

Third Circuit Affirms Bad Faith Involuntary Bankruptcy Dismissal, Increasing Risk of Punitive Damages

Last week's decision by the U. S. Court of Appeals for the Third Circuit in *In re: Forever Green Athletic Fields, Inc.*, No. 14-3906 (3d Cir. Oct. 16, 2015) held that an involuntary bankruptcy petition filed under 11 U.S.C. § 303 may be dismissed for bad faith. The decision places another hurdle for creditors to surmount when considering whether to put a debtor in bankruptcy and creates another means for debtors to oppose such filings. It also enumerates the standard for evaluating whether a filing is in bad faith.

Under the Bankruptcy Code, creditors can file an involuntary petition against a debtor under Chapter 7 or Chapter 11. Involuntary proceedings are intended to protect creditors from debtors who are making preferential payments to other creditors or dissipating their assets. Section 303 of the Bankruptcy Code, which governs involuntary cases, contains three requirements for commencing an action against a debtor who has 12 or more creditors: (1) there must be three or more petitioning creditors; (2) each petitioning creditor must hold a claim against the debtor that is not contingent as to liability or the subject of a bona fide dispute; and (3) the claims must aggregate at least \$15,325 more than the value of liens on the debtor's property. In addition, the court may only order relief against the debtor if the debtor is generally not paying its debts as they become due. Section 303(i)(2) contains one very important reference to bad faith, providing that if the court dismisses an involuntary petition as having been filed in bad faith, the court may award damages proximately caused by such filing and punitive damages against the creditor that filed the petition in bad faith.

The question before the Third Circuit was whether bad faith may serve as a basis for dismissal even where the criteria for commencing a suit are satisfied and where the debtor is admittedly not paying its debts as they become due. The creditors argued that their subjective motivations were irrelevant because § 303 contains objective criteria for who may file an involuntary petition, and if they are satisfied, § 303 provides that the court shall order relief against a debtor who is not paying its debts. Other courts were divided on the issue.

The court held that the text of § 303 does not foreclose bad-faith dismissals. Meeting the § 303 criteria is just the first hurdle. If the three requirements are satisfied, the bankruptcy court can still dismiss the case. To hold otherwise overlooks the equitable nature of bankruptcy. According to the court, the good faith filing requirements have strong roots in equity. "At its most fundamental level, the good faith requirement ensures that the Bankruptcy Code's careful balancing of interests is not undermined by petitioners whose aims are antithetical to the basic purposes of bankruptcy." Allowing for the dismissal of bad-faith filings will encourage creditors to file petitions for proper reasons such as to protect against the preferential treatment of other creditors or the dissipation of the debtor's assets.

The court adopted an amorphous "totality of the circumstances" standard for determining bad faith under § 303. The court identified a non-exhaustive list of factors that the courts may consider, including whether: the creditors satisfied the statutory criteria for filing the petition; the involuntary petition is meritorious; the creditors made a reasonable inquiry into the relevant facts and pertinent law before filing; there was evidence of preferential payments to certain creditors or dissipation of the debtor's assets; the filing was motivated by ill will or a desire to harass; the petitioning creditors used the filing to obtain a disproportionate advantage for themselves rather than to protect against other creditors doing the same; the filing was used as a tactical advantage in pending actions; the filing was used as a substitute for customary debt-collection procedures; and the filing had suspicious timing. The generalized nature of the "totality of the circumstances" test makes the filing of an involuntary petition even riskier within the Third Circuit.



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In the case before it, the court affirmed the Bankruptcy Court's finding of bad faith since the creditor "used the bankruptcy courts to gain a personal advantage in other pending actions or as a debt-collection device" and his actions "ran counter to the spirit of collective creditor action that should animate an involuntary filing." The court noted that the creditor had filed the petition in order to prevent the debtor from pursuing an arbitration action against him, thus obstructing the debtor from pursuing its largest asset, and had used the bankruptcy process to exert pressure on the debtor to pay the creditor's judgment without regard to the debtor's other creditors, many of which had higher priority claims.

The court sidestepped the question whether to adopt the so-called "bar to joinder" rule, which provides that a petition filed in bad faith cannot be saved by joining good-faith creditors under § 303 prior to dismissal. Most courts find this type of curing impermissible, but a growing minority of courts have rejected the rule because it lumps good- and bad-faith filers together and needlessly punishes everyone. Here, there was no evidence that any creditor tried to join the petition prior to dismissal, and it was too late for any creditor to save the petition even if the court were to reject the rule.

The decision to allow an involuntary petition under § 303 to be dismissed for bad faith provides another reason for creditors to exercise extreme caution when considering whether to commence an involuntary proceeding, especially since the Code allows the court to award both compensatory and punitive damages against any creditor that filed the petition in bad faith. The Third Circuit indicated that the petitioning creditor had failed to proffer evidence of having engaged in "the type of due diligence and sober decision-making process that should precede any involuntary filing," thus indicating a willingness to expose the creditor to discovery concerning its motivation and the actions taken prior to filing the petition. The decision also serves as a cautionary tale for each of the petitioning creditors, who now must concern themselves with determining the subjective motivation of their fellow creditors before joining in the filing of the involuntary petition lest they unwittingly expose themselves to punitive damages. It is no longer sufficient to merely determine that a fellow petitioning creditor holds a claim against the debtor that is not contingent as to liability or subject to a bona fide dispute. For debtors, it provides another means to challenge an involuntary proceeding, and perhaps a strong argument to forestall the filing of such a petition in the elaborate dance that often proceeds a filing.

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