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Petitioning Creditor Eligibility to Join an Involuntary Bankruptcy Petition

A trade creditor considering whether to join in the filing of an involuntary bankruptcy petition must first consider its eligibility to act as a petitioning creditor. Section 303 of the Bankruptcy Code, which governs involuntary bankruptcy petitions, conditions a creditor's eligibility to join in the petition on the creditor's claim not being subject to *bona fide* dispute as to liability or amount.

The U.S. Court of Appeals for the First Circuit (the "First Circuit"), in *Fustolo v. 50 Thomas Patton Drive, LLC* (the "*Fustolo Case*"), had to determine whether one of the petitioning creditors was eligible to join an involuntary petition where its claim was based on a judgment, the amount of which was unquestionably incorrect, and which was subject to an *unstayed* appeal. The issue before the court was whether the creditor's judgment claim was subject to a *bona fide* dispute as to liability or amount where the debtor had disputed only a portion of the judgment claim.

The First Circuit ruled that the petitioning creditor was eligible to participate in the involuntary bankruptcy filing where a portion of the creditor's judgment claim, based on discrete claims consisting of guaranteed obligations, was not subject to a *bona fide* dispute as to liability or amount. Unfortunately, the court confused matters by rejecting a bright line rule that would permit an otherwise eligible creditor with a partially disputed



involuntary petition it had joined is dismissed because its partially disputed claim is determined to be subject to a *bona fide* dispute.

Grounds for an Involuntary Bankruptcy Petition

Section 303 of the Bankruptcy Code contains the requirements for obtaining relief on an involuntary bankruptcy petition. Where the debtor has 12 or more creditors, at least three creditors holding unsecured claims totaling at least \$15,325 (or \$15,775 for cases filed on or after April 1, 2016) that are not contingent as to liability or the subject of a *bona fide* dispute as to liability or amount, must join in the filing of the involuntary bankruptcy petition.¹ What constitutes a "*bona fide* dispute" as to the amount of a petitioning creditor's claim that would disqualify the petitioning creditor and risk dismissal of the involuntary petition was the precise issue that the First Circuit addressed in the *Fustolo* case.

If the debtor contests the involuntary petition, the petitioning creditors also have the burden of proving that the debtor is generally not paying its debts, 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 debts as they become due have relied on various factors including: (a) the number of debts; (b) the amount of delinquency; (c) the materiality of non-payment by the debtor; (d) the total debt compared to the debtor's annual income; (e) the debtor's nonpayment of only the petitioning creditors' claims; and (f) whether the debtor has terminated its business and started liquidating its assets.

When the petitioners have satisfied all of the requirements of Section 303, the court will enter an order for

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claim to automatically participate in an involuntary petition. The court opened this door by declining to read a materiality requirement into Bankruptcy Code Section 303's *bona fide* dispute as to liability or amount language, which could mean that even a claim that is only partially disputed could be subject to a *bona fide* dispute.

This confusion might further discourage creditors from joining in an involuntary bankruptcy petition. The justifiable fear is that a petitioning creditor could be subject to the risk of being sanctioned where the

relief on the involuntary bankruptcy petition. The creditors can then assert an administrative priority claim for the fees they incurred in prosecuting the petition.

If the petitioning creditors cannot satisfy all of the prerequisites for relief on a contested involuntary bankruptcy petition, the bankruptcy court will dismiss the petition. Dismissal of an involuntary petition poses many risks for the unsuccessful petitioning creditors. The debtor could assert a broad range of damage claims, arising under Bankruptcy Code Section 303(i), following dismissal of the petition. These claims are designed to compensate the debtor for the serious harm that an improperly filed involuntary petition may cause and to also discourage petitioning creditors from joining a frivolous involuntary bankruptcy petition. The bankruptcy court could require the payment of the debtor's reasonable attorneys' and other professional fees and other costs incurred in contesting the petition. The court could also award the debtor compensatory damages for its actual losses incurred as a result of the filing of the petition, and even punitive damages, if the court finds that the petitioning creditors had acted in bad faith in filing the petition.

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Facts and Procedural History

Steven Fustolo ("Fustolo") and certain companies he owned were involved in the real estate business. 50 Thomas Patton Drive, LLC ("Patton Drive") held claims against Fustolo arising from four promissory notes issued by companies affiliated with Fustolo (the "Fustolo Companies") in favor of Patton Drive. Fustolo had personally guaranteed two of those notes (the "Guaranteed Notes"). The Guaranteed Notes totaled \$1.25 million and the two unguaranteed notes totaled \$1.5 million (the "Unguaranteed Notes").

After the Fustolo Companies defaulted on their obligations, Patton Drive sued them and Fustolo—on account of his personal guarantee—in a state court in Massachusetts. The state court determined that Fustolo was liable for breach of contract and rejected his argument for a reduction of the interest due under the notes based on Patton Drive's technical violation of a Massachusetts' state usury statute. The state court entered a final judgment in the approximate amount of \$6.76 million in favor of Patton Drive and against Fustolo (the "State Court Judgment").

Fustolo argued that the State Court Judgment was overstated by approximately \$4 million because he was personally liable only under the Guaranteed Notes, while the total amount of the judgment included the amount due on both the Guaranteed Notes and Unguaranteed Notes. Patton Drive did not contest Fustolo's assertion. Fustolo appealed the State Court Judgment on this and other grounds, but did not take any action to either stay the enforceability of the judgment or prosecute the appeal.

If the petitioning creditors cannot satisfy all of the prerequisites for relief on a contested involuntary bankruptcy petition, the bankruptcy court will dismiss the petition.

On May 6, 2013, more than eighteen months after the entry of the State Court Judgment, Patton Drive, along with The Patriot Group LLC ("Patriot") and Richard Mayer ("Mayer"), two of Fustolo's other creditors, filed an involuntary Chapter 7 petition against Fustolo in the United States Bankruptcy Court for the District of Massachusetts (the "Bankruptcy Court"). Fustolo did not dispute that Patriot and Mayer qualified as petitioning creditors. However, Fustolo disputed Patton Drive's eligibility to join in the petition because its judgment claim was subject to a "*bona fide* dispute as to liability or amount."

The Bankruptcy Court's and District Court's Decisions

After an evidentiary hearing before the Bankruptcy Court, Patton Drive, Patriot and Mayer (collectively, the "Petitioning Creditors") moved for summary judgment on the involuntary petition. Fustolo opposed the summary judgment motion, claiming that Patton Drive's claim was subject to *bona fide* dispute as to liability or amount because the State Court Judgment was subject to a pending appeal.

The Bankruptcy Court granted the Petitioning Creditors' summary judgment motion, and entered an order for relief on the involuntary bankruptcy petition. The Bankruptcy Court held that Patton Drive's claim based on the Guaranteed Notes was not subject to *bona fide* dispute as to liability or amount. The only *bona fide* dispute concerned the portion of the State Court Judgment based on the Unguaranteed Notes, which did not justify disqualifying Patton Drive as a petitioning creditor.

Fustolo then appealed the Bankruptcy Court's holding to the United States District Court for the District of Massachusetts (the "District Court"). The District Court upheld Patton Drive's eligibility as a petitioning creditor, but on a different ground. The District Court held that an *unstayed* state court judgment subject to an appeal is never the subject of a *bona fide* dispute.

Fustolo then appealed to the First Circuit.

The First Circuit's Decision

The First Circuit held that Patton Drive's claim was not subject to a *bona fide* dispute, but on different grounds than the Bankruptcy Court and the District Court had relied upon in reaching their respective holdings. Initially, the court noted that the State Court Judgment was stayed by operation of Massachusetts law as a result of the pending appeal. As a result, the State Court Judgment was not categorically insulated from being subject to *bona fide* dispute.

The First Circuit also noted that it should give deference to the State Court Judgment in determining whether Patton Drive's claim was subject to *bona fide* dispute because the state court had already considered and adjudicated the merits of Patton Drive's claims and entered judgment against Fustolo. However, the First Circuit acknowledged that the judgment was incorrect because it held Fustolo personally liable on notes that he had not guaranteed. Even Patton Drive conceded the error by remaining silent on the issue. This created a *bona fide* dispute as to how much Patton Drive was entitled to be paid on account of the judgment.

These claims are designed to compensate the debtor for the serious harm that an improperly filed involuntary petition may cause.

However, Fustolo admittedly owed at least \$1.25 million in principal on account of the Guaranteed Notes. Patton Drive argued for eligibility as a petitioning creditor based on the undisputed amount owed under the Guaranteed Notes. Patton Drive sought to ignore the disputed portion of the State Court Judgment because the amount that Fustolo admittedly owed to Patton Drive exceeded the amount necessary to make Patton Drive's claim eligible to participate in the involuntary petition.

The First Circuit rejected Patton Drive's argument as an inappropriate attempt to read an implicit materiality requirement into determining the existence of a "*bona fide* dispute as to liability or amount." However, the court still upheld Patton Drive's eligibility as a petitioning creditor because its claim for \$2.7 million due on the Guaranteed Notes was not subject to a *bona fide* dispute. The court relied on Fustolo's concession that he owed principal of \$1.25 million on the two notes that he had guaranteed. The court also concluded that Patton Drive's undisputed \$2.7 million claim included interest based on the Massachusetts state court's determination that Patton Drive was entitled to full payment of interest on the Guaranteed Notes, despite a technical violation of the Massachusetts usury statute.

Conclusion

While the First Circuit reached the correct holding that the undisputed portion of Patton Drive's stayed judgment claim was not subject to a "*bona fide* dispute as to liability or amount," the court's analysis was unnecessarily confusing.

The First Circuit acknowledged that the judgment was incorrect because it held Fustolo personally liable on notes that he had not guaranteed.

The court created this by refusing to simply adopt a bright line rule that would allow petitioning creditors whose claims are partially disputed, but are otherwise eligible, to join in filing an involuntary petition. The court's ruling could have a chilling effect on creditors' willingness to participate in an otherwise justified involuntary petition due to the potential liability that a petitioning creditor might face if the petition is dismissed as a result of its disqualification based on its partially disputed claim. ■

1. Where the debtor has fewer than 12 otherwise eligible unsecured creditors, excluding any employee or insider and any recipient of a voidable transfer, such as a preference or fraudulent conveyance, then one such unsecured creditor, with a claim of at least \$15,325 (or \$15,775 for cases filed on or after April 1, 2016), that is not subject to *bona fide* dispute as to liability or amount, can file an involuntary bankruptcy petition.

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