



Involuntary Bankruptcy Petition Risk: Dismissal Can Be Costly to Petitioning Creditors

Under the right circumstances, an involuntary bankruptcy filing can be a powerful tool for trade and other unsecured creditors attempting to obtain a recovery on their claims. However, creditors rarely resort to filing an involuntary bankruptcy petition due to the risk of significant liability if the petition is dismissed.

The ruling of the U.S. Court of Appeals for the Eleventh Circuit, in *In re Maury Rosenberg*, illustrates the potential magnitude of the exposure petitioning creditors face if their quest to prosecute an involuntary bankruptcy petition is unsuccessful and the petition is ultimately dismissed. The court held that a debtor's recovery in successfully defeating an involuntary petition is not limited to the debtor's attorneys' fees and costs incurred in the bankruptcy court. Instead, the debtor's recovery can also include the attorneys' fees and costs incurred in connection with: (a) any appeal from the bankruptcy court's dismissal of the involuntary petition, (b) the debtor's claims for its actual and punitive damages arising from a bad faith filing of the involuntary petition and (c) collecting the aforementioned fees.

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The Eleventh Circuit's holding only governs federal courts in Alabama, Florida and Georgia. It also runs counter to a decision by the U.S. Court of Appeals for the Ninth Circuit that limited a debtor's right to recovery, after dismissal of an involuntary petition, to only the fees incurred at the bankruptcy court level to obtain the dismissal. However, the Eleventh Circuit's holding serves as a warning to petitioning creditors that seek to appeal a bankruptcy court's dismissal of their involuntary bankruptcy petition. They are at risk of having to pay: (i) the debtor's fees incurred in fighting for dismissal of the involuntary petition both in the bankruptcy



and appellate courts, (ii) potential actual and punitive damage claims if the court finds the involuntary petition was filed in bad faith and (iii) the fees and costs incurred to collect such fees.

Grounds for Filing an Involuntary Bankruptcy Petition

Section 303 of the Bankruptcy Code includes the requirements that must be satisfied to file an involuntary bankruptcy petition. If a debtor has 12 or more creditors, at least three creditors holding unsecured claims totaling at a minimum \$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 an involuntary bankruptcy petition. On the other hand, if the debtor has fewer than 12 otherwise eligible unsecured creditors, excluding any employee or insider or any recipient of a voidable transfer, such as a preference or fraudulent transfer, then one such unsecured creditor with a claim of at least \$15,325 that is not contingent or the subject of a *bona fide* dispute as to liability or amount can file an involuntary bankruptcy petition.

If the debtor contests the involuntary petition, the petitioning creditors must also prove, as a prerequisite to being granted relief on the involuntary petition, 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. Courts considering whether a debtor is not paying its debts as they mature have relied on a number of factors, including, but not limited to: (i) the number of debts, (ii) the degree of delinquency, (iii) the materiality of non-payment by

the debtor, (iv) the total debt compared to the debtor's annual income, (v) whether the debtor is not paying only the petitioning creditors' claims and (vi) whether the debtor has terminated its business and started liquidating its assets.

Once the petitioning creditors satisfy all of the requirements in Bankruptcy Code §303, the bankruptcy court will grant relief on an involuntary bankruptcy petition and enter an order for relief. If, however, the petitioning creditors cannot satisfy all of the requirements necessary to obtain relief on a contested involuntary petition, which happened in the *In re Maury Rosenberg* case, the involuntary petition will be dismissed.

Upon dismissal of an involuntary petition, Bankruptcy Code §303(i)(1) permits the court to grant judgment against the petitioning creditors and in favor of the debtor for the debtor's costs and/or reasonable attorneys' fees incurred in fighting the involuntary petition unless (i) all of the petitioning creditors and the debtor consent to the dismissal, and (ii) the debtor has not waived its right to obtain a judgment under Bankruptcy Code §303. Bankruptcy Code §303(i)(1) is silent as to whether this relief applies only to costs and attorneys' fees incurred at the bankruptcy court level or whether it also applies to costs and fees incurred at the appellate court level. In the most egregious situations, Bankruptcy Code §303(i)(2) provides that when an involuntary petition is filed in bad faith, a court may grant judgment in the debtor's favor against the petitioning creditors for damages proximately caused by the filing or possibly punitive damages.

Congress intended that the potential risk of a large damage claim against the petitioning creditors would dissuade creditors from filing a frivolous involuntary bankruptcy petition. Such awards are included in the Bankruptcy Code to compensate a debtor for the serious potential harm that it could suffer on account of an improperly filed involuntary petition.

Facts and Procedural History

On Nov. 7, 2008, DVI Receivables XIV and five affiliates (the "petitioning creditors") filed an involuntary Chapter 7 petition against Maury Rosenberg ("Rosenberg") in the U.S. Bankruptcy Court for the Eastern District of Pennsylvania. The petitioning creditors' claims were based on Rosenberg's limited guaranty purportedly in their favor in connection with certain medical equipment leases issued to DVI Financial Services Inc.¹ by certain partnerships controlled by Rosenberg. Rosenberg opposed the involuntary petition, arguing that his guaranty did not run in favor of the petitioning creditors and they, therefore, had no claims against him.

The Bankruptcy Court dismissed the involuntary petition, ruling that Rosenberg's guaranty did, in fact, not run in favor of the petitioning creditors. As a result, the petitioning creditors did not have standing to file the petition. Thereafter, Rosenberg filed an adversary proceeding (the "adversary proceeding") against the petitioning creditors² in the bankruptcy court to recover his fees and costs incurred: (1) seeking

dismissal of the involuntary petition in the Bankruptcy Court, (2) sustaining dismissal of the petition in the District Court and in the Eleventh Circuit, (3) prosecuting his claims for actual and punitive damages based on the petitioners' bad faith filing of the involuntary petition under Bankruptcy Code §303(i)(2)³ and (4) recovering the aforementioned three categories of fees, otherwise referred to as "fees on fees."

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The Bankruptcy Court's Bench Trial

The Bankruptcy Court held a bench trial on the four categories of attorneys' fees that Rosenberg sought to recover. The court concluded that it had authority to award Rosenberg the fees and costs he had incurred in connection with both the dismissal of the involuntary petition in the Bankruptcy Court and defending the appeals of the dismissal of the involuntary petition in the District Court and the Eleventh Circuit. The court rejected the petitioning creditors' argument that Rosenberg was barred from recovering appellate fees as contrary to the legislative intent behind Bankruptcy Code §303(i). Likewise, the Bankruptcy Court ruled that it could award the fees that Rosenberg had incurred to date in connection with prosecuting the bad faith claims for damages under §303(i)(2), although the proceeding was still pending.

The Bankruptcy Court held that the petitioning creditors were liable for more than \$1 million of Rosenberg's attorneys' fees and costs.⁴ The petitioning creditors appealed this award to the District Court. They argued that Rosenberg was not entitled to recover any fees in connection with the appeal from the Bankruptcy Court's order dismissing the involuntary petition, the prosecution of any claims for damages arising from a bad faith filing and the fees incurred by Rosenberg to recover these fees.⁵

The District Court's Decision

On Sep. 24, 2013, the District Court entered an order affirming the Bankruptcy Court's order for three reasons. First, the Bankruptcy Court had correctly held that Rosenberg was entitled to reimbursement of his fees incurred in fighting dismissal of the involuntary petition in the appellate courts as well as the Bankruptcy Court. The court also ruled that the attorneys' fees Rosenberg had incurred prosecuting his bad faith damages claim under Bankruptcy Code §303(i)(2) against the petitioning creditors are recoverable under Bankruptcy Code §303(i)(1). Finally, the court upheld the Bankruptcy Court's award of "fees on fees" under §303(i)(1). The petitioning creditors next appealed to the Eleventh Circuit.

The Eleventh Circuit's Decision

The Eleventh Circuit held that the Bankruptcy Court had authority to require the petitioning creditors to reimburse Rosenberg for all of his fees and costs incurred in sustaining a dismissal of the involuntary petition on appeal⁶. The court observed that there are only two preconditions for a discretionary award of fees and costs under Bankruptcy Code §303(i)(1): (1) dismissal of an involuntary petition other than on consent of the debtor and petitioning creditors and (2) the debtor's refusal to waive his right to judgment. Bankruptcy Code §303(i)(1) also does not include any provision limiting the recovery of attorneys' fees and costs to those incurred in the bankruptcy court or to the fees incurred prior to dismissal of an involuntary petition.

The Eleventh Circuit then ruled that under §303(i)(1), Rosenberg was entitled to recover attorneys' fees and costs incurred to prosecute his claims for damages arising from the petitioning creditors' bad faith filing under Bankruptcy Code §303(i)(2). The court harmonized Bankruptcy Code §303(i)(1) and §303(i)(2), reading them together instead of regarding the sections as exclusive of each other. As such, an award of attorneys' fees under Bankruptcy Code §303(i)(1) applies to all phases of a Bankruptcy Code §303 action, including the dismissal of the petition and the fees and costs associated with an action to seek damages for a bad faith filing.⁷ As a result, Bankruptcy Code §303(i)(1) also authorizes the debtor's recovery of attorneys' fees and costs in connection with the prosecution of bad faith claims under Bankruptcy Code §303(i)(2).⁸

Trade and other general unsecured creditors considering joining in filing an involuntary bankruptcy petition against a deadbeat customer must first do their diligence and be mindful of the risks of an unsuccessful involuntary petition.

In rendering its decision, the Eleventh Circuit recognized, but disagreed with, the Ninth Circuit Court of Appeals' earlier decision, in *Higgins v. Vortex Fishing Systems, Inc.*, that fees incurred in connection with the dismissal of an involuntary bankruptcy petition at the appellate level (before either the district court or the circuit court of appeals) could not be awarded by a bankruptcy court. Instead, such fees could only be awarded by an appellate court pursuant to Rule 38 of the Federal Rules of Appellate Procedure ("Rule 38")⁹ governing frivolous appeals. The Ninth Circuit reasoned that Bankruptcy Code §303(i)(1)'s express authorization for the bankruptcy court to award fees that a debtor had incurred seeking dismissal of an involuntary petition in the bankruptcy court does not also necessarily grant the bankruptcy court the authority to award the debtor's fees incurred to uphold dismissal of the involuntary petition at the appellate level. Interestingly, the Ninth Circuit recognized that its holding created a discrepancy that only Congress could remedy, as Congress clearly

intended to allow a debtor to recover its attorneys' fees and costs if an involuntary petition was dismissed.

Contrary to the Ninth Circuit's decision, the Eleventh Circuit focused on how Bankruptcy Code §303(i)(1), unlike Rule 38, does not include a requirement that the petitioning creditors acted in bad faith¹⁰ as a prerequisite to awarding attorneys' fees and costs. Instead, the only precondition in Bankruptcy Code §303(i)(1) is the nonconsensual dismissal of an involuntary bankruptcy petition. In addition, the Eleventh Circuit stressed that Bankruptcy Code §303(i)(1) does not include any provisions limiting recovery of only attorneys' fees and costs incurred in the bankruptcy court, and it was, therefore, improper to read such a limitation into the statute. Bankruptcy Code §303(i)(1) is designed to compensate debtors who successfully defended against and obtained a dismissal of an involuntary bankruptcy petition. This right does not end at the bankruptcy court level and includes fees the debtor incurred at the appellate level. The Eleventh Circuit also relied on the distinction between provisions authorizing sanctions, like Rule 11 of the Federal Rules of Civil Procedure, where appellate fees cannot be awarded, and fee-shifting provisions, like Bankruptcy Code §303(i)(1), where appellate fees and costs are recoverable.

Conclusion

Trade and other general unsecured creditors considering joining in the filing of an involuntary bankruptcy petition against a deadbeat customer must first do their diligence and be mindful of the risks of an unsuccessful involuntary petition. The Eleventh Circuit's decision in the Rosenberg case is a cautionary tale about what can happen if sufficient diligence is not done, an involuntary petition is dismissed and the petitioning creditors are unsuccessful in their appeal of such dismissal. The petitioners could be responsible for a debtor's attorneys' fees and costs associated with the dismissal of the petition, not just at the bankruptcy court level, but also in the appellate courts. In addition, in the most egregious situations, the petitioners could also be liable for large compensatory and punitive damage claims that a debtor asserts based on a bad faith filing, together with the debtor's fees and costs related to prosecuting these claims and recovering such fees and costs.

Small wonder that so few creditors decide to join in filing an involuntary bankruptcy petition. Creditors should proceed very cautiously and do their homework to make sure that all of the requirements of an involuntary bankruptcy petition are satisfied prior to joining in the filing of the petition. Otherwise, the creditors could end up facing severe financial penalties! ■

1. DVI Financial Services, Inc. was an affiliate of the petitioning creditors, but was not a party in this case due to its own bankruptcy filing.

2. Other third parties related to the petitioning creditors were named as defendants in the adversary proceeding, but they are not relevant to this article.

3. During the trial, the petitioning creditors argued that it was

premature to consider whether the fees incurred in prosecuting the bad faith claims were appropriate because, at the time, Rosenberg's Bankruptcy Code §303(i)(2) damage claims were still pending in the District Court.

4. The Bankruptcy Court also reserved the right to award additional fees and costs once the bad faith action was concluded.

5. The District Court entered a final judgment in favor of Rosenberg, holding that the petitioning creditors were liable for \$360,000 in compensatory damages for emotional distress as a result of the bad faith filing under §303(i)(2).

6. The Eleventh Circuit noted that the petitioning creditors did not challenge the award of Rosenberg's attorneys' fees incurred in obtaining the dismissal of the involuntary petition in the Bankruptcy Court or the fees incurred by Rosenberg to recover those fees.

7. If the provisions were read exclusively, the award of attorneys' fees under Bankruptcy Code §303(i)(1) would apply only to the dismissal phase of the involuntary case (at trial before the bankruptcy court and on appeal), but not to the subsequent phase of prosecuting bad faith claims under Bankruptcy Code §303(i)(2). According to this interpretation, the sole remedy with respect to this subsequent stage would be the potential award of compensatory and punitive damages.

8. The Eleventh Circuit vacated the limited portion of the fee and cost award attributable to the attorneys' fees and costs incurred by Rosenberg to prosecute the bad faith claims. The court determined that this award was premature because the bad faith litigation was still pending when the award was rendered and ordered the lower courts to consider these fees at a future juncture.

9. Rule 38 in its entirety states "If a court of appeals determines that an appeal is frivolous, it may, after a separately filed motion or notice from the court and reasonable opportunity to respond, award just damages and single or double costs to the appellee."

10. The Eleventh Circuit was explaining the frivolity requirement in Rule 38 in terms of bad faith.

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