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Creditors' Standing To File Involuntary Petitions

by Scott Bernstein, Hunton & Williams LLP, New York

During the past year, there has been anecdotal evidence of a marked increase in the filing of involuntary bankruptcy petitions, such as those brought against Ponzi-schemer Bernie Madoff and lawyer Marc Drier.

The question that is raised is whether an unstayed final judgment that is subject to a pending appeal constitutes a claim that is subject to a bona fide dispute for the purpose of filing an involuntary petition. A recent decision by the U.S. Bankruptcy Court for the District of Delaware highlights the significance of this question.

Involuntary Bankruptcy Petitions

There are a number of reasons why creditors file involuntary bankruptcy petitions. A debtor may, for example, be transferring assets to a related or successor company, or might only be paying debts that have been guaranteed by or owed to insiders.

There might be concerns a debtor is about to file for bankruptcy in a geographically remote location, making it cost-prohibitive for creditors to participate in a voluntary bankruptcy proceeding.

Creditors may also seek the appointment of a Chapter 7 trustee who will possess the authority to investigate and, if appropriate, pursue claims against the officers and directors of the alleged debtor.

A debtor may be subject to an involuntary bankruptcy petition when: (i) it is generally not paying its undisputed debts as they become due, or (ii) if within a period of 120 days leading up to the filing of the petition a custodian, other than a trustee, receiver, or agent appointed or authorized to take charge of less than substantially all of the property of the debtor for the purpose of enforcing a lien against such property, was appointed or took possession. See 11 U.S.C. § 303(h).

Unlike in a voluntary bankruptcy filing, the court does not automatically enter an order for relief in an involuntary bankruptcy. It does so only if the alleged debtor does not controvert the involuntary position in a timely manner, or fails to mount a successful defense in a hearing on the merits.

If an order of relief is granted, the full protections of the Bankruptcy Code go into effect. In the event that a Chapter 7 order of relief is entered, the debtor's management is put out of possession and an unbiased disinterested trustee is appointed with a mandate to liquidate the debtor's assets, including causes of action, for the benefit of all creditors.

If an involuntary petition is dismissed, the bankruptcy court has the authority to enter a judgment against the petitioning creditors for the debtor's costs, attorneys' fees and any damages caused by a bad faith filing. See 11 U.S.C. § 303(i).

Debate Over What Constitutes a Bona Fide Dispute

Pursuant to section 303 of the Bankruptcy Code, an involuntary petition under Chapter 7 or 11 may be filed against any individual, partnership or corporation (with limited exceptions) by three or more petitioning creditors, each of whom holds at least one claim against the debtor that is not contingent to liability or subject to a bona fide dispute, and such claims must total at least $13,475 more than the value of any lien on the debtor's property that secures such claims. See 11 U.S.C. § 303(b)(1).

However, when a debtor has fewer than 12 creditors, then any one petitioning creditor may file an involuntary petition if it holds a claim in the amount of at least $13,475. See 11 U.S.C. § 303(b)(2).

While these requirements are relatively straight forward, there has been much debate over when a claim is subject to a bona fide dispute.

The Bankruptcy Code does not define bona fide dispute. Generally, courts agree that one exists if there is 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.

Under this standard, the bankruptcy court must determine whether there is an objective basis to ascertain the existence of a dispute.

In In re AMC Investors, LLC, Case No. 08-12264 (CSS), 2009 Bankr. LEXIS 1281 (Bankr. D. Del. June 5, 2009), the bankruptcy court was faced with the question of whether the sole petitioning creditor who held a judgment claim that was subject to an unstayed appeal was eligible to commence two involuntary cases.

In early 2003, Eugenia VI Venture Holdings Ltd. extended credit pursuant to an agreement secured by AMC Computer Corp.'s working capital and each of the alleged debtors executed an unconditional guaranty of AMC Computer's obligations to Eugenia under the credit agreement.

By May 2005, AMC Computer was insolvent and its board of directors voted to cease operations and approved an assignment for the benefit of creditors.

In response, Eugenia declared a default under the credit agreement, accelerated the outstanding obligations under the credit agreement, and demanded repayment both from AMC Computer and the two alleged debtors under the guarantees.

Eugenia filed suit against the alleged debtors in the New York Supreme Court to collect on the guarantees. The trial court entered summary judgment in favor of Eugenia and the appellate court affirmed the entry of summary judgment on liability, but remanded for a trial on the amount of the judgment.

The trial court held a two-day bench trial and entered a judgment in favor of Eugenia in the aggregate amount of approximately $10.75 million, which consisted of principal and interest, accounting fees, professional fees and expenses, and costs and disbursements.

The alleged debtors appealed only the portion of the judgment awarding professional fees, but did not obtain a stay of the judgment pending appeal. Prior to oral argument before the appellate court, Eugenia filed involuntary petitions against the alleged debtors who did not contest the allegations that they each had less than twelve creditors and were generally not paying their debts as they became due.

The purpose of the bankruptcy filing was to bring about the appointment of a Chapter 7 trustee to pursue litigation claims against the alleged debtors' officers and directors, if appropriate.

The involuntary debtors filed motions to dismiss on the basis, among other things, that Eugenia was not an eligible petitioning creditor because its unstayed judgment was on appeal.

As an initial matter, the AMC court recognized judicial division over the question of whether an unstayed judgment on appeal is subject to a bona fide dispute. As explained by the Delaware bankruptcy court, the majority of courts that have addressed this issue have held that an unstayed final judgment that is on appeal is not subject to a bona fide dispute.

The rationale behind the majority rule is that:

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 the basic principles respecting, and would effect a radical alternation of, the long-standing enforceability of unstayed final judgments to hold that the pendency of the debtor's appeal created a 'bona fide dispute' within the meaning of Code § 303.

In re AMC Investors, LLC, Case No. 08-12264 (CSS), 2009 Bankr. LEXIS 1281 at * 12 (quoting In re Drexler, 56 B.R. 960, 967 (Bankr. S.D.N.Y 1986)).

However, a minority of courts have held that it is possible for a creditor's claim to still be subject to a bona fide dispute when it possess an unstayed judgment on appeal.

For example, the Fourth Circuit Court of Appeals has held that a "creditor ... may not reduce its claim to judgment ... and then automatically seek enforcement in bankruptcy, at least where the judgment to be enforced is pending an appeal that presents substantial factual or legal questions." Platinum Fin. Servs. Corp. v. Byrd (In re Byrd), 357 F.3d 433, 438 (4th Cir. 2004).

The rationale behind this ruling is that a judgment does not guarantee the lack of a bond fide dispute in the absence of rulings by appellate courts or in the face of contrary rulings by other trial courts.

The Circuit Court put the burden of establishing the existence of a bona fide dispute on the alleged debtor and required evidence beyond the testimony of the appellant in the action to establish the existence of a bona fide dispute. See id. at 438-39.

The AMC court squarely rejected the minority ruling for three reasons.

First, the minority approach undermines the objective analysis of bona fide disputes by turning the bankruptcy court into an “odds maker” on appellate decision-making by requiring an examination of a trial court’s ruling.

Second, to hold that an unstayed final judgment is enforceable in trial courts and voluntary proceedings in bankruptcy court, but not in involuntary bankruptcy cases, runs contrary to the enforceability of unstayed final judgments. See In re AMC Investors, LLC, Case No. 08-12264 (CSS), 2009 Bankr. LEXIS 1281 at * 14.

Third, it clashes with the bankruptcy principle that in the absence of a specific federal interest to the contrary, bankruptcy courts take non-bankruptcy laws and rights as they find them.

The Fourth Circuit identified the purpose of the “bona fide dispute” provision as being “to prevent creditors from using involuntary bankruptcy to coerce a debtor to satisfy a judgment even when substantial questions may remain concerning the liability of the debtor.” Platinum Fin. Servs. Corp. v. Byrd (In re Byrd), 357 F.3d at 438.

However, the AMC court did not find a federal interest because non-bankruptcy courts allow judgment creditors to use an array of “state court enforcement procedures” to coerce payment while unstayed judgments are subject to appeal and there is no identifiable bankruptcy provision requiring a different result. In re AMC Investors, LLC, Case No. 08-12264 (CSS), 2009 Bankr. LEXIS 1281 at * 17.

As a result, the AMC court held that the existence of a judgment by a court that has not been stayed pending appeal, in and of itself, is sufficient to establish that the claim underlying the judgment is not in bona fide dispute for purposes of determining whether a petitioning creditor is eligible to commence an involuntary case.[1]

Accordingly, the AMC court entered the order for relief against the two alleged debtors, who were not generally paying their debts as they become due, because Eugenia was the holder of a non-contingent, liquidated claim in the amount of approximately $10.7 million, which exceeds the threshold amount of $13,475. See id. at * 21.

The AMC decision is significant because it removes an incentive for a debtor that is domiciled or conducting business in Delaware to appeal every judgment that is entered against it in an effort to prevent the filing of an involuntary petition in that jurisdiction.

Moreover, it eliminates a considerable disincentive for a judgment creditor deciding whether to file an involuntary petition based on an unstayed judgment that is subject to an appeal by removing the potential for the incurrence of attorneys’ fees and costs, that may be substantial, that would result from having to re-litigate the merits of its judgment before the bankruptcy court.

[1] The AMC court left for another day the applicability of this ruling to unstayed judgments on appeal that involve default judgments, which may present factual questions different than those before the court and by their very nature do not involve decisions on the merits. See id. at * fn 27, * 19.