

# Are Creditors With Partially Disputed Claims Eligible to Join an Involuntary Bankruptcy Petition? Yes and No!



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Trade and other unsecured creditors concerned about a debtor's nonpayment of their claims may consider joining an involuntary bankruptcy petition against that debtor. However, a petitioning creditor's eligibility to join in an involuntary bankruptcy is conditioned on its claim not being subject to a *bona fide* dispute.

The meaning of "*bona fide* dispute" has long been the subject of controversy. One of the more recently litigated issues over the meaning of *bona fide* dispute is whether a creditor's partially disputed claim is subject to a *bona fide* dispute that would disqualify the creditor from joining an involuntary petition.

Some courts, like the United States Bankruptcy Court for the Central District of California, in *In re QDOS, Inc. (QDOS)*, have disqualified a petitioning creditor with a partially disputed claim, holding that the claim is subject to a *bona fide* dispute. Other courts, like the United States Bankruptcy Court in Utah, in *In re General Aeronautics Corporation (General Aeronautics)*, have ruled partially disputed claims are not subject to *bona fide* dispute, and therefore creditors holding partially disputed claims are not barred from being petitioning creditors.

## Grounds for an Involuntary Bankruptcy Petition

Section 303 of the Bankruptcy Code imposes two requirements on petitioning creditors seeking relief on an involuntary bankruptcy petition. First, Section 303(b)(1),

which was at issue in the *QDOS* and *General Aeronautics* cases, states that if a debtor has 12 or more creditors, at least three creditors holding unsecured claims that total, in the aggregate, at least \$15,775 and are not contingent as to liability or the subject of a *bona fide* dispute *as to liability or amount* must join in filing an involuntary petition. Second, Section 303(h)(1) requires petitioning creditors to 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 they become due.

Prior to 2005, most courts had ruled that a dispute as to a portion of a creditor's claim did not give rise to a "*bona fide* dispute" that disqualified the creditor from seeking involuntary bankruptcy relief. This rule was based on Congress' stated intent that the purpose of Section 303(b)(1)'s limitation was "to prevent creditors from using involuntary bankruptcy as a club to coerce a debtor to pay debts as to which the debtor, in good faith, had legitimate defenses."

The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") amendments to the Bankruptcy Code changed Section 303(b)(1) to require that petitioning creditors' claims cannot be subject to a *bona fide* dispute "*as to liability or amount*." This change has prompted courts to question the eligibility of petitioning creditors whose claims are partially disputed and has led to conflicting court rulings. Some courts have concluded that BAPCPA substantively changed Section

303(b)(1) such that any partially disputed claim should be considered subject to a *bona fide* dispute regardless of how small the disputed portion of the claim. Other courts have viewed the BAPCPA's amendment of Section 303(b)(1) as merely clarifying prior legislative intent to focus primarily on liability issues and not preclude creditors whose claims are partially disputed from seeking involuntary bankruptcy relief.

It is worth noting that a bankruptcy court's decision not to grant relief on an involuntary petition poses great risks for petitioning creditors. When the petitioning creditors have satisfied all of Section 303's requirements, the court will enter an order for relief on their involuntary bankruptcy petition. The petitioning creditors can then assert an administrative priority claim for the fees they incurred prosecuting the petition.

However, a debtor that successfully contests and obtains dismissal of an involuntary bankruptcy petition can assert a broad range of damage claims against the petitioning creditors. These claims, set forth in Bankruptcy Code Section 303(i), are designed to compensate a debtor for the serious harm that an improperly filed involuntary petition may cause and discourage petitioning creditors from joining a frivolous involuntary bankruptcy petition. The bankruptcy court could require the petitioning creditors to pay a debtor's reasonable attorneys' and other professional fees and the 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 involuntary filing, and in the most egregious cases, punitive damages, if the court finds that the petitioning creditors had acted in bad faith.

## Facts and Procedural History

### (a) *In re QDOS, Inc.*

QDOS, Inc. dba Direct Sports Network ("QDOS") is a digital media company which distributes sports programming with a focus on team-produced content. QDOS obtained capital through debt and equity funding.

On May 31, 2018, three creditors of QDOS filed an involuntary Chapter 11 petition against QDOS. QDOS responded by

moving to dismiss the involuntary petition, in part by challenging the standing of one of the petitioning creditors, Felice Terrigno ("Terrigno"), for failing to satisfy Section 303(b)(1). In advance of a hearing scheduled on August 8, 2018, the bankruptcy court published a tentative ruling granting QDOS's motion to dismiss the involuntary petition, disqualifying Terrigno—and, therefore, finding there were less than the requisite three petitioning creditors needed to support the involuntary petition. Shortly thereafter, and prior to the hearing date, an additional creditor, Jim Maddox, filed a joinder to the involuntary petition.

The bankruptcy court continued the hearing to August 10, 2018, and directed the petitioning creditors to appear personally and present evidence of their claims. When three of the petitioning creditors stated they were unavailable on August 10, the bankruptcy court again continued the evidentiary hearing to September 10, 2018. Following Terrigno's and Maddox's failure to appear at the September hearing, the bankruptcy court further continued the hearing to October 17, 2018, and ordered that it would strike all declarations by a petitioning creditor that failed to appear at that hearing. Maddox again failed to appear at the October hearing. In an attempt to remedy his prospective failure to appear on the hearing date, Maddox filed a proof of claim on September 26, 2018, alleging he was owed no less than \$220,000 for principal and interest on a prepetition loan to QDOS. QDOS asserted the loan was usurious, challenging Maddox's right to collect interest (but not his right to collect the principal owed). Maddox's standing as a petitioning creditor, based on whether his partially disputed claim was subject to *bona fide* dispute, was at issue in the QDOS case.

### (b) *In re General Aeronautics Corporation*

General Aeronautics Corporation and a predecessor entity (collectively, "GAC") were unsuccessful at building and marketing gyroplanes for over 30 years. GAC never progressed beyond the developmental stages for most of the aircraft it was developing and had never brought any aircraft to market that had generated any meaningful revenue. As a result, GAC

suffered liquidity problems during most of its existence.

By April 2015, GAC had only \$205 in its bank account and many of GAC's employees either had resigned or were laid off. In late 2016, GAC received approximately \$5 million in additional funding. However GAC's CEO and board of directors were deadlocked over the use of these funds. In January, 2017, GAC's board of directors ousted the CEO based on their disagreement with the CEO's insistence on using a portion of the funds to repay GAC's prior debts instead of funding the development of a new prototype gyroplane. GAC then proceeded to largely ignore paying many of its unpaid debts.

On September 28, 2017, six of GAC's creditors—who had claims against GAC for unpaid rent, unpaid compensation and unpaid loans made to the company—filed an involuntary bankruptcy petition against GAC in the United States Bankruptcy Court for the Central District of California. On June 25, 2018, three additional creditors joined in the involuntary petition.

GAC filed a motion to dismiss the involuntary bankruptcy case. GAC argued that the petitioning creditors had lacked standing to prosecute the involuntary petition under Section 303(b)(1) because their partially disputed claims were subject to *bona fide* dispute. The petitioning creditors argued that they had standing to join the involuntary petition under Section 303(b)(1) because GAC was disputing only a portion of their claims, and they had satisfied Section 303(b)(1) because the undisputed portions of their claims exceeded the minimum statutory threshold.

## The Courts' Decisions

### (a) *In re QDOS, Inc.*

The bankruptcy court first addressed QDOS' disputes concerning the claims of Terrigno and Maddox. The court ruled that Terrigno was not a qualified petitioning creditor because his \$60,000 investment in QDOS was not a loan/claim, as Terrigno had asserted, but was actually an equity interest based on Terrigno's purchase of QDOS' common stock.

There was no dispute that Maddox was a creditor of QDOS based on the loan he had made to QDOS and the promissory note that QDOS had executed in his favor. The issue in the *QDOS* case was whether Maddox's claim was subject to a *bona fide* dispute under Section 303(b)(1) that would have disqualified Maddox as a petitioning creditor. QDOS argued that Maddox's claim was subject to *bona fide* dispute because Maddox's loan was usurious and applicable state (California) law had barred Maddox from collecting the interest he was charging QDOS. The petitioning creditors asserted that even if Maddox's loan was usurious, Maddox was still entitled to payment of the principal portion of his claim and the undisputed part of his claim was not subject to *bona fide* dispute.

The QDOS court rejected the petitioning creditors' argument and held that Maddox's claim was subject to *bona fide* dispute as to the amount of the claim and disqualified Maddox as a petitioning creditor. The court noted that Section 303(b)(1)'s reference to disputes as to both "liability and amount" has a clear meaning. A debtor that disputes a claim as to liability is disputing the entire amount of the claim. However, a debtor disputing a claim as to amount is disputing only part of the claim. In either circumstance, the category of dispute falls within the scope of a *bona fide* dispute under a strict reading of Section 303(b)(1). The court observed that any contrary ruling would render redundant Section 303(b)(1)'s inclusion of the word, "amount," because "amount" would effectively mean the same thing as "liability."

In addition, the court relied on Section 303's legislative history, asserting that Congress had intended to disqualify petitioning creditors whose claims are disputed as to either liability or amount. The court also stated that a dispute over any part of the claim is a dispute as to the amount of the claim.

The court then offered an example of a creditor sending an invoice in the amount of \$1,000 to a debtor. As the court observed, if the debtor responded to that invoice by asserting it owes only \$600 to the creditor, "it would be palpably false to state under

these circumstances that the invoice is not in dispute."

The court dismissed the involuntary bankruptcy petition because two of the four petitioning creditors, Terrigno and Maddox, lacked standing to be petitioning creditors under Section 303. That left only two qualified petitioning creditors—short of the three-creditor requirement under Section 303. The court then scheduled a hearing to determine whether the petitioning creditors should pay QDOS's legal fees and costs in connection with the failed involuntary filing. However, the disqualified petitioners have filed a notice of appeal to the Ninth Circuit's Bankruptcy Appellate Panel, which remains pending.

Also, recently, the United States District Court for the District of Nevada, in *State of Montana Department of Revenue v. Blixseth* (the "*Blixseth* Court"), reached the same holding as the QDOS court. The *Blixseth* Court upheld the dismissal of an involuntary petition after disqualifying two petitioning creditors whose partially disputed claims were found to be subject to a *bona fide* dispute as to amount.

The *Blixseth* Court noted that Section 303(b)(1) does not qualify its requirement that a petitioning creditor's claim must be free of any *bona fide* dispute as to the amount of the claim. Section 303(b)(1) states that any *bona fide* dispute as to any portion of a petitioning creditor's claim disqualifies the creditor from participating in an involuntary petition. Section 303(b)(1) does not state that a *bona fide* dispute only exists when the dispute reduces the aggregate amount of the petitioning creditors' claims below Section 303's minimum threshold (\$14,425 in the *Blixseth* case). An appeal from this decision to the United States Circuit Court of Appeals for the Ninth Circuit has been filed and is pending.

### **(b) In re General Aeronautics Corporation**

The bankruptcy court, in *General Aeronautics*, held that a petitioning creditor has standing to join an involuntary bankruptcy petition even if a debtor disputes part of the claim. A creditor's partially disputed claim is not subject to *bona fide*

dispute that would otherwise disqualify the creditor as a petitioning creditor as long as some portion of the creditor's claim is not disputed, which along with the undisputed portions of the other petitioning creditors' claims, meets the statutory \$15,775 threshold of Section 303(b)(1).

The court presumed that Congress had acted "with knowledge of existing law and judicial concepts" when it had enacted the BAPCPA amendment to Section 303(b)(1) that added the "liability or amount" language. The court further observed that Congress had enacted Section 303(b)(1) to strike a balance between the petitioning creditors' access to the bankruptcy courts and would-be debtors remaining free from involuntary petitions filed by creditors with legitimately disputed claims. The court concluded that any interpretation of BAPCPA's amendment of Section 303(b)(1) that disqualifies a petitioning creditor where any portion of its claim is disputed would noticeably shift the balance by drastically restricting creditors' ability to join an involuntary petition. That kind of significant change in pre-BAPCPA practice is unjustified where there is no clear indication in the legislative history that Congress had intended to make such a change.

The *General Aeronautics* court also considered the absurdity of a strict plain meaning interpretation of Section 303(b)(1) that would disqualify many petitioning creditors, including those whose claims are subject to minor disputes and are otherwise undisputed. By way of an example, the court concluded it would be absurd to disqualify a creditor who has asserted a \$100,000 claim from joining an involuntary petition because the debtor disputes \$100—a miniscule fraction—of the creditor's claim.

The court then analyzed each of the petitioning creditor's claims, ultimately finding at least seven of the petitioning creditors had claims that were partially undisputed in varying degrees and collectively in excess of the statutory minimum of \$15,775 under Section 303(b)(1). As a result, the court found that the petitioning creditors had satisfied Section 303(b)(1) based on a sufficient number of qualified petitioning creditors (i.e., more than three creditors

with undisputed claims exceeding the statutory minimum amount to satisfy Section 303(b)(1).

## Conclusion

The *General Aeronautics* and *QDOS* decisions, issued within only about a month of one another, illustrate the conflicting holdings on the meaning of a “*bona fide* dispute” under Section 303(b)(1). Some courts have held that creditors with partially disputed claims do not have claims subject to *bona fide* dispute while other courts have held that partially disputed claims are subject to *bona fide* dispute. Perhaps courts faced with this issue will be swayed by the factual circumstances of their particular cases. For example, would the *QDOS* court have been more inclined to rule in favor of the petitioning creditors of *QDOS* had they complied with the court’s requests for their appearance at the evidentiary hearings? Likewise, was the *General Aeronautics* court swayed by GAC’s failure over several years to make good on its debts to certain of its creditors despite receiving funding from third parties?

These questions lead to one clear answer: a creditor considering pushing a company into bankruptcy should do its diligence to make sure it satisfies Section 303. That includes making certain that no portion of its claim is disputed. Otherwise, the creditor may not only face the risk of dismissal of its involuntary petition, but also face the risk of having to pick up the would-be debtor’s tab for contesting an involuntary petition, and paying additional potentially large actual and punitive damage claims if a court finds the involuntary petition was filed in bad faith. ████████████████████

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