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Petitioning Creditors Beware

A Bad Faith Filing Can Sink an Involuntary Bankruptcy Petition

Involuntary bankruptcy filings have historically, under the right circumstances, been a potent tool for trade and other unsecured creditors. However, the grounds for dismissing an involuntary bankruptcy petition have recently been broadened, raising the bar for creditors seeking relief.

The U.S. Court of Appeals for the Third Circuit, in *In re Forever Green Athletic Fields, Inc.*, upheld the dismissal of an involuntary bankruptcy proceeding that was filed in bad faith. It did not matter that the petitioning creditors had satisfied all of the requirements contained in Bankruptcy Code Section 303 for obtaining relief on an involuntary petition. Complicating matters further, the Third Circuit adopted a very fact specific “totality of the circumstances” test to determine whether the petitioning creditors had filed the involuntary petition in bad faith, which will likely lead to additional expensive litigation over what constitutes bad faith.

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Although not discussed in detail in the decision, a dismissal of an involuntary petition, particularly on bad faith grounds, can result in significant damage claims against the petitioning creditors. Bankruptcy Code Section 303(i) allows a debtor to seek damages against the petitioning creditors for the debtor’s costs and/or reasonable attorneys’ fees incurred in pursuing the dismissal of the involuntary petition, and, if the petition is dismissed on bad faith grounds, the debtor could also obtain an award of its actual and punitive damages.

The Third Circuit’s decision will likely further discourage creditors from joining in the filing of an involuntary bankruptcy petition. Trade creditors should, therefore, continue to proceed with extreme caution when considering whether to participate in an involuntary bankruptcy filing.

Grounds for Filing an Involuntary Bankruptcy Petition

Section 303 of the Bankruptcy Code sets forth the requirements that must be satisfied to obtain relief on an



involuntary bankruptcy petition. If a debtor has 12 or more creditors, a minimum of three creditors holding unsecured claims totaling at least \$15,325—that are not contingent or the subject of a *bona fide* dispute as to liability or amount—must join in the filing of the involuntary bankruptcy petition. The petitioning creditors must also prove that the debtor is generally not paying its debts that are not otherwise subject to a *bona fide* dispute as to liability or amount, as such debts become due.

Facts

Forever Green Athletic Fields (“Forever Green”), founded by Keith Day, sold artificial turf playing fields. In 2005, Forever Green sued a competitor, ProGreen, in a Pennsylvania state court for \$5 million, alleging the diversion of corporate assets (the “Bucks County Action”). Charles Dawson was the owner of ProGreen. Dawson was also a former sales representative employed by Forever Green. Dawson would have been personally liable for any damages awarded to Forever Green in the Bucks County Action.

Also in 2005, Dawson and his wife (the “Dawsons”) sued Forever Green in Louisiana for unpaid commissions and wages (the “Louisiana Action”). In March of 2012, the Louisiana state court entered a consent judgment exceeding \$300,000 in the Dawsons’ favor and against Forever Green. Forever Green never made any payments on account of the consent judgment.

Meanwhile, Forever Green and ProGreen had agreed to arbitrate their claims pending in the Bucks County Action. However, ProGreen subsequently filed a motion to terminate the arbitration alleging that Forever Green was insolvent and Day could not or would not pay the arbitrator’s fees and expenses. In addition, the Dawsons

claimed that any amounts Forever Green and Day had previously paid to the arbitrator were subject to execution and garnishment for payment of the unsatisfied consent judgment.

The Dawsons transferred their judgment in the Louisiana Action to Pennsylvania and obtained a writ of execution against the arbitrator and his law firm to assist ProGreen's efforts to terminate the arbitration. The arbitrator responded by indefinitely suspending the arbitration proceedings until it could be determined whether the Dawsons were entitled to Forever Green's and Day's previous payments made to the arbitrator. Dawson testified in a deposition that he had intended to use the consent judgment against Forever Green to seize all of Forever Green's assets he could locate, including the payments the arbitrator had received.

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Forever Green then filed a complaint in state court (the "Philadelphia Action") to reinstate the arbitration proceedings. Forever Green claimed in the Philadelphia Action that Dawson had threatened to file an involuntary bankruptcy proceeding against Forever Green if it did not agree to terminate the arbitration. After commencing the Philadelphia Action, counsel for the Dawsons also sent Forever Green a letter stating that the arbitration would be suspended indefinitely until the consent judgment was paid off.

The Dawsons never participated in the Philadelphia Action. Instead, consistent with Dawson's threats, the Dawsons and a law firm named Cohen Seglias Pallas Greenhall & Furman ("Cohen Seglias") filed an involuntary Chapter 7 bankruptcy case against Forever Green. Dawson testified that the petitioning creditors chose this route because their counsel suggested that it was the best way to seize Forever Green's assets.

Forever Green then filed a motion to dismiss the involuntary filing as a bad faith filing. The Bankruptcy Court dismissed the involuntary petition after determining that it was a bad faith filing. The U.S. District Court for the District of Delaware affirmed the Bankruptcy Court's decision. The Dawsons, without Cohen Seglias, subsequently appealed the District Court's ruling to the U.S. Court of Appeals for the Third Circuit.

The Third Circuit's Decision

The Third Circuit first held that an involuntary petition may be dismissed as a bad faith filing even where the petitioning creditors had satisfied all of Bankruptcy Code Section 303's requirements for an involuntary bankruptcy filing. The court characterized Section 303 as just the first hurdle that petitioning creditors must satisfy to obtain relief on their involuntary petition. A debtor could still invoke the petitioning creditors'

bad faith as an additional ground for dismissing an involuntary petition.

The Third Circuit then relied on a single reference to bad faith in Section 303 to support its holding that Congress had intended for bad faith to serve as both a basis for dismissal of an involuntary petition and also for a subsequent damage claim the debtor could assert against the petitioning creditors after the dismissal of the petition. It would not make sense for the Bankruptcy Code to authorize an award of damages (including punitive damages) for bad-faith filings, but not also permit a court to consider the petitioning creditors' bad faith (e.g., using an involuntary bankruptcy petition as a collection tool) when determining whether to dismiss an involuntary petition in the first instance.

The Third Circuit also noted that bankruptcy courts are courts of equity and that the good faith filing requirements for voluntary and involuntary bankruptcy filings are, therefore, strongly rooted in equity. Petitioning creditors should be discouraged from joining in the filing of an involuntary bankruptcy petition for an improper purpose, particularly in light of the severe harm that a debtor usually sustains from an involuntary bankruptcy filing. In that light, invoking a bad faith filing as an additional ground for dismissing an involuntary bankruptcy petition should encourage creditors to act properly in deciding whether to join an involuntary petition. Applying these principles to uphold the dismissal of the involuntary petition in the *Forever Green* case, the Third Circuit ruled that Dawson had acted in bad faith by seeking to use the bankruptcy court to gain a personal advantage in collecting his claim.

The Third Circuit adopted the "totality of the circumstances" standard in determining what constitutes a bad faith filing.¹ That standard requires consideration of numerous factors when determining whether an involuntary petition was filed in bad faith. These factors include whether: (i) the creditors satisfied the statutory requirements for filing an involuntary petition, (ii) the involuntary petition was meritorious, (iii) the creditors conducted a reasonable inquiry into the relevant facts and law that justified the involuntary bankruptcy filing against the debtor, (iv) there was evidence of preferential payments to certain creditors and/or a dissipation of the debtor's assets, (v) the filing was motivated by ill will against, or a desire to harass, the debtor, (vi) the petitioning creditors used the filing to obtain a disproportionate advantage for themselves instead of discouraging other creditors from doing the same, (vii) the filing was used as a tactical advantage in a pending action, (viii) the filing was used as a substitute for customary debt-collection procedures, and (ix) the timing of the filing was suspicious.

The Third Circuit applied these factors to conclude that the Dawsons had filed their involuntary petition in bad faith. Prior to filing the petition, Dawson admitted that he had intended to use all means at his disposal to obtain payment of the consent judgment entered in the Louisiana Action and dismissal of Forever Green's claims against ProGreen in the Bucks

County Action. The court found that Dawson's efforts to collect the consent judgment were contrary to the spirit of collective creditor action that is supposed to be at the core of an involuntary bankruptcy proceeding. Instead, Dawson put his interests in collecting the consent judgment above the interests of all other creditors by obstructing the arbitration and Forever Green's efforts to pursue its largest asset, Forever Green's claims against Pro Green alleged in the Bucks County Action, the recoveries from which would have been used to pay Forever Green's creditors. Dawson also improperly threatened the filing of an involuntary bankruptcy petition.

The Third Circuit also did not find any evidence that Dawson had engaged in the customary due diligence that should generally precede an involuntary bankruptcy filing. In fact, the timing of the filing was extremely suspicious, just days before Dawson's response brief was due in the Philadelphia Action. Further, there was no evidence that Forever Green was making preferential payments to creditors or that Forever Green's assets were being depleted. To the contrary, despite Dawson's efforts, Forever Green was doing everything in its power to pursue its largest asset, its litigation against ProGreen, for the benefit of all of its creditors.

The Third Circuit's holding that an involuntary petition could be dismissed based on a bad faith filing is not universally accepted. Other courts have held that bad faith is not an independent ground to dismiss an involuntary bankruptcy petition. They reasoned that Bankruptcy Code Section 303 contains the sole criteria that must be satisfied to obtain relief on an involuntary petition. In addition, Section 303 only discusses bad faith in the context of damages after dismissal of an involuntary petition. If Congress wished to include bad faith as an independent ground for dismissing an involuntary petition, it would have modified Section 303 to add this as an additional ground for dismissal.

An involuntary petition may be dismissed as a bad faith filing even where the petitioning creditors had satisfied all of Bankruptcy Code Section 303's requirements.

Conclusion

The Third Circuit's holding that an involuntary petition can be dismissed as a bad faith filing should serve as a further warning to trade creditors of the risks of participating in an involuntary bankruptcy proceeding and the need to conduct appropriate due diligence to ensure that all of the requirements for an involuntary bankruptcy filing have been met. The court's adoption of a "totality of the circumstances" test when analyzing bad faith will make it very difficult for a petitioning creditor to know in advance whether its conduct rises to the level of bad faith. This uncertainty as to what constitutes a bad faith filing, when combined with having to confirm that the other petitioning creditors have joined in the filing of the

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involuntary petition for a proper purpose, may add to trade creditors' concerns about the risk of participating in an involuntary petition and discourage their participation even when it is justified. ■

1. Other courts have applied several alternative tests to determine what constitutes bad faith. Unlike the extremely subjective and unpredictable "totality of the circumstances" test adopted by the Third Circuit, the alternative tests provide petitioning creditors with more predictability as to whether an involuntary petition was filed in bad faith.

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