INSIDE THE MINDS

Chapter 11 Bankruptcy and Restructuring Strategies

Leading Lawyers on Navigating Recent Trends, Cases, and Strategies Affecting Chapter 11 Clients

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Involuntary Bankruptcy: Determining When a Claim Is Subject to a Bona Fide Dispute

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Introduction

I am a partner at Loeb & Loeb LLP, where I focus primarily on insolvency and commercial litigation matters. I have practiced in the insolvency field since 1987 and have represented debtors, creditors, and creditor committees in cases throughout the United States. I also served by election as a Chapter 7 trustee in a case in the US Bankruptcy Court for the District of New Mexico involving a planned unit development that owned and controlled numerous real properties, a thirty-six-hole golf course and country club, a water and sewer utility, and over 26,000 acre feet of water rights. At the time, this was the second-largest Chapter 7 bankruptcy in the history of New Mexico and still ranks in the top three. In my insolvency practice, I have been involved in cases involving almost every type of industry including real estate, manufacturing, oil and gas, and entertainment. The best aspect of my practice and career is that every insolvency case provides me with an opportunity to learn and understand a new industry and to broaden and sharpen my practice skills.

Voluntary versus Involuntary Bankruptcy

With respect to federal bankruptcy law, there are generally two types of proceedings: voluntary bankruptcy and involuntary bankruptcy. The overwhelming majority of cases that are filed in the United States are voluntary bankruptcies where the debtor chooses to seek relief under the US Bankruptcy Code.[1] Although much rarer, involuntary bankruptcies are also an extremely important aspect of the bankruptcy system, since they serve as a tool for creditors to try to force a debtor to liquidate its assets.

The most common scenario in which creditors seek to file an involuntary bankruptcy petition against a debtor occurs when the creditors have claims or judgments they are unable to execute on or satisfy through their respective state court processes. This is because creditors' rights and abilities to execute on or satisfy judgments or claims are controlled by applicable state law. The distinction amongst states can be dramatic. For example, in Texas, the real and personal property exemptions are so liberally construed in favor of the debtor that it is often difficult for a

[1] 11 U.S.C. §§ 101 et seq.

creditor to find any non-exempt property to satisfy the claim or judgment.[2] By contrast, in California, the debtor's real property (homestead) exemption is limited to $75,000.[3] The personal property exemptions are likewise extremely limited.[4] Accordingly, each state's real and personal property exemption statutes will help define the propriety of seeking an involuntary bankruptcy petition.

In a typical involuntary bankruptcy petition, the creditors file what is known as an involuntary Chapter 7 bankruptcy petition, which seeks to have a Chapter 7 trustee appointed to liquidate all of the non-exempt assets of the debtor. Pursuant to § 303 of the Bankruptcy Code, for the creditor of a debtor to place the debtor into involuntary bankruptcy, they must hold claims aggregating at least $14,475 that are neither contingent, unliquidated, nor subject to a bona fide dispute.[5] Once the involuntary bankruptcy petition is filed, the putative debtor has twenty-one days after service of the summons within which to either contest the petition or voluntarily convert to a bankruptcy proceeding under Chapter 11 of the Bankruptcy Code. This would allow the debtor to reorganize its affairs without necessarily having to liquidate assets.[6] The voluntary conversion to a Chapter 11 is more typically seen in corporate cases than individual cases, but individuals are allowed to seek protection through Chapter 11 as well.[7] Filing an involuntary bankruptcy petition is not without risk, however, as the Bankruptcy Code allows the court to award costs and fees if the involuntary petition is dismissed,[8] and can even award punitive damages if the involuntary petition was filed in bad faith.[9]

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[2] *See* Tex. Prop. Code Ann. § 42.001 *et seq*.
[3] *See* Cal. Civ. Proc. Code § 704.730(a)(1) (West). The amount increases to $175,000 if the homeowner is sixty-five years of age or older or is mentally or physically disabled. *Id*. at § 704.730(a)(3).
[4] *See id.* §§ 704.010 *et seq*.
[5] 11 U.S.C. § 303(b) (2006).
[6] FED. R. BANKR. P. 1011(b).
[7] *See* 11 U.S.C. §§ 109, 1115.
[8] Upon the dismissal of the involuntary petition, the presumption arises in favor of the debtor for costs and fees, and the burden to rebut is on the petitioning creditors based on the totality of the circumstances. *In re Maple-Whitworth*, 556 F.3d 742 *opinion corrected sub nom. In re Maple-Whitworth, Inc.*, 559 F.3d 917 (9th Cir. 2009). *See also In re S. California Sunbelt Developers, Inc.*, 608 F.3d 456 (9th Cir. 2010) (punitive damages of $130,000 awarded against petitioning creditors for bad-faith filing).
[9] *See* 11 U.S.C. § 303(i).

§ 303(b) Litigation: The Bona Fide Dispute Debate

The most litigated element in § 303(b) is the "not subject to a bona fide dispute" provision. While this provision has been the subject of substantial litigation over the years, a new, very interesting wrinkle has occurred with respect to this provision. In a recent case, the Ninth Circuit Court of Appeals essentially held that if state court judgment creditors had claims on appeal that were not stayed by means of a court order or supersedeas bond (described below), they were sufficiently non-contingent, liquidated, and therefore not subject to bona fide dispute so as to allow them to proceed with the involuntary bankruptcy proceeding against the debtor. In state court litigation, when the losing party wants to avoid execution on a judgment, they have to post a bond in the amount of the judgment plus a specified amount of interest to prevent execution. This is often a decisive factor in whether to appeal or seek bankruptcy protection.

In *In re Marciano* (Marciano I), the court upheld the petitioning creditor's involuntary bankruptcy, notwithstanding the fact that state court judgments obtained were under appeal in the state court system.[10] The court granted the petitioner's motion for summary judgment regarding the propriety of the filing and denied the debtor's motion to dismiss the involuntary petition. More interestingly, the state court judgments that were obtained by the petitioning creditors were default judgments, as a result of the debtor's pleadings being struck by the state court judge due to alleged acts of discovery abuse and violation of court orders. The primary focus of both the bankruptcy court and the appellate courts reviewing and ruling upon the decision focused on the fact that the judgments were all unstayed and fully enforceable under state law. Because of the substantial amount of the judgments, the debtor was unable to post a supersedeas bond or take other action to stay enforcement and/or execution of such judgments. The court held that the petitioning creditors' unstayed judgments constituted *prima facie* evidence that no bona fide dispute existed as to their claims against the debtor.[11]

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[10] *In re Marciano*, 446 B.R. 407 (Bankr. C.D. Cal. 2010) *aff'd*, 459 B.R. 27 (B.A.P. 9th Cir. 2011) *aff'd*, 708 F.3d 1123 (9th Cir. 2013).
[11] *Id*. at 422 (citing *In re Byrd*, 357 F.3d 433, 438 (4th Cir. 2004)).

In his appeal to the Bankruptcy Appellate Panel, Marciano argued for a different interpretation of *Byrd* than that of the bankruptcy court. In *Byrd*, the Fourth Circuit held that the "not the subject of bona fide dispute" element of 11 U.S.C. § 303 precluded the retention of the involuntary bankruptcy petition because an enforceable judgment can remain subject to bona fide dispute. In *Marciano I*, the court rejected the *Byrd* analysis and instead applied the reasoning of the US Bankruptcy Court for the Southern District of New York. *In re Drexler* held in part:[12]

> A claim based upon an unstayed judgment as to which an appeal has been taken by the debtor is not the subject of bona fide dispute. Once entered, an unstayed final judgment may be enforced in accordance with its terms and with applicable law or rules, even though an appeal is pending. The filing of an involuntary petition is but one of many means by which a judgment creditor may seek to attempt collection of something upon its judgment…
>
> It would be contrary to basic principles respecting, and would effect a radical alteration of, the long-standing enforceability of unstayed final judgments to hold that the dependency of the debtor's appeal created a "bona fide dispute" within the meaning of Code § 303. (Internal citations omitted.)[13]

By adopting the *Drexler* approach, the bankruptcy court in Marciano I concluded that the petitioning creditors had established each of the elements in 11 U.S.C. § 303 and entered a motion for summary judgment order granting the order for relief.[14]

Both the summary judgment order and the order for relief ended by the bankruptcy court were then affirmed by the Bankruptcy Appellate Panel. After undertaking its own review relating to issues involving § 303(b)(1) of the Bankruptcy Code, the panel also concluded that the unstayed state court

[12] *In re Drexler*, 56 B.R. 960, 967 (Bankr. S.D.N.Y. 1986).
[13] *In re Marciano*, 446 B.R. at 422.
[14] *Id.*

judgments were in and of themselves not subject to bona fide dispute for purposes of determining creditor eligibility under § 303(b)(1). The Bankruptcy Appellate Panel followed the Delaware Bankruptcy Court holding in *In re Amc Investors, L.L.C.*, which held that a claim based upon a judgment, in the absence of a stay, is not subject to a bona fide dispute for purposes of determining whether a petitioning creditor is eligible to commence an involuntary petition.[15] They held that for purposes of § 303(b), a bona fide dispute requires an objective basis for citing a factual or a legal dispute as to the validation of the debt.[16] The panel also relied upon the Tenth Circuit Bankruptcy Appellate Panel decision in *C.W. Mining Co. v. Aquila, Inc.* (*In re C.W. Mining Co.*) (which followed the *AMC* case).[17]

In a very expansive and impassioned dissent, Judge Markel set forth numerous reasons why the involuntary bankruptcy should not have been sustained, and how allowing the petitioning creditors to proceed while the underlying state court judgments were on appeal effectively allowed the creditors to make an "end run" around the very clear provisions of § 303. Judge Markel found that both *Drexler* and *AMC* disregarded the plain meaning of § 303(b)'s term "bona fide dispute." He focused on the need to look at a term's ordinary meaning in accord with the Supreme Court's holdings in *Ransom v. FIA Card Servs., N.A.* and *Hamilton v. Lanning.*[18]

Further, he held that if Congress meant to exclude unstayed judgments on appeal from the category of claims subject to bona fide dispute, it is their sole prerogative to do so.[19] Alternatively, by allowing state court creditors with unstayed judgments on appeal to proceed, such creditors would be strongly encouraged to seek involuntary bankruptcy prior to the state court judgments running their due course through the appellate process. Not only are they encouraged to do so, but their attorneys are almost required to recommend the involuntary bankruptcy strategy to force a liquidation of the debtor's assets in such circumstances. Additionally, allowing involuntary

[15] *In re AMC Investors, LLC*, 406 B.R. 478, 481 (Bankr. D. Del. 2009).
[16] *In re Vortex Fishing Sys., Inc.*, 277 F.3d 1057, 1064 (9th Cir. 2001).
[17] *In re C.W. Mining Co.*, 431 B.R. 307 (B.A.P. 10th Cir. 2009).
[18] *Ransom v. FIA Card Servs., N.A.*, 131 S. Ct. 716, 724 (2011); *Hamilton v. Lanning*, 130 S. Ct. 2464, 2471 (2010).
[19] *Lamie v. U.S. Tr.*, 540 U.S. 526, 528 (2004).

petitions against individuals may raise serious constitutional issues,[20] by forcing an individual to reorganize his affairs against his will.

The controversial Bankruptcy Appellate Panel decision was then itself appealed to the Ninth Circuit Court of Appeals in *In re Marciano*, which affirmed the decisions of the bankruptcy court and Bankruptcy Appellate Panel.[21] They rejected the *Byrd* holding and concluded that the *Drexler* rule was correct as a matter of both statutory interpretation and federalism. In yet another controversial 2-to-1 decision, Judge Ikuta, in a very lengthy and passionate descent, reiterated many of the points made by Judge Markel and raised serious concerns about the future interpretations and applications of § 303(b)(1).

To more fully analyze the issues raised in the *Marciano* and *Byrd* opinions, it is necessary to focus on the purpose of a judgment under state law. In *Marciano I*, the court held that under California law, the state court judgments in the absence of a stay pending appeal were not contingent as to liability or amount, and that the petitioning creditors were entitled to immediate payment of those claims in the amount set by the supersedeas court judgments.[22] The Ninth Circuit then determined that the petitioning creditors had fully vested property interests in these claims under California law.[23]

The courts then determined whether the application of an objective standard to evaluate whether there was an objective basis for either a factual or legal dispute as to the validity of the debt for purposes of determining a petitioning creditor's eligibility under § 303(b)(1) might change the analysis.[24] In a very surprising conclusion, the court stated that it was difficult to imagine a more "objective" measure of the validity of the claim than an unstayed judgment entered by a court of competent jurisdiction.[25] In my opinion, this conclusion misses the mark by assuming that a

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[20] *See* Margaret Howard, *Bankruptcy Bondage*, 2009 U. ILL. L. REV. 191; Erwin Chemerinsky, *Constitutional Issues Posed in the Bankruptcy Abuse and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 571, 586-88 (2005).
[21] *In re Marciano*, 708 F.3d 1123 (9th Cir. 2013).
[22] *See* Cal. Civ. Proc. Code § 917.1(a)(1) (1986).
[23] *Butner v. United States*, 440 U.S. 48, 55 (1979) (noting the property interests for bankruptcy proceeding purposes are typically defined by state law).
[24] *See Vortex supra* n. 15.
[25] *Id*. at 1128.

judgment debtor's inability to post supersedeas bonds in excess of $100,000,000 somehow validates the underlying judgment. This type of analysis and conclusion merely creates a rift between those debtors that can afford to post supersedeas bonds and stay execution of state court judgments and those that cannot. Congress did not intend to create this kind of result when it enacted the provisions of § 303. In this regard, as the Tenth Circuit Court of Appeals held in *Bartmann v. Maverick Tube Corp.*, the court must determine whether a bona fide dispute exists and a creditor is thus qualified under § 303(b) as of the date of filing of the involuntary petition.[26] Accordingly, if the decision of the Tenth Circuit is literally construed to mean that regardless of whether the validity of the judgment may be questioned and reversed in the future, then unstayed state court judgments as of the date of filing can never be subject to a bona fide dispute and the process must end there. This reasoning again seems to be inconsistent with one's appellate rights in the state court system, and the need for the involuntary petition to be truly a last resort for creditors where no relief can be obtained at the end of the day in state court.

In addition to the cases discussed hereinabove, there are a few other recent cases of import involving the definition of the "bona fide dispute" element under § 303(b)(1). *In re Hicks* involved an involuntary petition filed against an individual by five different banks from which the debtor had borrowed several million dollars to finance various real estate projects.[27] After the debtor defaulted, each of the banks exercised its respective state law remedies and foreclosed on the properties pledged as security for the loans. All of the foreclosure sales consummated prior to the bankruptcy filing resulted in deficiency balances, which became the basis for the banks' claims against the debtor. As of the bankruptcy filing, the validity and the amount of the deficiency claims were all the subject of state court litigation. After a trial on the merits, the bankruptcy court determined that none of the banks' claims were the subject of a bona fide dispute. Recognizing that the Bankruptcy Code fails to define "bona fide dispute," the bankruptcy court relied on the Sixth Circuit Bankruptcy Appellate Panel decision in *Mktg. & Creative Solutions, Inc. v. Scripps Howard Broad. Co.*, which outlined the generally accepted definition that "a claim is

[26] *Bartmann v. Maverick Tube Corp.*, 853 F.2d 1540, 1544 (10th Cir. 1988).
[27] *In re Hicks*, 11-32263, 2011 WL 6000861 (Bankr. E.D. Tenn. Nov. 30, 2011).

subject to a bona fide dispute, '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.'"[28] The Tennessee Bankruptcy Court made it clear that its duty was not to resolve any issues of material fact or law, but instead to simply identify the existence of any such issues. In determining whether a claim is subject to a legitimate dispute of law, the court may be required, and is permitted, to conduct a cursory analysis of the legal issues to ascertain whether an objective legal basis for the dispute exists. In determining that the claims were not the subject of a bona fide dispute, the bankruptcy court held that even though the deficiency claims were the subject of state court litigation, the banks' various claims were not the subject of a bona fide dispute vis-à-vis § 303(a). According to the court's holding, it is not enough for the claim to be simply the subject of litigation; such litigation must be evaluated further to determine whether a legitimate question exists about the application of the law to the undisputed facts presented.

In *In re Vicor Technologies, Inc.*, the court relied upon the Seventh Circuit Court of Appeals opinion in *In re Busick* to apply what is now the majority standard of utilizing an objective basis to determine whether a factual or legal dispute exists as to the validity of the debt.[29] The *Vicor* court went through an exhaustive analysis regarding the pre-2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) law and the amendments to § 303(b)(1) effected through the enactment of BAPCPA.[30] In what is an increasingly common pattern, the debtor asserted a potential counterclaim against the creditor, but the court found that such fact does not in and of itself create a bona fide dispute. Further, because each of the petitioning creditors in the *Vicor* case held multiple claims, it was not a disqualifying event that some of the claims may be subject to a bona fide dispute if others were not. Put alternatively, if at least some of the claims asserted by the petitioning creditors are not subject to a bona fide dispute, and the remaining elements of § 303(b) are met, the involuntary petition may be proper.

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[28] *In re Mktg. & Creative Solutions, Inc.*, 338 B.R. 300, 305 (B.A.P. 6th Cir. 2006).
[29] *In re Vicor Technologies, Inc.*, 12-39329-EPK, 2013 WL 1397460 (Bankr. S.D. Fla. Apr. 5, 2013); *Matter of Busick*, 831 F.2d 745, 750 (7th Cir. 1987).
[30] Pub. L. No. 109-8, 119 Stat. 23 (2005).

Approaches for Advising Clients

As discussed in the beginning of this chapter, involuntary bankruptcy has become a more common tool in the last several years for creditors to try to satisfy claims or judgments they hold. In light of the Ninth Circuit holding in the *Marciano* case, practitioners who represent clients who have unstayed state court judgments face a very difficult dilemma: do you advise the client to place the debtor into involuntary bankruptcy to enhance the possibility of collecting on the judgment where there are non-exempt assets available, or do you avoid the possibility of having sanctions imposed under § 303(i) if, for some reason, the court finds that any of the three criteria for filing the involuntary bankruptcy petition has not been met? My suggestion in handling this dilemma is to clearly advise the client in writing of the current state of the law with regard to involuntary bankruptcy as well as the statutory pitfall if the involuntary bankruptcy case is dismissed. In addition, an extremely useful tool I have used several times in the past with regard to involuntary bankruptcy petitions is to write the debtor (or its counsel if applicable) in advance of the involuntary bankruptcy petition, advising them that your client has claims or judgments in excess of the statutory threshold, that you understand the claim or judgment to not be disputed, contingent, or unliquidated, and that you are not aware of any other facts that would negate the ability to file an involuntary bankruptcy petition (such as not having a sufficient number of creditor/petitioning creditors.) This type of "safe harbor" letter will almost always protect the petitioning creditors from any finding of bad faith and would limit their exposure in the event the involuntary bankruptcy petition is dismissed to the actual costs and fees incurred by the involuntary debtor in defending the involuntary bankruptcy petition. I have also found throughout the years that if you do not act precipitously, make every effort possible to engage the debtor and its counsel regarding the satisfaction of judgments, and undertake appropriate and thorough due diligence with respect to the debtor's status (such as undertaking UCC-1 lien searches and real property record searches in the appropriate counties), the odds of success and the probability of unnecessary expense and sanctions is greatly magnified.

Conclusion

In conclusion, based upon the trends in the lower courts and the Ninth Circuit's ruling in *Marciano*, a state court judgment debtor is essentially

required to obtain a stay pending appeal to prevent an involuntary bankruptcy from being filed against them. Conversely, a practitioner representing the creditors in this scenario is almost required to recommend this course of action to avoid potential claims of malpractice. In light of the fact that there is a split amongst the circuits on this issue, there at least exists the possibility that the Supreme Court will address the issue head-on and provide clarity as to the definition of the term "bona fide dispute." In the meantime, those practitioners not in the Ninth and Fourth Circuits must carefully weigh their options, especially given the bad-faith filing provisions set forth in 11 U.S.C. § 303(i).

Key Takeaways

- Each court has interpreted § 303 differently in regards to the bona fide dispute—make sure to explain the pitfalls and issues to your client before making a decision so they are well aware of the risks involved in all sides.
- If representing a creditor, writing a "safe harbor" letter to the debtor can negate any claims of bad faith that the debtor may allege in the future.
- In a case where the petitioning creditors are asserting multiple claims, an involuntary petition may still be proper as long as some claims are not subject to a bona fide dispute and the remaining elements of § 303(b) are met.
- If you represent a debtor that has a large judgment that cannot be bonded around, you must advise and prepare them that an involuntary bankruptcy is possible and that simply appealing the state court judgment will not fully protect or exonerate them.

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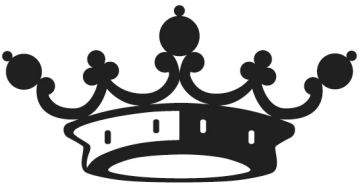

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