ALERTS

Involuntary Bankruptcy: Limited Remedy and Strong Sanctions for Abuse

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The remedy of involuntary bankruptcy "exists as an avenue of relief for the benefit of the overall creditor body.... [I]t was not intended to redress the special grievances, no matter how legitimate, of particular creditors...." *In re Murray*, 900 F.3d 53, 59-60 (2d Cir. 2018). The courts of appeals have been consistent. *In re Edgar A. Reyes-Colon*, 2019 WL 1785039 *1 (1st Cir. Apr. 24, 2019) (affirmed dismissal of involuntary petition filed by only two creditors; at least three petitioners required; parties engaged in "twelve years of litigation concerning the number of [debtor's] creditors and whether he might... be placed in bankruptcy involuntarily for 'equitable' reasons."); *In re 8 Speeds 8 Inc.*, 2019 WL 1891802, *3 (9th Cir. Apr. 29, 2019) (dissent) ("Involuntary bankruptcy is a drastic course of action that carries significant consequences, and '[f]iling an involuntary petition should be a measure of last resort'.... The fee-shifting and damages provision of [Bankruptcy Code] § 303(i) are intended to deter frivolous filings.... The Majority holds that... a third party who appears for a debtor and successfully defends against an involuntary petition can never request that the debtor be awarded costs, a reasonable attorney's fee, or damages.").

A bankruptcy court decision recently detailed how courts applying Bankruptcy Code ("Code") § 303(i) can sanction creditors who "abuse... the power given to [them]... to file an involuntary bankruptcy petition." *In re Anmuth Holdings LLC*, 2019 WL 1421169, * 1 (Bankr. E.D.N.Y. Mar. 27, 2019). Because the three involuntary petitions against corporate entities in *Anmuth* admittedly "lacked any merit," *Id.* at *12, the court ultimately awarded the debtors attorneys' fees, punitive damages, retroactive

dismissal of the involuntary petitions to the dates on which they were filed, and an injunction against future filing by the petitioning creditors. *Id.*, at *27. The decision shows why the filing of an involuntary bankruptcy requires careful pre-filing legal judgment.

Legal Background

A law professor stated 25 years ago that "[i]nvoluntary cases make up quite a small percentage of the bankruptcy filings each year, which shows how far the emphasis has moved from bankruptcy as a creditors' remedy." Brian A. Blum, *Bankruptcy and Debtor/Creditor*, § 15.5.1, at 216 (Little, Brown & Co. 1993). The Second Circuit confirmed in *Murray* that "far fewer [cases] are initiated as involuntary petitions by creditors, much less a single creditor," citing statistics from the Administrative Office of the United States Courts, and, quoting the bankruptcy court, "less than 1/10 of 1% of all bankruptcy cases" are involuntary. 900 F.3d at 590.

Qualifications for Filing an Involuntary Petition: Bankruptcy Code §§ 303(a), (b) and (c). Petitioning creditors must first show that the debtor is eligible for involuntary relief. Section 303(b) bars the filing of such a petition against a farmer or charitable corporation. Section 303(a) also makes involuntary relief available only under Chapters 7 (liquidation) and 11 (reorganization).

Section 303(b)(1) requires that each petitioning creditor hold non-contingent, undisputed, unsecured claims totaling at least $16,750. If the debtor has 12 or more creditors, at least three petitioning creditors must join in the petition. But if the debtor has 11 or fewer creditors, the Code requires only one petitioning creditor. Excluded from the eligible class of petitioned creditors are employees, the debtor's insiders or any recipient of a voidable pre-bankruptcy transfer. Creditors with contingent claims or claims subject to a bona fide dispute are also ineligible. Requiring three eligible petitioning creditors in most cases protects the debtor from the involuntary bankruptcy risk at the instance of a single creditor.

Grounds for Involuntary Relief — § 303(h). Section 303(h) requires the petitioning creditors to prove one of two alternative grounds for involuntary relief: (a) the debtor is generally not paying its debts as they become due; or (b) a custodian (e.g., receiver, assignee, liquidator) was appointed or took possession of the debtor's property within the 120-day period prior to the filing of the petition. A custodian who takes "charge of

less than substantially all" of the debtor's property (e.g., one parcel of real estate) does not meet this requirement. In sum, these two grounds for relief limit the power of creditors to force a debtor into bankruptcy, requiring that the alleged debtor have serious financial problems.

Whether a debtor is generally not paying its debts as they become due is ordinarily a fact question. Courts look at the extent of the debtor's default and the relative value of the defaulted debt. But unpaid debts subject to a good faith dispute are excluded from this analysis.

The alternative "custodian" ground in § 303(h)(2) enables federal bankruptcy law to supersede state law receiverships or assignments for the benefit of creditors. In the latter case, the debtor usually picks the assignee, which can lead to collusion or other forms of abuse.

Anmuth: When Sanctions Are Warranted

The three petitioning creditors in *Anmuth*, "A," "B" and "C," filed involuntary Chapter 7 petitions against Anmuth and two affiliates within hours "after receiving an adverse decision in state court" that had denied their request for a stay of a draw on letters of credit. When the debtors moved to dismiss the involuntary petitions and sought sanctions, including legal fees, costs, compensatory damages and punitive damages under Code §§ 303(i) and 105, the petitioning creditors "conceded that their purported claims against…the Debtors were subject to a bona fide dispute and that as such, they were ineligible to file the Involuntary Petitions." *Anmuth*, 2019 WL 1421169, at *1.

The original attorney for A, B and C testified that he explained the requirements for filing an involuntary petition, warning each of them "of the risks, including potential sanctions, associated with filing an involuntary petition." *Id.* at *6. Both B and C denied speaking with that counsel, but they all agreed that A was authorized to make decisions on their behalf. A testified that "the purpose of the filings… was to prevent [a bank] from transferring the Cash Collateral." *Id.* Although the original counsel had "refused to sign or file" a later fourth involuntary petition, A "filed the petition in person at the Bankruptcy Court," signing all petitions on his own behalf and, with authorization, on behalf of B. *Id.* B testified "that he 'never saw' the petitions before they were filed, did not consult an attorney, and that the 'case is run… by [C] and [A].' C "testified that while

he signed the Involuntary Petitions, he never consulted with an attorney, and he, 'relied on [A], what [A] told me to do, I did'." *Id.* at *7.

The three involuntary petitions list identical claims, all "subject to a bona fide dispute," based on loans, the proceeds of which secured a letter of credit. These claims were the same as those litigated in the state court, making the petitioning creditors admittedly ineligible. *Id.*, at *7.

Post-Petition Conduct of A. A texted the debtor's principal, "X," "threatening to file an involuntary petition against [him] individually," after the filing of the involuntary petitions. *Id.* When the three debtors moved to dismiss the involuntary petitions, seeking sanctions, A wrote to X: "[w]ant to just let you know Monday I am filing in bankruptcy against [you] personal and that means [you] can't do any more Bussiness [sic] for a long time not playing around not going to waste more time...." *Id.* Before A was to be deposed, he threatened, "it will become very dirty" and "very [sic] ugly for [X]." A also "made multiple efforts to compel [X] to litigate their issues in rabbinical court.... A posted [a] letter on street signs and poles and in synagogues in Brooklyn.... Additionally, [A] hired a company to print leaflets denouncing [X] that were disseminated in synagogues throughout Brooklyn." *Id.*

The petitioning creditors, when their original counsel resigned, "consented to the dismissal of the involuntary petitions with newly retained counsel." *Id.* at *8.

Legal Standard for Sanctions. After hearings on the debtors' sanctions motion, the court quoted § 303(i) as follows:

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... (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.

11 U.S.C. § 303(i) (emphasis added). *Id.*

The court had admittedly dismissed the involuntary petitions and the debtor had not waived its right to the sanctions under the statute. But the petitioning creditors argued that their consent to dismissal precluded an award. According to the court, "the motion to dismiss [the involuntary

petitions] was not filed by the Petitioning Creditors, nor was it a joint motion." *Id.* at *10. Instead, the debtors had moved to dismiss and the "petitioning creditors did not oppose." *Id.* Because the debtors "were forced to make a motion to dismiss," the court's "dismissal of the Involuntary Petitions was not 'on consent.'" *Id.* "Consent under § 303(i) is not found where a petitioning creditor merely capitulates to a debtor's request for dismissal." *Id.* In fact, at "every stage of this case, the [debtors] have expressly reserved their rights to pursue § 303 damages. The egregious acts of the Petitioning Creditors, which persisted post-filing, coupled with their failure to offer consent until the [Debtors] filed a motion to dismiss, render the argument that their 'consent' to dismissal precludes a § 303(i) award wholly without merit." *Id.*

Attorneys' Fees and Costs. "When an involuntary petition is dismissed, 'there is a presumption that costs and attorneys' fees will be awarded to the alleged debtor.'" *In re TPG Troy LLC*, 793 F.3d 228 (2d Cir. 2015). "Section 303(i)(1) is a fee-shifting provision that requires no showing of bad faith and aims to keep the putative estate whole." *Id.*, at 235. According to the court in *Anmuth*, "the fee award … may include fees incurred in all phases of the litigation before this Court." 2019 WL 1421169, at *12.

The bankruptcy court in *Anmuth* relied on the "totality of the circumstances" to justify its award. It considered "(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 the objectives behind the filing of the petition." *Id.*, quoting *TPG Troy* 793 F.3d 228, 235 (2d Cir. 2015). Not only did the involuntary petitions here lack any merit, but the petitioning creditors had also "not offered any evidence to rebut the presumption that the … Debtors are entitled to an award of attorneys' fees." *Id.*

The petitioning creditors had assumed certain risks, including the reimbursement of legal fees. As a result, the debtors had to incur legal fees to prepare for trial on their sanctions motions, including four depositions. *Id.*

The petitioning creditors also acted unreasonably before and after they filed the involuntary petitions. They "acted with blatant disregard for the appropriateness of their actions," continuing "to threaten and harass" X and ignoring warnings from the debtors' counsel. The court therefore awarded attorneys' fees and costs of about $115,000. *Id.* at *13.

Damages. Code § 303(i)(2) requires a finding of bad faith for damages, with the debtor "having the burden of proving bad faith." *In re Bayshore Wire Prods.*, 209 F.3d 100, 105 (2d Cir. 2000). A "debtor may only recover actual and punitive damages upon a finding of bad faith." 2019 WL 1421169, at *14.

A, B and C filed the involuntary petitions in response to an adverse state court ruling, "within hours of receiving" that decision, "as a litigation tactic." Moreover, held the *Anmuth* court, "the timing of the filing demonstrates 'egregious bad faith and an improper use of the bankruptcy system.'" *Id.* at *15-*16, quoting *In re Silverman*, 230 B.R. 46, 52 (Bankr. D.N.J. 1998).

The petitioning creditors in *Anmuth* also tried to coerce a settlement when they filed the involuntary petitions. A's trial testimony confirmed that fact, as did the testimony of the petitioning creditors' original counsel. Their "admitted purpose in filing the petitions to pressure" a settlement thus constituted "manifest bad faith." *Id.* at *16.

The *Anmuth* court further found "ample evidence to support a finding that" A, B and C filed the involuntary petitions "with ill will, malice and desire to embarrass and harass the [debtors] and [X]." *Id.*, at *17. A's testimony showed "the type of 'personal antipathy' to be considered when determining whether a filing was motivated by ill will." *Id.* After the filing against the corporate entities, A "sent repeated messages threatening to file an involuntary petition against [X] personally," testifying that his threats "were intended to 'put pressure' on [X] to participate in arbitration in rabbinical court." *Id.* at *18. In short, A's "threatening messages... reveal his intent to use bankruptcy as a weapon to force [X] to terminate" his claims for sanctions.

A "appreciated," yet disregarded, the serious consequences an involuntary petition inflicts on the alleged debtor. He told X that he would not be able to "do any more Bussiness [sic] for a long time not playing around not going to waste more time...." *Id.* In response to his lawyer's warnings, A said that he "was not worried about it" and "continued to threaten additional involuntary filings, texting that 'it will become very dirty' and 'very ugly' for X." A's additional public denunciations of X in local synagogues were intended not only "to embarrass and harass" X," but "were [also] part of the Petitioning Creditors' general litigation strategy to... coerce a settlement," confirming the "bad faith" of the filing." *Id.* at *19.

A, B and C even failed to make a reasonable inquiry before filing the baseless involuntary petitions. They knew, "at all relevant times," that their claims were disputed. They litigated for more than four years in the state court and had participated in an arbitration, admittedly filing the involuntary petitions to force a settlement. A, B and C falsely "stated under oath in the Involuntary Petitions that their claims were undisputed and that the … debtors were not paying their debts." *Id.*, at *19. They "made no effort of any kind to investigate" whether the allegations were true. *Id.* at *20.

The court further rejected the petitioning creditors' asserted "advice of counsel" defense. Their "testimony was contradictory and lacked credibility." *Id.* Regardless of what their counsel might have told them, they knew "that the [asserted] claims were subject to a hotly contested dispute, given that, hours earlier, the [state] court had ruled against them." A's testimony confirmed that he had "entered [his counsel's] office with his improper purpose already formed." *Id.* at *22.

Compensatory and Punitive Damages. Although the debtors could not make a record sufficient "to determine the amount of any compensatory damages," the court did award them $600,000 in punitive damages. This award, said the court, was "especially appropriate in light of the Petitioning Creditors' egregious bad faith conduct"; their "lack of remorse and threats of future involuntary petitions…"; and their "knowingly false statements" made in the involuntary petitions. *Id.* at *25. A, B and C also undertook their actions "as an intertwined group," enabling the court to assess damages against all of them. *Id.* at *26. B and C had given A permission to act on behalf of the group and had to bear the responsibility for allowing A "to file and prosecute" the "irresponsible, abusive involuntary petition[s] in [their] name." *Id.*, quoting *In re Meltzer*, 535 B.R. 803, 818 (Bankr. N.D. Ill. 2015).

Comments

1. *Anmuth* is consistent with case law from the courts of appeals. *In re Murray*, 900 F.3d 53, 61-63 (2d Cir. 2018) (bankruptcy court properly "declined to serve as a 'rented battlefield' or 'collection agency'" for a single creditor; "bankruptcy is not a judgment enforcement device."; involuntary 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"; debtor neither wanted nor needed a bankruptcy discharge, and there were no "competing creditors."); *In re TPG Troy LLC*, 793 F.3d 228, 235 (2d Cir. 2015) (affirmed bankruptcy court's award of $513,427 in attorney's fees and costs to vindicated debtor under 303(i)(1); fee award "serves to discourage the filing of involuntary bankruptcy petitions to force debtors to pay a disputed debt."); *In re Forever Green Athletic Fields Inc.*, 804 F.3d 328, 334 (3d Cir. 2015) ("[B]ad faith provides an independent basis for dismissing an involuntary petition," despite the creditors' having met all of the "statutory requirements"; ". . . Congress intended bad faith to serve as a basis for both dismissal and damages."; "the equitable nature of bankruptcy. . . [imposes] this general good faith filing requirement in the context of involuntary petitions. . . ."], citing *In re U.S. Optical Inc.*, 991 F.2d 792 (4th 1993); *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.").

2. These cases illustrate the risks for creditors in filing an involuntary bankruptcy petition. What they do not do, however, is explain why and when eligible creditors would be justified in filing an involuntary petition. Bankruptcy is a collective process for the entire group of creditors. "Involuntary bankruptcy petitions help ensure the orderly and fair distribution of an estate by giving creditors an alternative to watching . . . as assets are depleted, either by the debtor or by rival creditors . . . ." *Murray*, 900 F.3d at 59. Eligible creditors may thus 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 all of these cases show, 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.

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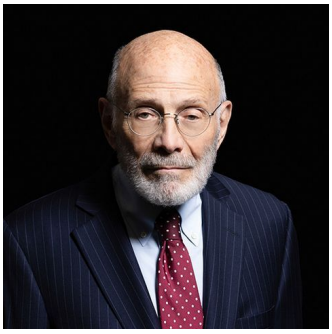

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