Involuntary Bankruptcy Petitions - Use With Caution

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On October 16, 2015, the United States Court of Appeals for the Third Circuit, in *In re: Forever Green Athletic Fields, Inc.,* held that an involuntary bankruptcy petition filed under 11 U.S.C. §303 may be dismissed for being filed in bad faith even though the petitioning creditors met all of the required criteria for filing the petition. The *Forever Green* decision gives creditors another factor to consider before filing an involuntary petition, and gives debtors another means to oppose involuntary filings. Ultimately, the *Forever Green* decision provides yet another reason why filing an involuntary petition may not be a good collection tool for creditors, and could expose creditors to damages.

Involuntary Bankruptcy Petition requirements

Under §303 of the Bankruptcy Code, creditors can file an involuntary bankruptcy petition under either Chapter 7 or 11 against a debtor who has more than 12 creditors if they meet three criteria:

1. there must be three or more petitioning creditors,
2. each petitioning creditor must hold a claim against the debtor that is neither contingent as to liability or the subject of a bona fide dispute, and
3. the claims must aggregate at least $15,325 more than the value of any liens held with respect to the debtor's property.

If the petitioning creditors meet the threshold criteria and the court determines, after an evidentiary hearing, that the debtor is not generally paying its debts as they become due, the court will enter an order for relief and the bankruptcy case will proceed just as if a voluntary petition had been filed.

Creditors should know, however, that there is a significant caveat to this simple test. Pursuant to §303(i)(2) of the Code, if the court dismisses an involuntary petition after a determination that it was filed in bad faith, the court may impose sanctions on the petitioning creditors. This provision forms the basis for the decision in *Forever Green.*

The Facts

The involuntary petition against Forever Green Athletic Fields, Inc., an installer of athletic fields, arose out of a dispute between Charles C. Dawson and his wife Kelli Dawson, on the one hand, and Keith Day, the founder of Forever Green, on the other. Charles Dawson had been an employee of Forever Green, but went out on his own and started a competing business (Pro Green). Dawson and his wife sued Forever Green for unpaid commissions and wages that were due to him when he left Forever Green. In March 2011, after years of litigation, a consent judgment was entered in Louisiana in favor of the Dawsons.

While the Dawsons' litigation was pending in Louisiana, Forever Green filed a complaint against Pro Green in Bucks County, Pennsylvania for $5,000,000 seeking damages for the diversion of corporate assets. The parties to the Bucks County action agreed to arbitrate the dispute, but several weeks after the consent judgment was entered in Louisiana, the Dawsons terminated the arbitration and used their judgment to levy on the deposit paid to the arbitrator by Forever Green. To counter the termination of the arbitration, Forever Green filed a complaint in the Philadelphia Court of Common Pleas to reinstate the arbitration. Shortly thereafter, the Dawsons

and a law firm that was owed several hundred thousand dollars filed an involuntary Chapter 7 petition against Forever Green. Mr. Dawson made it clear that he was going to use whatever means were available to collect the judgment against Forever Green.

It was not disputed that the petitioning creditors, Charles Dawson, Kelli Dawson and the law firm met the §303(b) criteria. Further, it was undisputed that Forever Green was not paying its debts as they came due. Accordingly, it would seem like this was a textbook involuntary petition and the order for relief should be entered. Unfortunately for the Dawsons, the bankruptcy court felt otherwise.

The Bankruptcy Court Ruling

Forever Green defended the involuntary petition by claiming that it should be dismissed because it had been filed in bad faith. The bankruptcy court agreed. After an evidentiary hearing, the bankruptcy court dismissed the involuntary petition reasoning that because bankruptcy courts are courts of equity, anyone who files a bankruptcy petition, whether voluntary or involuntary, must come to the court for a proper purpose. Because involuntary Chapter 7 proceedings are intended to protect creditors from debtors who are making preferential payments or otherwise dissipating assets, the bankruptcy court determined that creditors who file involuntary petitions purely for debt collection purposes or to gain advantage in litigation are acting in bad faith. Accordingly, and despite the fact that the petitioning creditors otherwise met the statutory requirements of §303, the bankruptcy court dismissed the case.

The Appeal

On appeal, the district court agreed and the Dawsons further appealed to the Third Circuit. The Dawsons' primary argument was fairly simple. They reasoned that since they met all of the §303(b)(1) criteria, there could be no finding of bad faith requiring dismissal. The Third Circuit disagreed, affirming the bankruptcy and district courts.

In its opinion, the appeals court addressed three issues:

1. whether an involuntary petition may be dismissed as a bad faith filing,
2. whether the bankruptcy court erred in its finding of bad faith, and
3. whether the joinder of creditors acting in good faith could have prevented the dismissal.

With respect to the first issue, the Third Circuit agreed with the bankruptcy court's analysis saying ". . . [M]eeting the §303(b)(1) criteria, like pleading a *prima facie* case in many actions is just the first hurdle. It does not bear on other defenses that support dismissal. In other words, if the three filing requirements are not satisfied, we agree the bankruptcy court *must* dismiss the case; but if the three requirements are satisfied, that doesn't mean that the bankruptcy court *can't* dismiss the case." *Forever Green, supra* (emphasis added). In supporting this position, the *Forever Green* court further stated "We see no reason why the code would permit the imposition of damages (including punitive damages) for bad-faith filings but not allow the same conduct – such as using involuntary bankruptcy as a litigation tactic in pending proceedings – to provide a basis for dismissing the petition."

The court then went on to review the record and determined that, based on Mr. Dawson's stated reasons for filing the petition, the bankruptcy court had not abused its discretion in dismissing the case. Then, with respect to the third issue, the Third Circuit essentially punted. While it acknowledged that there was potential for an issue had other creditors, acting in good faith, joined the petition prior to its dismissal, in fact none had. Since no additional creditors joined the petition, the court reasoned that it did not need to determine whether or not the addition of new petitioning creditors would have saved it.

Implications

The bottom line is that in the Third Circuit creditors must clearly and carefully examine their motives before filing an involuntary petition. Involuntary petitions may still serve a legitimate purpose – where the purported debtor is suspected of transferring assets or preferring other creditors – but using an involuntary petition for an improper purpose – such as attempting to gain an advantage in pending litigation – may have significant consequences.

Members of White and Williams LLP's Financial Restructuring and Bankruptcy Practice Group regularly represent debtors and secured and unsecured creditors in commercial bankruptcy and collection matters both in and out of court. Please contact Tom Pinney (215.864.6371; pinneyt@whiteandwilliams.com) with any questions regarding involuntary bankruptcy petitions or any other commercial bankruptcy matter.