ALERTS

# Third Circuit Affirms Dismissal of Good Involuntary Petition for Bad Faith

**October 29, 2015**

"[B]ad faith provides an independent basis for dismissing an involuntary [bankruptcy] petition" despite the creditors' having met all of the "statutory requirements," held the U.S. Court of Appeals for the Third Circuit on Oct. 16, 2015. *In re Forever Green Athletic Fields, Inc.*, 2015 WL 6080665, at *1 (3d Cir. Oct. 16, 2015). As the court stressed in this rarely litigated type of case, even when creditors file an otherwise valid petition, "that doesn't mean the bankruptcy court can't dismiss the case." *Id.* at *4.

An involuntary bankruptcy petition "is an extreme remedy with serious consequences to the alleged debtor," explained the Third Circuit. *Id.* at *5. This appellate decision is important because the Bankruptcy Code ("Code") provides no "standard for evaluating bad faith," "courts have applied a dizzying array of standards," and most cases in this context deal with "post-dismissal damages."[1]

## Facts

The debtor sued one of its competitors ("P") in the Pennsylvania courts in 2005 for diverting $5 million of corporate assets. If the debtor prevailed in the Pennsylvania action, "D," the owner of P and a former sales representative of the debtor, would be personally liable. In 2005, D and his wife also sued the debtor for unpaid commissions in Louisiana. After years of litigation, the Louisiana court entered a consent judgment in favor of D for $300,000, but the debtor has not "paid a penny on this judgment." 2015 WL 6080665, at *1.

The parties in the debtor's Pennsylvania action — P and the debtor — agreed to arbitrate their dispute, but once D attained a consent judgment in Louisiana, he moved to terminate the arbitration, arguing that the debtor was insolvent and noting his unsatisfied $300,000 judgment against the debtor. D then started to enforce his Louisiana judgment against the debtor's advance deposit paid to the arbitrator.

During the course of a deposition, D stated that he intended to "[f]ind any available asset that [the debtor] may have and to use the [judgment] lien to seize it." The debtor tried to reinstate the arbitration, noting that "[D] and his counsel had 'threatened to put [the debtor] into bankruptcy' if [the debtor] did not agree to terminate the arbitration." *Id.* D's counsel stressed that until the debtor satisfied P's judgment, the arbitration would be stayed indefinitely. When the Pennsylvania court scheduled a briefing and hearing schedule on the debtor's attempt to reinstate the arbitration, D, his spouse and a third party filed an involuntary Chapter 7 bankruptcy petition against the debtor.

The debtor conceded the existence of three petitioning creditors holding uncontested unsecured claims aggregating the requisite amount, consistent with the requirements of Code Section 303(b). But the debtor also moved to dismiss the involuntary petition "as a bad-faith filing" despite the petitioning creditors' "facial compliance with" the Code. *Id.* at *2.

## The Bankruptcy Court

The bankruptcy court held a trial, finding that the debtor had "essentially shut down its business" in 2012, that "its operating account had no activity and [that] its balance never exceeded $30." The debtor was "winding down its affairs and recovering assets for its approximately 50 creditors." Its largest asset was its $5-million claim against P, but it had $2.3 million in liabilities. Although the debtor had not been paying its debts, its principal had "personally paid off hundreds of thousands of dollars of" corporate debt and was "personally funding all of" the debtor's litigation, including the suit against P. *Id.*

The bankruptcy court dismissed the involuntary petition, reasoning that in a court of equity, "a petitioning creditor … must come to the court for a proper purpose." In its view, involuntary bankruptcy cases "are intended to protect creditors from debtors who are making preferential payments to

other creditors or from the dissipation of the Debtor's assets." Nevertheless, it found D to be "a bad-faith creditor … motivated by two improper purposes: to frustrate [the debtor's] efforts to litigate its claim against P and to collect on a debt." *Id.* The district court affirmed.

# Analysis

## Bad Faith Filing

Code Section 303(i)(2) provides that a court may award damages against any creditor when it dismisses an involuntary petition if the filing was "in bad faith." The section "deals with post-dismissal damages" available when creditors fail to satisfy the statutory requirements for an involuntary bankruptcy case contained in Code Section 303(b) (three or more petitioning creditors with non-contingent, undisputed claims aggregating at least $15,325). *See, e.g.*, *In re TPG Troy*, 793 F.3d at 235 ("[A]n award of attorneys' fees and costs serves to discourage the filing of involuntary petitions to force debtors to pay on a disputed debt.").

The court rejected D's argument that it could not "engage in a bad-faith inquiry" when "the criteria for commencing a [bankruptcy case] are satisfied and where the debtor is admittedly not paying its debts as they become due." *Id.* at *3. Although some courts accept the argument that a creditor's "subjective motivations are irrelevant," and although Code Section 303(i) "discusses bath faith only in the context of assessing damages after a petition has been dismissed," the court disagreed with D. In its view, even "if the three [statutory] requirements are satisfied, the bankruptcy court still can dismiss the case," adding that "by including an express reference to bad faith in § 303(i)(2), Congress intended for bad faith to serve as a basis for both dismissal and damages." *Id.* at *4.

More significant, said the court, D overlooked "the equitable nature of bankruptcy." The Third Circuit has stressed that the "'good faith' filing requirements have 'strong roots in equity.'" *Id.*, citing *In re SGL Carbon*, 200 F.3d 154, 161 (3d Cir. 1999) (*held*, "Chapter 11 petition is subject to dismissal for 'cause' … unless it is filed in good faith.") "As courts of equity, bankruptcy courts are equipped with the doctrine of good faith so that they can patrol the border between good- and bad-faith filings." *Id.*, citing *SGL Carbon*, 200 F.3d at 161; *In re Little Creek Dev. Co.*, 779 F.2d 1068, 1072 (5th Cir. 1986). Explaining that the "majority of courts agree," the Third Circuit refused to "depart from this general 'good faith' filing

requirement in the context of involuntary petitions for bankruptcy." *Id.* at *4, citing *In re U.S. Optical, Inc.*, 1993 WL 93931, at *3 (4th Cir. April 1, 1993) ("Courts are duty bound to conduct an inquiry, if requested, to determine whether an involuntary petition has been filed in good faith. Bad faith filings are to be dismissed."); *In re Bock Transp., Inc.*, 327 B.R. 378, 381 (B.A.P. 8th Cir. 2005) ("A bad faith filing can also be cause for the dismissal of a[n] [involuntary] petition.").

"Policy considerations," explained the Third Circuit, made it "wary of creditors who may find alluring the 'retributive quality' of thrusting a debtor into bankruptcy." *Id.* at *5. Creditors should be allowed to file involuntary bankruptcy petitions only " for proper reasons such as to protect against the preferential treatment of other creditors or the dissipation of the debtor's assets." *Id.*

## Test for Bad Faith

The debtor had to "show by a preponderance of the evidence that the creditors acted in bad faith." *Id.* Adopting a "totality of the circumstances" standard for determining bad faith in this context, after a "fact-intensive review," the Third Circuit looked at whether "the creditors satisfied the statutory criteria for filing the petition; the involuntary petition was meritorious; the creditors made a reasonable inquiry into the relevant facts and pertinent law before filing; there was evidence of preferential payments to certain creditors or of dissipation of the debtor's assets; the filing was motivated by ill will or a desire to harass; the petitioning creditors used the filling to obtain a disproportionate advantage for themselves rather than to protect against other creditors doing the same; the filing was used as a tactical advantage in pending actions; the filing was used as a substitute for customary debt-collection procedures; and the filing had suspicious timing." *Id.* at *6.

The Third Circuit agreed with the bankruptcy court, applying this standard, that D'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 [P]." *Id.* Moreover, D's "plan was to use the consent judgment to garnish the arbitrator's fees, thereby forcing the arbitrator to halt the arbitration." In fact, D 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.*

D's actions thus "ran counter to the spirit of collective creditor action that should animate an involuntary filing." D "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." D "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 [such as D] 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.").

The Third Circuit found no evidence that D had conducted "due diligence" or "sober decision-making" before filing the involuntary petition. Instead, the court identified the following facts showing bad faith:

- "Suspicious timing" — filing the petition immediately before its "brief was due" in the Pennsylvania action regarding the arbitration;
- Threatening involuntary bankruptcy "as an alternative weapon for stopping the arbitration and cashing in on the consent judgment";
- No preferential transfers by the debtor;
- Payments to creditors only made by the debtor's principal, but not by the debtor;
- No evidence of the debtor's depleting its assets;
- The debtor's principal was "footing the bill for any of its litigation" to recover assets for the debtor.

In sum, the record amply supported the bankruptcy court's finding of D's bad faith. *Id.* at *7.

## Other Good Faith Creditors Could Not Have Cured D's Bad Faith

The court rejected D's argument that "other good-faith creditors should have been given the chance to cure the petition," based on Code Section 303(c), which allows other creditors to join the petition before dismissal. Although some courts have applied the so-called "bar to joinder" rule that good faith creditors cannot join in a bad faith petition prior to dismissal, the Third Circuit never had to apply such a rule. In its view, it was "too late for any creditor to save the petition" here. According to the text of Code Section 303(c), other creditors must join "before the case is dismissed." Here, no creditor even tried "to join the petition before the case was dismissed."Also, D had "plenty of time … to recruit other potentially curing creditors — approximately nine months lapsed between the hearing on the motion to dismiss and the issuance of the Bankruptcy Court's decision." *Id.*

## Comment

Filing an involuntary petition is obviously risky. But the lesson here for creditors is to justify the filing for *all* creditors. Is the debtor dissipating its assets? Has the debtor used its assets to prefer some creditors with cash payments or liens?

A more practical consideration before filing an involuntary petition is whether it will get the client paid. If not, prosecuting a claim in a non-bankruptcy court may be more effective. A non-bankruptcy court can also resolve any fraudulent transfer claims the creditor may have, although not preferential transfer claims. Most important, any recovery by the creditor will not be shared with other creditors, unlike in bankruptcy, which is a collective creditor remedy.

*Authored by Michael L. Cook .*

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

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[1] *Id.*, at *5, *3.See our July 23, 2015 *Alert*, "Second Circuit Affirms Dismissal of Involuntary Bankruptcy Case Because of Creditors' Legitimately Disputed Claims," discussing *In re TPG Troy, LLC*, 793 F.3d 228 (2d Cir. 2015) (*held*, court properly awarded attorneys' fees after dismissing involuntary petition).

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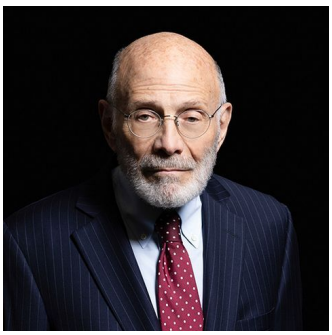

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