Are Creditors with Partially Disputed Claims Eligible to Join an Involuntary Bankruptcy Petition? The Saga Continues...

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Bruce S. Nathan, Esq., is a partner in the New York office of the law firm of Lowenstein Sandler LLP, practices in the firm's Bankruptcy, Financial Reorganization & Creditors' Rights Group, and is a recognized expert on trade creditors' rights and the representation of creditors in bankruptcy and other legal matters. He is a member of NACM, a former member of the board of directors of the American Bankruptcy Institute and a former co-chair of ABI's Unsecured Trade Creditors Committee. Bruce is also the co-chair of the Avoiding Powers Advisory Committee working with ABI's commission to study the reform of Chapter 11. He can be reached at bnathan@lowenstein.com.

Michael Papandrea, Esq., is an associate in Lowenstein Sandler's Bankruptcy, Financial Reorganization & Creditors' Rights Department focused on providing practical solutions for debtors, creditors' committees, individual creditors, and other interested parties involved in bankruptcy and creditors' rights matters. Prior to joining the firm, Mike clerked for multiple bankruptcy judges in the District of New Jersey and Eastern District of Pennsylvania. He can be reached at mpapandrea@lowenstein.com.

Trade and other unsecured creditors concerned about a debtor's nonpayment of their claims may consider joining in the filing of an involuntary bankruptcy petition against that debtor. A petitioning creditor whose claim is not subject to a "bona fide dispute as to liability or amount" has standing to file an involuntary bankruptcy petition pursuant to Section 303(b) of the Bankruptcy Code.

Conflicting interpretations of the "bona fide dispute" limitation on a petitioning creditor's standing to join an involuntary petition have been the subject of much litigation, as the courts have recently been grappling with how the "bona fide dispute" limitation applies to creditors holding partially disputed claims. A growing number of courts have held that a petitioning creditor's partially disputed claim is subject to a "bona fide dispute as to liability or amount," which disqualifies the creditor from joining an involuntary petition. Other courts have held that the undisputed portion of a creditor's partially disputed claim is *not* subject to a "bona fide dispute" and that, therefore, a creditor holding a partially disputed claim is not barred from being a petitioning creditor.

The United States Court of Appeals for the Ninth Circuit (the "Ninth Circuit"), *in Montana Dept. of Revenue vs. Blixseth*, recently joined the United States Courts of Appeals for the First and Fifth Circuits in adopting the strict and less creditor-friendly interpretation of Section 303(b)(1)—that a creditor holding a partially disputed claim lacks standing to join an involuntary bankruptcy petition because even a partially disputed claim must be considered to be subject to a *bona fide* dispute. This trend in the case law has raised the bar for creditors considering joining in filing an involuntary petition. This should encourage petitioning creditors to make sure that the debtor does not dispute any portion of their claims. Otherwise, creditors with even partially disputed claims risk being disqualified as petitioning creditors, dismissal of the involuntary petition and exposure to sanctions.

I. 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 *Blixseth* case—states that if a debtor has 12 or more creditors, at least three creditors holding unsecured claims that total at least $16,750 in the aggregate (for involuntary petitions filed on and after April 1, 2019) 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, if a debtor contests an involuntary petition, Section 303(h)(1) requires the 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. If 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.

Prior to the 2005 amendment of the United States Bankruptcy Code contained in the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA"), the prevailing view was that a creditor's

partially disputed claim is not subject to a "bona fide dispute" that disqualifies the creditor from seeking involuntary bankruptcy relief as long as some portion of the claim was undisputed. 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."

BAPCPA amended 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 held that BAPCPA had substantively changed Section 303(b)(1) to treat any partially disputed claim as subject to a *bona fide* dispute (because the claim is disputed as to its amount), disqualifying a creditor asserting a partially disputed claim from joining in an involuntary petition regardless of how small the disputed portion of the claim may be. Other courts have viewed BAPCPA's amendment of Section 303(b)(1) as merely clarifying prior legislative intent to focus primarily on liability issues regarding petitioning creditors' claims and not preclude creditors with partially disputed claims from seeking involuntary bankruptcy relief.

A bankruptcy court's dismissal of an involuntary petition poses great risks for petitioning creditors. If a debtor successfully contests and obtains dismissal of an involuntary bankruptcy petition, the debtor 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 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 bankruptcy 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.

II. *Blixseth*'s Facts and Procedural History

In July 2009, the Montana Department of Revenue ("MDOR") assessed over $50 million in taxes, penalties, and interest, including approximately $9 million in tax adjustments for the 2004 tax year, against Timothy Blixseth in connection with numerous "audit issues" identified during a tax audit MDOR had conducted. After an informal review process with MDOR (that resulted in MDOR modestly adjusting its original audit assessment), Blixseth filed a complaint before the Montana State Tax Appeals Board disputing all but one of the audit issues raised by MDOR; Blixseth had conceded that he owed approximately $215,000 in connection with one of the audit issues related to MDOR's multi-million-dollar audit assessment for the 2004 tax year.

In April 2011, MDOR, joined by the Idaho State Tax Commission ("ISTC"), the California Franchise Tax Board (the "CFTB") and, thereafter, Yellowstone Club Liquidating Trust ("Yellowstone"), as petitioning creditors, commenced an involuntary Chapter 7 bankruptcy case against Blixseth. Each of the state entities asserted claims on account of unpaid taxes and associated penalties and interest. Notably, MDOR asserted only a $219,258 claim, which was based solely on the undisputed portion of MDOR's seven-figure claim for the 2004 tax year—*i.e.*, the taxes, penalties, and interest purportedly flowing from the sole audit issue Blixseth had conceded.

Blixseth moved to dismiss the bankruptcy proceedings, arguing that the petitioning creditors' claims were each subject to a *bona fide* dispute and, therefore, the petitioning creditors lacked standing under Section 303(b)(1) to join in the filing of their involuntary petition. Following an evidentiary hearing, the bankruptcy court converted Blixseth's motion to dismiss the involuntary petition into a motion for summary judgment, and granted the motion.

The bankruptcy court first ruled that Blixseth had more than 12 creditors. Therefore, pursuant to Section 303(b), at least three qualifying petitioning creditors were required for the involuntary bankruptcy case to proceed. The bankruptcy court then held that three of the four petitioning creditors' (MDOR's, ISTC's, and CFTB's) claims were subject to *bona fide* dispute pursuant to Section 303(b)(1) and, therefore, these creditors lacked standing to join the involuntary petition. While Yellowstone may have had standing based on an undisputed claim, the presence of one petitioning creditor is not enough to satisfy Section 303(b)'s requirements and therefore was not sufficient to justify going forward on the involuntary petition.

The bankruptcy court noted that Section 303(b)(1) "should be construed to disqualify petitioning claims based on any *bona fide* dispute as to amount, even if some 'portion' of the claim is undisputed." Specifically, with respect to MDOR, the bankruptcy court explained that "a taxing entity generally has but one claim for each calendar year" and MDOR could not create a separate liability for the sole tax issue that Blixseth had conceded with respect to the 2004 assessment. As a result, the bankruptcy court concluded that MDOR's claim was subject to a *bona fide* dispute, notwithstanding that approximately $200,000 of MDOR's claim was undisputed, because Blixseth disputed the remaining multi-million-dollar liability asserted by MDOR for the 2004 tax year.

MDOR then appealed to the district court, which affirmed the bankruptcy court's decision. The district court also held that a creditor with a partially disputed claim cannot be a petitioning creditor, even if the undisputed portion of its claim exceeds the statutory threshold amount. The court concluded that Section 303(b)(1) is unambiguous, and must be interpreted and applied based on its plain meaning. The court refused to read a materiality provision into Section 303(b)(1) as that would allow a creditor to participate in an involuntary petition where the debtor disputed a portion of the creditor's claim—regardless of the amount—notwithstanding Section 303(b)(1)'s requirement that no petitioner's claim can be subject to a *bona fide* dispute as to amount.

MDOR then appealed to the Ninth Circuit.

III. The Ninth Circuit's Decision

The Ninth Circuit affirmed the lower courts' decisions, holding a claim is subject to a *bona fide* dispute for purposes of Section 303(b)(1) so long as the debtor disputes any portion of the claim. In doing so, the Ninth Circuit reconsidered its prior holding, in *In re Focus Media, Inc.*, that a dispute as to the amount of a petitioning creditor's claim creates a *bona fide* dispute only if the dispute takes the total amount of the claim below the statutory threshold amount under Section 303(b)(1). As the Ninth Circuit explained, it reached its holding in *Focus Media* shortly before Congress amended Section 303(b)(1) to provide that a petitioning creditor whose claim is subject to a *bona fide* dispute "as to liability *or amount*" cannot join in the filing of an involuntary petition.

The Ninth Circuit, in the *Blixseth* case, relied on the plain language of Section 303(b)(1). According to the Ninth Circuit, since a dispute as to "liability" means the entire amount of a claim is disputed, Section 303(b)(1)'s reference to "amount" must be intended to encompass a dispute with respect to less than the entire amount of the claim. Moreover, Section 303(b)(1) does not limit disputes as to the amount of a petitioning creditor's claim to only those disputes that drop the amount of the creditor's claim below the statutory threshold. In fact, Section 303(b)(1) does not qualify the word "amount" at all. Instead, the reference to "amount" in the context of the *bona fide* dispute limitation on a creditor's standing to join an involuntary petition would be superfluous if a partially disputed claim were not considered subject to a *bona fide* dispute.

The Ninth Circuit also noted that two other United States Courts of Appeals, for the First and Fifth Circuits, had previously reached the same conclusion that, according to the plain language of Section 303(b)(1), a dispute as to the amount of a petitioning creditor's claim constitutes a *bona fide* dispute that would disqualify the creditor from joining an involuntary bankruptcy petition. The First Circuit, in *Fustolo vs. 50 Thomas Patton Drive, LLC*, held that any dispute as to the amount of a petitioning creditor's claim disqualifies the creditor from joining in the filing of an involuntary petition. The First Circuit declined to read a materiality requirement into what constitutes a *bona fide* dispute as to the amount of a petitioner's claim. Similarly, the Fifth Circuit, in *In re Green Hills Dev. Co.*, concluded that Congress had made clear that, as a result of BAPCPA's amendment of Section 303(b)(1), a petitioning creditor whose claim is partially disputed does not have standing to join in filing an involuntary petition.

Finally, the Ninth Circuit addressed the argument raised by a number of legal authorities—including a leading bankruptcy law treatise (*Collier on Bankruptcy*) and a 2018 opinion by the Utah bankruptcy court (*In re General Aeronautics Corporation*)—that construing Section 303(b)(1) so as to preclude creditors with partially disputed claims from joining involuntary petitions could create absurd results. The potential for absurd results was illustrated by the *General Aeronautics* court when, in holding that a creditor with a partially disputed claim should not necessarily be precluded from joining an involuntary petition, the court hypothesized that it would be absurd to disqualify a creditor asserting a $100,000 claim from joining an involuntary petition just because the debtor had disputed $100—a miniscule portion—of the creditor's claim.

The Ninth Circuit rejected the notion that its interpretation of Section 303(b)(1) might cause an absurd result. Rather, the Ninth Circuit explained that the underlying policy of Section 303(b)(1) is to discourage creditors from "using bankruptcy to force debtors into paying legitimately disputed debts as an alternative to resolving disputed claims through other means," and the facts of the *Blixseth* case "exemplif[y] that following the plain language [of Section 303(b)(1)] is the logical interpretation that gives effect to the statute's basic policy." The Ninth Circuit noted the impropriety of MDOR seeking to leverage its approximately $200,000 undisputed claim to collect the remaining multi-million-dollar disputed portion of its $9 million claim for the 2004 tax year by joining in the involuntary petition against Blixseth. The court concluded this type of conduct—the leveraging of a miniscule undisputed portion of an otherwise disputed claim to force a debtor into bankruptcy—is precisely what Section 303(b)(1)'s "bona fide dispute" limitation on a petitioning creditor's standing to join an involuntary bankruptcy petition is intended to prohibit.

IV. Conclusion

The balance of legal authorities is beginning to shift toward a strict interpretation of Section 303(b)(1)'s "bona fide dispute" limitation, with three Courts of Appeals (the First, the Fifth, and now, the Ninth) holding that a dispute as to any portion of a claim constitutes a *bona fide* dispute that strips a creditor's standing to join an involuntary bankruptcy petition. However, the issue likely will remain hotly contested, as it appears the courts might be significantly influenced by the specific facts and procedural history in their respective cases. For example, in *Blixseth*, the Ninth Circuit concluded its opinion by stating that "although a portion of MDOR's claim was undisputed on the petition date, the vast majority of its claim remained disputed." One must wonder whether the Ninth Circuit would have ruled differently, and MDOR would have been granted standing to be a petitioning creditor, had the vast majority of MDOR's claim been *undisputed* (in line with the Utah bankruptcy court's hypothetical in *General Aeronautics*).[1]

It is safe to say that a creditor considering pushing its financially distressed customer into an involuntary bankruptcy proceeding should do its diligence to make sure that no portion of its claim is disputed. Failure to do so exposes the creditor not only to the risk of dismissal of the involuntary petition, but also to the risk of a court's imposition of significant damages against the petitioning creditor.

1 MDOR has filed a petition for rehearing with the Ninth Circuit that is unrelated to the issue of whether a partially disputed claim is subject to a "bona fide dispute" pursuant to Section 303(b)(1) of the Bankruptcy Code. MDOR's petition for rehearing argues that two of the petitioning creditors, ISTC and CFTB, have standing to join in the involuntary petition because their claims are not subject to "bona fide dispute."