tenants by the entirety. The debtor lived in the apartment with his spouse and their two children. With its judgment, W obtained a lien on the shares of the cooperative apartment.

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<sup>1</sup> Available [here](#).

W then filed an involuntary bankruptcy petition against the debtor in February 2014, admittedly, “to take advantage of bankruptcy remedies that would allow it to force a sale of the apartment — notwithstanding [the debtor’s] wife’s interest which would be recognized after the sale — rather than state law remedies that would permit it to execute on [the debtor’s] interest only.” *Id.*, at \*2. The debtor moved to dismiss the petition and alternatively asked the bankruptcy court to abstain from hearing the case.

The bankruptcy court dismissed the petition on its own motion under Bankruptcy Code (“Code”) § 707(a) after discovery and oral argument. W had improperly exploited the bankruptcy system, it held, relying on Code § 707(a) to dismiss the case for “cause.” *Id.* After detailing its reasoning, the bankruptcy court stressed “the behavior of [W, as] a creditor . . .” *Id.*, at \*2. Significantly, the bankruptcy court declined to rule on the debtor’s “bad faith” argument, its sanctions request or abstention.

W argued on appeal that the bankruptcy court had erred because the involuntary petition met the statutory requirements, there was no finding of bad faith, and because bankruptcy “would provide . . . relief not available outside of the bankruptcy forum.” *Id.*, at \*3. The district court affirmed the bankruptcy court, reasoning that New York law provided “a sufficient means for [W] to enforce its judgment and [W’s] inability to execute on [the debtor’s] wife’s interest under that law does not, under these circumstances, justify a need for [bankruptcy] relief . . .” *Id.*

### **The Second Circuit**

A bankruptcy court must engage in a fact-intensive analysis to determine what constituted “cause” to warrant dismissal, said the court, because the Code does not define “cause.” *Id.*, at \*3. Accordingly, it had to consider “whether dismissal would be in the best interest not only of the parties but of the bankruptcy system.” *Id.* Although a debtor is ordinarily interested in obtaining a fresh start upon the discharge of its debts, a creditor focuses on whether “it is prejudiced by dismissal such as when it is ‘prevented from taking other measures’ to collect.” *Id.*

Acknowledging “equitable considerations” and “the sound discretion” of the bankruptcy court, the Second Circuit “found the following factors [to] favor dismissal” here: W “is a sole creditor; judgment enforcement remedies exist under state law; and no assets would be lost or dissipated in the event the bankruptcy case does not continue.” *Id.*, at \*4. The court rejected W’s argument that “New York’s remedies for enforcing a judgment on property owned in a tenancy by the entirety do not adequately protect its interests.” *Id.*

*No Abuse of Discretion by Bankruptcy Court.* In sum, reasoned the Second Circuit, “dismissal better advances [the] debtor’s interests . . ., furthers the interests of the bankruptcy courts and the public, and does not substantially prejudice [W’s] interests as a creditor . . . . [T]he judgment enforcement remedies under New York law sufficiently protect [W’s] interests as a sole creditor.” *Id.*

*Unusual Nature of Involuntary Bankruptcy Petitions.* Code § 303 contains the requirements for an involuntary petition and “courts tend to scrutinize such petitions closely.” *Id.* But “neither party dispute[d] that the [statutory] requirements were met” here. *Id.* Still, explained the court, “a bankruptcy court may dismiss [the petition] for cause under Section 707(a) after notice and a hearing.” *Id.*, at \*5. The “New York remedies are sufficient in this case [and] do not substantially prejudice [W’s] interests . . . .” *Id.* Citing the Third Circuit’s *Forever Green* decision, the court stressed that “inappropriate use of the . . . Code may constitute cause to dismiss,” and that mere debt collection is not a proper purpose for

a bankruptcy filing. *Id.* The court did not have to find bad faith on W's part because "misuse" of the Code "is one of a number of factors supporting cause to dismiss." *Id.*

The Second Circuit distilled the bankruptcy court's detailed findings of "cause" as follows: "[W's] petition was part of a long-running two-party dispute, there were no other creditors to protect, and it had been brought solely as a judgment enforcement device for which adequate remedies existed in state law." *Id.* The debtor neither wanted nor needed a bankruptcy discharge, and there were no "competing creditors." *Id.*

*No Prejudice to W.* The court rejected W's argument that New York's judgment enforcement remedies are inadequate when compared to available bankruptcy remedies. Under New York law, W could "execute on [the debtor's] shares in his apartment and . . . cause those shares to be sold in a judgment execution sale." *Id.*, at \*6. According to W, the Code would, in contrast, permit the sale of *both* the debtor's interest and the interest of his non-debtor spouse in the apartment, subject to the requirements of Code § 363(h). The Second Circuit stressed, though, that it was "by no means certain that [W] would be authorized to sell the apartment" in a bankruptcy case and that any sale proceeds would be "speculative." *Id.*, at \*6.

This case, said the court, "involves only one creditor and no risk of asset depletion in favor of other creditors. *Id.*, at \*7. A "two-party dispute" like this one "should not be in bankruptcy court to begin with." *Id.*

*Interests of Debtor and the Bankruptcy System.* Because "the interests of a debtor *must* be considered when determining whether cause exists to dismiss" an involuntary petition, the debtor's "vigorous opposition to the petition" is relevant. *Id.* More important to the court, though, was "the interest of the bankruptcy system . . . and . . . the public interest . . . in preventing parties from exploiting the bankruptcy system for non-bankruptcy-related reasons, especially when adequate remedies exist in state courts." *Id.*

## Comment

1. The Second Circuit's sensible analysis relied heavily on the bankruptcy court's magisterial opinion. As that court noted, had the debtor fraudulently transferred assets, W could sue in the state court "without resort to the bankruptcy court." 543 B.R. at 492, citing N.Y. Debtor & Creditor Law § 271 *et seq.* Moreover, no "creditor community" needed the protection of bankruptcy law. *Id.*, at 486. "[B]ankruptcy was created as a *collective remedy*, to achieve *pari passu* distribution amongst creditors . . ." *Id.* (emphasis in text). Here, "there are no other creditors' needs and concerns to protect . . ." *Id.*
2. The Third Circuit's *Forever Green* decision provides perspective on a bad faith involuntary petition. In that case, a judgment creditor had been sued by the debtor in an arbitration proceeding. The Third Circuit affirmed the bankruptcy court's finding that the creditor had acted in bad faith in blocking the debtor's efforts to litigate against it and to collect on its claim. 804 F.3d at 332.

The creditor's "litigation strategy was to use any means necessary to force the payment of [his] Consent Judgment and the abandonment of [the debtor's] claims against [him]." 804 F.2d at 336. Moreover, the creditor's "plan was to use the consent judgment to garnish the arbitrator's fees, thereby forcing the arbitrator to halt the arbitration." In fact, the creditor and "his counsel

said they would keep the arbitration suspended until [the debtor] paid on the consent judgment,” and “[t]hey also threatened to file an involuntary petition unless [the debtor] agreed to stop the [arbitration] proceedings.” *Id.*

The creditor’s actions thus “ran counter to the spirit of collective creditor action that should animate an involuntary filing.” The creditor “put his own interest above all others . . . [b]y trying to end the arbitration” and “was obstructing [the debtor] from pursuing its largest asset, the potential proceeds of which [the debtor] could have used to pay its creditors.” The creditor “was also using the bankruptcy process to exert pressure on [the debtor] to pay the consent judgment without regard to . . . other creditors, many of which had higher priority claims.” Agreeing with other courts, the Third Circuit found it “improper for creditors to use the bankruptcy courts to gain a personal advantage in other pending actions or as a debt-collection device.” *Id.*, citing *In re Nordbrock*, 772 F.2d 397, 400 (8th Cir. 1985) (“A creditor does not have a special need for bankruptcy relief if it can go to state court to collect a debt.”).

3. *Murray* also shows, as a matter of state debtor-creditor law, the utility of the tenancy by the entirety as an asset-protection device. *W* could only reach the debtor’s interest in the apartment shares, *not* those of his wife. Nor could *W* “force a partition or sale of the apartment, or . . . inhabit the apartment . . . . [The debtor’s] wife [had] her right of survivorship in the apartment [and] would own the apartment free and clear . . . if [the debtor] predeceases her.” 2018 WL 3848316, \*6.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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