

Alert

Second Circuit Affirms Dismissal of Involuntary Bankruptcy Case Because of Creditors' Legitimately Disputed Claims

July 23, 2015

A bankruptcy court must dismiss a creditor's involuntary bankruptcy petition when the debtor has raised a "legitimate basis" for disputing the petitioning creditor's underlying claim, held the U.S. Court of Appeals for the Second Circuit on July 14, 2015. *In re TPG Troy, LLC*, 2015 WL 4220619, at *5 (2d Cir. July 14, 2015). The Second Circuit also affirmed the bankruptcy court's award of \$513,427 in attorney's fees and costs to the vindicated debtor under Bankruptcy Code ("Code") Section 303(i)(1). *Id.* at *6. According to the court, the fee award "serves to discourage the filing of involuntary bankruptcy petitions to force debtors to pay a disputed debt." *Id.* at *5-6. This case represents creditors' improper use of an involuntary bankruptcy petition. Practically, it also underscores the risks that a creditor faces when a court dismisses its petition.

Relevance

Creditors are often tempted to file an involuntary bankruptcy petition against their debtor as a way to compel the payment of a debt. To file such a petition, however, the creditor's claim must, among other requirements, not be "the subject of a bona fide dispute as to liability or amount." Code § 303(b)(1). As the *TPG* case shows, the involuntary bankruptcy petition is not just another collection device.

TPG deals only with the standing of a petitioning creditor. The Code, however, imposes other requirements for an involuntary filing. If the debtor has 12 or more creditors, at least three petitioning creditors are required. Code § 303(b)(1)-(2). The petitioner must be a creditor or serve as an indenture trustee for creditors. Code § 303(b)(1). A petitioning creditor's claim must also be non-contingent. *Id.* All of the petitioning creditors must hold unsecured claims that total at least \$15,325. *Id.* Farmers and nonprofit corporations are not eligible debtors. *Id.* § 303(a). Involuntary bankruptcy relief is available only under Chapters 7 and 11 of the Code. *Id.* Finally, the Code provides two alternative grounds for relief: (1) "the debtor is generally not paying" its "debts as [they] become due ... "; or (2) "a custodian ... was appointed or took possession" of "substantially all of the property of the debtor" within the preceding 120 days. *Id.* § 303(h). In sum, these substantive obstacles are meant to ensure that only financially troubled debtors can be forced into bankruptcy involuntarily, balancing the interests of debtors and creditors.

Facts

Three creditors ("Creditors") filed an involuntary bankruptcy petition against two affiliated debtors ("Debtors") to recover losses incurred when the Debtors' partially-owned subsidiaries defaulted on \$1.3 billion of their notes ("Notes"). The Debtors had not issued or guaranteed the Notes and had sold their interest in the issuing subsidiaries long before the default. After starting many suits against the Debtors,

the Creditors then filed an involuntary bankruptcy petition against them, asserting they were liable for the subsidiaries' debts on an alter ego theory.

The Bankruptcy and District Courts

The bankruptcy court dismissed the involuntary petition on two grounds. First, it found a "bona fide dispute" as to whether the Debtors were liable to the Creditors. Alternatively, the bankruptcy court abstained under Code Section 305(a)(1) because the parties were already litigating the liability issue in other courts, implicating state, not federal, law. It stressed the "plethora of ongoing litigation" between the parties. The district court affirmed the bankruptcy court in full. *Id.* at *1-2.

The Second Circuit

The Second Circuit first addressed the Creditors' challenge to its jurisdiction under Code Section 305(c) (abstention order "not reviewable by appeal or otherwise by the court of appeals ... or by the Supreme Court of the United States"). Although the court admitted its lack of jurisdiction to review the bankruptcy court's abstention order, it still reviewed the bankruptcy court's award of attorney's fees and costs based on the legitimately disputed claims asserted by the creditors. *Id.* at *3.

Legitimate Dispute

The Second Circuit reviewed the bankruptcy court's finding of a bona fide dispute solely for the purpose of deciding the propriety of the attorney's fee award against the Creditors. *Id.* at *4-5. A court must, in the Second Circuit's view, "determine whether there is an objective basis for either a factual or a legal dispute as to the validity of the debt." *Id.* at *4 (citing *In re BDC 56, LLC*, 330 F.3d 111, 117 (2d Cir. 2003)). If "there is either a genuine issue of material fact that bears upon the debtor's liability or a meritorious contention as to the application of law to undisputed facts," a good faith dispute exists. *Id.* As the court explained, "Congress intended to disqualify a creditor whenever there is any legitimate basis for the debtor not paying the debt, whether that basis is factual or legal." *Id.* Moreover, "[a]n involuntary bankruptcy case cannot be the means of pressuring a debtor to pay a legitimately disputed debt." *Id.* Although the petitioning creditor bears the initial burden of showing that no bona fide dispute exists, the debtor must then show the existence of a bona fide dispute. *Id.* The mere existence of pending litigation is insufficient to prove the existence of a bona fide dispute, but it does strongly suggest that one exists. *Id.* at *5. Here, the bankruptcy court properly considered the Debtor's arguments that: alter ego liability did not apply to foreign entities; the Creditors had knowingly consented to the transactions at issue; and the Debtors had not engaged in a fraudulent redemption transaction. *Id.* Nor did the bankruptcy court have to resolve fact issues, reasoned the Second Circuit, because it only had to determine whether a bona fide dispute exists, not resolve it. *Id.*

Attorney's Fees

The Second Circuit acknowledged a judicial presumption that costs and attorney's fees will be awarded to the alleged debtor and that a creditor's bad faith is not a prerequisite to a fee award. *Id.* at *5-6. "Most ... courts" apply a "totality of the circumstances test," taking into account: "(1) the merits of the involuntary petition; (2) the role of any improper conduct on the part of the alleged debtor; (3) the reasonableness of the actions taken by the petitioning creditors; and (4) the motivation and objectives behind the filing of the petition." *Id.* at *6. According to the bankruptcy court, the "Creditors ha[d] put forward no evidence to rebut the presumption that the [Debtors] are entitled to an award of attorneys' fees." *Id.*, citing *In re TPG Troy*, 2013 WL 3789344, at *4 (Bankr. S.D.N.Y. July 18, 2013).

Comments

The *TPG* case illustrates the risks for creditors in filing an involuntary bankruptcy petition. What it does not do, however, is explain why and when creditors would be justified in filing an involuntary petition. Bankruptcy is a collective process for the entire group of creditors. Creditors may, therefore, force a financially troubled debtor into bankruptcy to enable a trustee to recover fraudulent transfers and preferences, to challenge a defective lien on the debtor's assets, or to pursue third parties who have caused the debtor's downfall. As *TPG* shows, though, involuntary bankruptcy is *not* a way to resolve a two-party dispute.

Authored by [Michael L. Cook](#).

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

This information has been prepared by Schulte Roth & Zabel LLP ("SRZ") for general informational purposes only. It does not constitute legal advice, and is presented without any representation or warranty as to its accuracy, completeness or timeliness. Transmission or receipt of this information does not create an attorney-client relationship with SRZ. Electronic mail or other communications with SRZ cannot be guaranteed to be confidential and will not (without SRZ agreement) create an attorney-client relationship with SRZ. Parties seeking advice should consult with legal counsel familiar with their particular circumstances. The contents of these materials may constitute attorney advertising under the regulations of various jurisdictions.

SchulteRoth&Zabel

New York | Washington DC | London

www.srz.com