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In What State Is the Harm Felt When a Derivative Suit Is Pursued By Creditors?

Personal Jurisdiction Under the Purposeful Availment Test

By Russell C. Silberglied

Can a trustee of a litigation trust created under a plan sue in a U.S. bankruptcy court the directors and officers of a non-debtor Canadian parent, when many of the defendant D&Os had rarely set foot in the forum state? According to a recent Tenth Circuit opinion, the answer is yes. *Newsome v. Gallacher*, 722 F.3d 1257, (10th Cir. 2013). This might surprise directors and officers of Canadian parent companies. As explained below, the holding might be explained, in part, by a misreading of the Delaware Supreme Court's holding in *North Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

Background

The plaintiff was a litigation trustee. While the opinion does not specifically so state, it appears that he was appointed pursuant to a confirmed plan of Mahalo Energy USA. The court states that the bankruptcy court appointed the trustee "to administer the legal claims of Mahalo Energy (USA)." *Newsome*, 722 F.3d at 1262. It also notes that "The bankruptcy court … gave Newsome charge over Mahalo USA's legal claims, instructing him to administer them 'for the benefit of creditors.'" *Id*. at 1266.

The trustee sued Mahalo Canada's D&Os. Mahalo USA was a wholly owned subsidiary of Mahalo Canada. Mahalo USA was a Delaware corporation operating exclusively in Oklahoma, while Mahalo Canada was incorporated and operated in Alberta. All defendants were citizens of Alberta.

The suit alleged breaches of fiduciary duty against directors of Mahalo Canada, some of whom also were D&Os of Mahalo USA. The opinion never explores whether the "overlapping" directors could have been subject to jurisdiction on

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Involuntary Bankruptcy Standard

Ninth Circuit Splits from Fourth Circuit

By Brett J. Berlin

A judgment creditor that is considering filing an involuntary bankruptcy petition against a debtor should consult venue-specific controlling law if the debtor has appealed the judgment. Depending on the jurisdiction, the debtor's appeal may or may not be a factor for the bankruptcy court to consider in determining whether the creditor's claim meets the involuntary petition requirements of the Bankruptcy Code.

Generally, to be eligible as a petitioning creditor in an involuntary bankruptcy case, a creditor must hold a claim against the debtor that, among other things, "is not contingent as to liability or the subject of a bona fide dispute as to liability or amount." 11 U.S.C. § 303(b)(1). Under the approach of certain courts, when the creditor's claim is based on a state court judgment from which the debtor has appealed, and the judgment is not stayed during the appeal, the appeal could be deemed a "bona fide dispute" rendering the judgment claim ineligible to support the involuntary petition.

Earlier this year, the Ninth Circuit Court of Appeals considered

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the ground that they were D&Os of the debtor itself. *See, e.g.*, 10 Del. C. § 3114 (directors of a Delaware Corporation consent to jurisdiction in Delaware for claims against them in their capacity as directors). Instead, it focuses on these individuals' roles as directors of the Canadian parent.

The suit's gravamen was as follows. Mahalo Canada allegedly acquired another company, assumed its debt, and transferred the debt to Mahalo USA while keeping the equity at Mahalo Canada. It also encumbered Mahalo USA's assets as security for Mahalo Canada's $50M line of credit. Then Mahalo Canada sold some of its assets to an investment vehicle in which most of the defendants had invested, which made Mahalo USA's assets the primary security for Mahalo Canada's line of credit. Finally, Mahalo Canada allegedly caused Mahalo USA to pay off the entirety of Mahalo Canada's line of credit and enter into a new $105M line of credit, upon which Mahalo USA quickly defaulted. The individual defendants allegedly caused these actions to further their own profits, at the expense of Mahalo USA and its creditors.

The Court's Holding

To determine whether the assertion of personal jurisdiction over these Canadian citizens was constitutionally permissible, the court started with the proposition that the defendants were not alleged to have "continuous and systematic general business contacts with the forum state" sufficient to support general personal jurisdiction. *Id.* at 1264 (citation omitted). Thus, specific personal jurisdiction — *i.e.*, jurisdiction specific to the dispute — is necessary to support a finding of minimum contacts. That, in turn, requires an analysis of whether the defendants have purposefully directed their activities at the forum state. For tort claims, the "purposeful availment" test has three factors: "(a) an intentional act … that was (b) expressly aimed at the forum state … with (c) knowledge that the brunt of the injury would be felt in the forum state." *Id.* at 1265 (citation omitted).

Here, the key to applying that test was understanding the nature of, as the court put it, "who was injured, and where?" *Id.* at 1257, 1261, 1267, 1268. And that is where the opinion gets controversial.

Citing *Gheewalla*, 930 A.2d at 101-03, the court stated that upon insolvency, "the director … owes fiduciary duties to the creditors as well as the corporation." *Newsome*, 722 F.3d at 12667. The court stated that under *Gheewalla*, creditors can "almost never bring a direct action for breach of fiduciary duty," *id.*, due to policy concerns — directors must not be said to owe fiduciary duties to creditors because they must retain their ability to negotiate rigorously with creditors. (It should be noted that "almost never" is not what the Delaware Supreme Court stated in *Gheewalla*; it specifically held that creditors "have no right to assert direct claims," overruling *Production Res. Group, LLC v. NCT Group, Inc.*, 863 A. 2d 772 (Del. Ch. 2004), which had left open such a possibility.

Since creditors cannot bring direct claims, the court acknowledged that the following questions exist: "if Newsome is not considered to be asserting the creditors' claims, but rather Mahalo USA's claims, then where was Mahalo USA injured? And may we nonetheless consider injury to and location of Mahalo USA's creditors when evaluating personal jurisdiction?" *Newsome*, 722 F.3d at 1267. In other words, the court grappled with whether it could consider where the creditors were harmed in determining where

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Prepayment Premiums and Make-Whole Payments

Part Two of a Two-Part Article

By Joel H. Levitin

Last month, we discussed "prepayment premiums" or "make-whole payments." The purpose of such prepayment premiums is to compensate lenders for what would otherwise be the loss of their bargained-for yields for the scheduled lives of their loans. Prepayment premiums are usually either based on a fixed fee, such as a percentage of the principal balance at the time of prepayment, or a yield maintenance formula that approximates the lenders' damages in the event of prepayment.

We pointed out that in the bankruptcy context, a prepayment premium will rarely be triggered by the debtor's voluntary prepayment of debt. Instead, usually the debtor will have defaulted and the debt will have been accelerated prior to bankruptcy, or the debt will have automatically accelerated due to the bankruptcy filing. The discussion continues herein.

Is the Prepayment Premium Plainly Disproportionate?

In considering whether a prepayment premium is "plainly disproportionate" to the lender's potential loss, courts look at the damages foreseeable at the time of contracting and not the actual damages at the time of prepayment or acceleration of the debt. *See In re Sch. Specialty, Inc.*, 2013 WL 183513, at *2 (citing *Walter E. Heller & Co., Inc. v. Am. Flyers Airline Corp.*, 459 F.2d 896, 898-99 (2d. Cir. 1972)). Furthermore, courts consider whether the prepayment premium clause is the result of arm's-length negotiations between represented sophisticated parties. *See In re Sch. Specialty, Inc.*, 2013 WL 183513, at *3 (internal citations omitted). A number of courts have held that prepayment consideration calculated on the basis of U.S. Treasury Bond interest rates is not plainly disproportionate to the lender's possible loss. *Id.* at *4 (internal citations omitted); *In re S. Side House, LLC*, 451 B.R. at 271; *but see In re Skyler Ridge*, 80 B.R. 500, 505 (Bankr. C.D. Cal. 1987) (stating that using U.S. Treasury notes would have been acceptable provided that appropriate adjustment were included to bring rate up to then-existing comparable mortgage rate).

In *In re Vanderveer Estates Holdings, Inc.*, the court held that the prepayment premium was not plainly disproportionate to the creditor's possible loss. 283 B.R. at 130 (citing *United Merchs. & Mfrs., Inc. v. Equitable Life Assurance Soc'y of the U.S.* (In re United Merchs. & Mfrs., Inc.), 674 F.2d 134, 143 (2d Cir. 1982)). The prepayment premium was the result of arm's-length negotiations and was calculated based on prevailing Treasury Bond yields at or about the time of prepayment and was structured to allow the creditor to collect its bargained-for yield if the prepaid funds were reinvested in a Treasury Bill of comparable maturity. *In re Vanderveer Estates Holdings, Inc.*, 283 B.R. at 130. The court reasoned that the prepayment premium clause did not result in an automatic premium upon prepayment. *Id.* If interest rates increased such that the Treasury Bond yield would exceed the interest rate under the loan documents, then the creditor could still obtain the bargained-for interest, and the prepayment premium would be zero. *Id.*

Does the Reasonableness Standard Apply?

In addition to evaluating the enforceability of a prepayment premium clause as liquidated damages, many courts have held that the prepayment premium must satisfy the reasonableness standard set forth in Section 506(b) of the Bankruptcy Code. Courts have taken different approaches as to how reasonableness under Section 506(b) is evaluated. Some courts have held that if the prepayment premium passed muster under the liquidated damages standard, then it should similarly be enforceable under Section 506(b). *See In re Sch. Specialty, Inc.*, 2013 WL 183513, at *5. Other courts have evaluated liquidated damages and reasonableness under Section 506(b) as two distinct issues. *See In re Vanderveer Estates Holdings, Inc.*, 283 B.R. at 131-34.

Section 506(b) allows an oversecured creditor to recover "reasonable [post-petition] fees, costs, or charges provided for under the [relevant] agreement … ." 11 U.S.C. § 506(b) (2005); *see also In re Vanderveer Estates Holdings, Inc.*, 283 B.R. at 131. At least one court has held that prepayment premium clauses are not subject to Section 506(b) where the premium became due before the debtor filed for bankruptcy and therefore was included as part of the creditor's claim. *In re CP Holdings, Inc.*, 332 B.R. at 392.

If a court determines that Section 506(b) applies to a prepayment premium, typically its initial inquiry in evaluating reasonableness is the purpose of the premium. *See, e.g., In re Duralite Truck Body & Container Corp.*, 153 B.R. at 713.

Generally, prepayment premiums protect lenders against falling interest rates. Without a prepayment premium, a borrower would have an incentive to refinance the debt, thus depriving the lender of the benefit of its bargain, namely, the unearned interest at above current market rates over the unexpired

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> term of the loan. On the other hand, if the loan was involuntarily prepaid when market interest rates were higher than the contractual rate, the lender could reinvest the funds at the higher rate, resulting in a windfall to the lender.

Id. at 713-14 (internal citations omitted).

The majority of courts have held that to qualify as "reasonable" under Section 506(b), prepayment premiums must reflect the creditor's actual damages. *See, e.g., In re Schwegmann Giant Supermarkets P'ship*, 264 B.R. 823, 828 (Bankr. E.D. La. 2001) (citations omitted). *But see Noonan*, 245 B.R. at 330 (declining to use actual damages to determine reasonableness due to fact that actual damages were hard to calculate in line of credit situation). Actual damages are calculated as "the difference between the market rate of interest at the time of prepayment and the contract rate for the duration of the loan, discounted to present value." *In re Schwegmann Giant Supermarkets P'ship*, 264 B.R. at 828 (quoting *In re Duralite Truck Body & Container Corp.*, 153 B.R. at 714).

Courts have considered prepayment premium clauses to be "unreasonable" for a variety of reasons. Prepayment premiums that allow a creditor to recover the same amount regardless of whether the market interest rates increase or decrease are said to "presume a loss" and are deemed unreasonable. *Id*. at 829 (quoting *In re Duralite Truck Body & Container Corp.*, 153 B.R. at 714-15) (prepayment premium allowed creditor to receive 10% of prepaid principal regardless of market interest rates).

Additionally, prepayment premiums are likely to be found unreasonable and therefore unenforceable if they fail to discount the recovery to present value. *See Schwegmann Giant Supermarkets P'ship*, 264 B.R. at 829 (citing *In re Duralite Truck Body & Container Corp.*, 153 B.R. at 714-15). The court in *In re Kroh Bros. Dev. Co.*, 88 B.R. 997, 1002 (Bankr. W.D. Mo. 1988), struck down a prepayment premium that amounted to 25% of the loan's principal, and held that a reasonable prepayment premium is "at most" the equivalent of 10% of the loan's principal.

In the context of debt acceleration in bankruptcy, loan documents must include clear and unambiguous language to enable creditors to have a chance of collecting prepayment premiums.

Many courts have followed this guideline. *See, e.g., In re Schwegmann Giant Supermarkets P'ship*, 264 B.R. at 829-30 (holding 18% premium unreasonable); *Noonan*, 245 B.R. at 331 (holding 5.9% premium reasonable); *Anchor Resolution Corp. v. State St. Bank & Trust Co.* (*In re Anchor Resolution Corp.*), 221 B.R. 330, 341 (Bankr. D. Del. 1998) (holding 6.9 % premium reasonable). *But see Fin. Ctr. Assocs. of East Meadow, L.P. v. Funding Corp.* (*In re Fin. Ctr. Assocs. of East Meadow, L.P.*), 140 B.R. 829, 839 (Bankr. E.D.N.Y. 1992) (disagreeing with *Kroh Bros. Dev.* and holding that although 25% premium was high, it was not unreasonable).

Conclusion

Prepayment premiums are important for creditors' ability to fully receive their anticipated benefit of lending money. In the context of debt acceleration in bankruptcy, loan documents must include clear and unambiguous language to enable creditors to have a chance of collecting prepayment premiums. Prepayment premiums are more likely to be enforceable if they meet state law standards permitting liquidated damages, typically that damages must be difficult to determine at the time of contracting, and if the contractual damages are not be plainly disproportionate to the creditors' potential damages. In courts that apply the reasonableness standard under Section 506(b) of the Bankruptcy Code, prepayment premiums are most likely to be enforced if the clauses are structured so that the amounts reflect the particular creditors' actual damages.

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the tort took place under the purposeful availment test, even though the claim did not belong to the creditors, but rather to Mahalo USA itself.

It held that the answer is yes. Essentially treating the concept of a derivative claim as procedural, it stated that:

> when Delaware courts say that the injured party is the corporation principally, and the creditors only derivatively, these courts are really responding to the question of when and how creditors may sue for those injuries. Thus, to say "this is the corporation's injury," does not mean that the creditors have suffered no harm, just that the creditors may not sue directly for that harm.

Id. at * 1268.

Accordingly, the court held that "we do not believe due process requires us to ignore where the injury was actually felt, even if those who felt it face some impediment to suit on account of substantive corporate law." *Id*. Rather, "a court evaluating personal jurisdiction need not ignore the creditors' or shareholders' place of residence simply because the cause of action belongs to the corporation." *Id*.

Because most of the creditors were Oklahoma residents, the court concluded that the harm occurred in Oklahoma under the purposeful

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availment test. Therefore, the Canadian residents were subject to jurisdiction in Oklahoma.

Analysis

In the author's view, the court was mistaken in holding that the harm to the corporation occurred where the creditors were harmed. Delaware law on derivative claims is not merely procedural, limiting the technicalities of how creditors or stockholder may sue. Rather, it is substantive law. *See, e.g., Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993) ("The stockholder derivative suit is an important and unique feature of corporate governance.") The concept is that the company itself is harmed, and therefore any recovery in the suit belongs to the corporation. *See Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004) ("Because a derivative suit is being brought on behalf of the corporation, the recovery, if any, must go to the corporation.").

That is why the suit is described as the company's property. *See, e.g., Rales*, 634 A.2d at 932 ("In [a derivative] suit, a stockholder asserts a cause of action belonging to the corporation."). Accordingly, it is no mere technicality of "when and how creditors may sue for those injuries," as the *Newsome* court stated. Indeed, *Newsome's* thematic question of "who was injured" is emphatically answered by settled Delaware law involving derivative claims: One of the only two questions that must be answered in determining whether a claim is direct or derivative is "who suffered the alleged harm (the corporation or the suing stockholders, individually)." *Tooley*, 845 A.2d at 1033.

In a derivative suit, the residual stakeholders, who indirectly benefit from an increase in corporate value, are those afforded standing to prosecute the corporation's claim if they follow the right steps — shareholders of a solvent corporation, or creditors of an insolvent corporation. *See Gheewalla*, 930A.2d at 92. But the fact that a person may obtain standing to prosecute the corporation's claims in no way suggests that any harm to that person is relevant to any aspect of the case. *See Tooley*, 845 A.2d at 1036 (a direct "claim is distinct from an injury caused to the corporation itself.").

Indeed, the very concept is that all such stakeholders experienced the same harm, secondarily — a loss in company value. *See, e.g., Gheewalla*, 930 A.2d at 102 (derivative claims "belong to the corporation itself because even if the improper acts occur when the firm is insolvent, they operate to injure the firm in the first instance by reducing its value, injuring creditors only indirectly by diminishing the value of the firm and therefore the assets from which the creditors may satisfy their claims.") (quoting *Production Res.*, 863 A.2d at 776).

In short, the fact that a creditor has suffered harm ought to be irrelevant because the purposeful availment test measures specific jurisdiction, and harm to creditors individually is an entirely different claim than one asserted in a derivative suit, which solely looks to the harm suffered by the corporation.

The analysis in *Newsome* is even more attenuated because the suit was not a derivative suit, but rather a direct suit filed by the company's representative — a trustee appointed pursuant to a plan. The trustee was vested only with the corporation's own claims, not the claims belonging to creditors. *Newsome*, 722 F3d at 1266. To the extent that creditors also were individually harmed, that harm would result in a separate set of claims which the trustee does not have the power to bring. *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 191 (Del. Ch. 2006), aff'd sub nom. *Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007) ("federal bankruptcy law is clear that litigation trusts do not have standing to pursue the direct claims of creditors"); *In re World Health Alternatives, Inc.*, 385 B.R. 576, 595 (Bankr. D. Del. 2008) ("a bankruptcy trustee does not have standing to assert claims on behalf of an estate's creditors"). It is difficult to see how harms alleged from those separate claims, which the trustee may not even pursue, could matter for the purposes of personal jurisdiction over the claims the trustee is empowered to prosecute. After all, the purposeful availment test is a test of specific personal jurisdiction, not general personal jurisdiction.

The lynchpin of the court's analysis might well be its misperception of *Gheewalla*. The court stated that "in a lawsuit claiming breach of fiduciary duty, we believe it is appropriate to consider harm to those to whom a fiduciary duty was owed — in this case, the creditors — when answering the question of who was injured and where." *Newsome*, 722 F.3d at 1268. But *Ghewalla* does not hold that creditors are owed fiduciary duties when the company is insolvent. Rather, *Gheewalla* holds that upon actual insolvency, directors owe fiduciary duties to the corporation itself. *Ghewalla*, 930 A.2d at 101.

The Delaware Supreme Court certainly recognized that upon insolvency, what is in the best interests of the corporation often departs from what is in the best interests of stockholders, and noted that creditors at that point are the residual beneficiaries of any increase in value. *Id*. But it never said that duties shift to creditors; instead, it held only that the directors' duty is "to maximize the value of the insolvent corporation for the benefit of all those having an interest in it" — whether creditors or stockholders. *Id*. at 103. While a breach of that duty may be enforced by a creditor with derivative standing, there is no duty owed directly to creditors. *Id*. ("individual creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors.").

Thus, it is neither proper to consider the creditors' individual harm to be harm felt by the corporation, nor to consider the harm felt

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individually by creditors on the basis that fiduciary duties are owed to creditors. The first concept considers the wrong claim, and the second is simply an inaccurate statement of Delaware law.

Moreover, the Tenth Circuit's analysis is not one that the state whose substantive law applies — Delaware — has ever entertained. After research, we located no Delaware case, ruling on an objection to personal jurisdiction in a derivative suit, that rests its opinion on (or even considers) where the stockholders or creditors are located. That is simply not a factor that a Delaware court has ever held to be germane. Perhaps the reason for this is practical: The *Newsome* case apparently was very unusual in that nearly all of the creditors were Oklahoma residents. In a typical derivative case, stockholders or creditors might be located in many states. *Newsome* does not analyze whether the purposeful availment test would have been met if, for example, 30% of the creditors were located in Oklahoma — or whether, if creditors are located and "harmed" in 40 states, the Canadian defendants would have been subject to jurisdiction in 40 states.

Practical Advice

It is not clear whether other courts will follow the Tenth Circuit on this issue. If faced with such a case, defendants should argue that Newsome should not be followed because fiduciary duties are not owed to creditors under Delaware law, the harm to a creditor is separate to the harm felt directly by the company, and in general the defendants did not avail themselves purposefully with the forum state. The plaintiffs, in contrast, should consider placing more emphasis on the fact that the "overlapping" directors and officers — *i.e.*, those who were directors of Mahalo USA as well as Mahalo Canada — already had subjected themselves to jurisdiction within the United States in their role as D&Os of Mahalo USA. Moreover, in attempting to state a reasoned basis for arguing that the harm to the company occurred in the forum state, the plaintiff should focus on whether the forum state was the state of the company's principal place of business, as was the case in *Newsome*, or where it was incorporated, because it is logical to believe that the company is harmed where the company itself is located or incorporated.

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this question as a matter of first impression in *Marciano v. Chapnick* (*In re Marciano*), 708 F.3d 1123 (9th Cir. 2013). Adopting a stricter approach than that of the Fourth Circuit in *Platinum Fin. Servs. Corp. v. Byrd* (*In re Byrd*), 357 F.3d 433 (4th Cir. 2004), the Ninth Circuit concluded that an unstayed, enforceable state court judgment — despite an appeal — is *per se* a claim against the debtor that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount. The Fourth Circuit in *Byrd*, by contrast, rejected the *per se* rule in favor of an approach that is more flexible, and which therefore potentially may inure to the debtor's benefit. Under this approach, the bankruptcy court may consider the details of the appeal and deem it to be a bona fide dispute.

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Involuntary Bankruptcy Filing Requirements

Section 303(b)(1) of the Bankruptcy Code provides, with certain exceptions, that an involuntary Chapter 7 or Chapter 11 case may be commenced against a "person" eligible to be a debtor under either chapter:

> by three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount, or an indenture trustee representing such a holder, if such noncontingent, undisputed claims aggregate at least $14,425 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims … .

Because "bona fide dispute as to liability or amount" is not defined in the Bankruptcy Code, its meaning has been left to the courts.

The Fourth Circuit's *Byrd* Rule

In *Byrd*, the Fourth Circuit held that an appeal of a judgment might, indeed, qualify as a bona fide dispute. Under this approach (the "*Byrd* Rule"), an unstayed judgment — even if immediately enforceable under state law despite the appeal — remains subject to the debtor's opportunity to demonstrate to the bankruptcy court that the appeal is a bona fide dispute for purposes of section 303(b). Though the Fourth Circuit presupposed that an appeal might rise to the level of a bona fide dispute only in an "unusual" case, its holding in *Byrd* nevertheless recognizes this "unusual" possibility and states the premise that unstayed state court judgments "do not *guarantee* the lack of a bona fide dispute" (emphasis added). Critically, in a proper application of the *Byrd* Rule, the bankruptcy court does not rule on the merits of the appeal. Rather, the court considers the more limited question of whether the circumstances and merits of the appeal qualify as

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a bona fide dispute for purposes of section 303 of the Bankruptcy Code.

The Ninth Circuit's Decision In *Marciano*

The Ninth Circuit disagreed with this approach in *Marciano*. In that case, Georges Marciano sued five of his former employees in California state court, alleging theft. Three employees filed cross-complaints against Marciano, alleging defamation and intentional infliction of emotional distress. As a sanction for discovery abuses, the state trial court struck Marciano's answers to the cross-complaints. After a jury trial on damages, the trial court entered separate judgments in favor of the employees for $105 million in aggregate. Marciano appealed the judgments, but did not post a bond to stay them during appeal. The appellate courts denied Marciano's requests for a stay pending appeal, and the California Supreme Court denied his petition for review.

While the appeals were pending, various creditors began collection efforts. The employee judgment creditors then filed an involuntary Chapter 11 petition against Marciano in a California bankruptcy court. Marciano argued, among other things, that the employees were not eligible petitioning creditors under section 303(b)(1) because their claims were subject to bona fide dispute (*i.e.*, his appeals). The bankruptcy court and a Ninth Circuit bankruptcy appellate panel successively held that an unstayed non-default state court judgment is a claim not in bona fide dispute as to liability or amount under section 303(b)(1).

The Ninth Circuit affirmed on appeal as a matter of first impression. In so holding, the court of appeals joined the majority view on this issue, which has become known as the "*Drexler* Rule" after a 1986 decision from the U.S. Bankruptcy Court for the Southern District of New York. *See In re Drexler*, 56 B.R. 960 (Bankr. S.D.N.Y. 1986). According to this approach, an unstayed non-default state court judgment on appeal is never the subject of a bona fide dispute if the judgment is immediately enforceable under applicable state law.

The Ninth Circuit found the *Drexler* Rule to be more correct than *Byrd* "as a matter of both statutory interpretation and federalism." With respect to statutory interpretation, the court noted that although the Bankruptcy Code does not define "bona fide dispute," it does define "claim." *See* 11 U.S.C. § 101(5)(A). Under that definition, a claim is expressly not limited by "whether or not [the creditor's claim or right] is reduced to judgment." Based on this observation, the Ninth Circuit recognized a distinction between a judgment and the original, underlying claim that gave rise to it.

On the basis of that distinction, once a creditor reduces an underlying claim to judgment, any disputes the debtor may have raised against them (or may continue to raise in the appeal) have been sufficiently overcome for purposes of section 303(b)(1) of the Bankruptcy Code, so long as governing state law makes the judgment immediately enforceable absent a stay pending appeal. Thus, the Ninth Circuit stated, under the *Drexler* Rule, the immediate enforceability under state law of the unstayed judgment, despite the appeal, means the judgment claim is "plainly not contingent as to liability or amount." Consequently, under *Marciano* and *Drexler*, the judgment claim meets the requirements of section 303(b)(1).

According to the Ninth Circuit, the principles of federalism support this interpretation. Allowing a bankruptcy court to "inquire further as to the validity" of a claim based on a state trial court judgment rather than treating such a claim on "an objective basis" as being beyond bona fide dispute, the court explained, would be inappropriate for an Article I federal court. The Ninth Circuit wrote that permitting such an inquiry would render the principles of "full faith and credit … of little consequence." According to the court, "[i]f the creditor is entitled to have the judgment treated as valid in the state courts, we see no reason why a bankruptcy court should be allowed to question the judgment."

Dissenting Opinion

The reasoning of the minority view courts resonated with Ninth Circuit Judge Sandra S. Ikuta, who dissented in *Marciano*. In her view, a *per se* rule that claims arising from unstayed state court judgments can never be subject to bona fide dispute, even during a pending appeal process, does not provide debtors with sufficient protection against the "substantial consequences" of involuntary bankruptcy and "potential abuses" of that remedy by zealous creditors. She viewed the majority's approach as a "shortcut" that is contrary to section 303(b) and to earlier Ninth Circuit decisions.

Specifically, Circuit Judge Ikuta suggested that the Ninth Circuit's earlier decision in *In re Vortex Fishing Sys., Inc.*, 277 F.3d 1057 (9th Cir. 2001), echoed *Byrd* and adopted an "objective test" requiring courts to undertake "a factual, case-by-case inquiry into the nature of each claim," to determine "whether there is an objective basis for either a factual or a legal dispute as to the validity of the debt" (internal citations and quotations omitted). Instead, she explained, the majority opinion in *Marciano* distinguished *Vortex* briefly but completely for "deal[ing] with contract claims not yet reduced to judgment" and said nothing more about it. "Clearly, our articulation of the objective test in *Vortex* (expressly joining the other circuits that had adopted the test)," Circuit Judge Ikuta wrote, "was not dependent on the facts of that case, but rather provided the circuit's construction of 'subject to a bona fide dispute' in § 303(b)."

On the issue of statutory interpretation, whereas the majority in *Marciano* read section 101(5)

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of the Bankruptcy Code (defining "claim") to support a focus on the judgment (as distinguished from the underlying claims), Circuit Judge Ikuta felt that the emphasis must remain on the underlying claims and whether they remain subject to bona fide dispute via the appeal. From this perspective, the immediate enforceability of the unstayed judgment was irrelevant to Circuit Judge Ikuta.

Finally, Circuit Judge Ikuta contended that her approach creates no federalism issue because it does not call upon the bankruptcy court to "relitigate the debtor's liability" under state law. Rather, she wrote, "the question whether a determination is *subject to* a genuine dispute is separate from determining the merits of that dispute" (emphasis in original).

Conclusion

In adopting the majority view, the Ninth Circuit has joined bankruptcy courts in New York, Delaware, Virginia, Louisiana, Pennsylvania and South Carolina. *See, e.g., Drexler*, 56 B.R. at 967; *In re AMC Investors, LLC*, 406 B.R. 478 (Bankr. D. Del. 2009); *In re Cohn-Phillips, Ltd.*, 193 B.R. 757 (Bankr. E.D. Va. 1996); *In re Norris*, 183 B.R. 437 (Bankr. W.D. La. 1995); *In re Raymark Indus., Inc.*, 99 B.R. 298 (Bankr. E.D. Pa. 1989); *In re Caucus Distribs., Inc.*, 83 B.R. 921 (Bankr. E.D.Va. 1988); I*n re Galaxy Boat Mfg. Co. Inc.*, 72 B.R. 200 (Bankr. S.C. 1986).

Courts in Pennsylvania, meanwhile, have issued decisions following the minority *Byrd* Rule, as have bankruptcy courts in West Virginia and Texas. *See In re Tucker*, 2010 WL 4823917 (Bankr. N.D. W.Va. Nov. 22, 2010); *In re Henry S. Miller Commercial, LLC*, 418 B.R. 912 (Bankr. N.D. Tex. 2009); *In re Graber*, 319 B.R. 374 (Bankr. E.D. Pa. 2004); *In re Prisuta*, 121 B.R. 474 (Bankr. W.D. Pa. 1990). In some of these latter decisions, such as Prisuta, the judgments in question had not yet been appealed, but the court was willing to entertain, and found, grounds for bona fide dispute. *See Prisuta*, 121 B.R. at 477 ("The disputes in this case concerning the debts owed by alleged debtors to petitioners appear bona fide … despite the uncontested, unstayed, unappealed judgments of record which gave rise to the debts.")

Interestingly — though ultimately irrelevant under the *Drexler* Rule — the state court jury in *Marciano* never considered the merits of Marciano's answer and defenses to the cross-claims against him, because the state court struck them as a sanction for discovery abuses and proceeded as if he had defaulted. Even so, courts employing the majority *Drexler* Rule would say that the merits were sufficiently determined for purposes of eliminating any bona fide dispute within the meaning of section 303(b) of the Bankruptcy Code. Apparently, in *Marciano*, the state appellate court ultimately upheld the judgments but reduced their aggregate amount by two-thirds. Even in their reduced amounts, however, the claims totaled $30 million and therefore far exceeded the $14,425 minimum of section 303(b).

In any circuit, a group of creditors should consider its position carefully before commencing an involuntary bankruptcy case against a debtor. The creditors should confirm that all aspects of section 303(b)(1) are complied with, including whether the debtor could raise "a bona fide dispute as to [the] liability or amount" of the claims involved. If one or more of the claims are based on a state court judgment that the debtor has appealed without obtaining a stay, the creditor should confirm whether the applicable bankruptcy court is bound or likely to follow the majority *Drexler* Rule or the minority *Byrd* Rule with respect to the existence of a "bona fide dispute" regarding the underlying claim.

Under the *Drexler* Rule, the creditor may proceed without concern that the debtor will assert that the claim is subject to a bona fide dispute. Under the *Byrd* Rule, however, the debtor will have the opportunity to persuade the bankruptcy court that the appeal has sufficient merit to constitute a bona fide dispute, which would render the claim ineligible to support the involuntary petition if the bankruptcy court agrees.

Practically speaking, the outcome of a bankruptcy court's *Byrd* analysis might be the same as under the approach of *Drexler* and *Marciano*, and the existence of an appeal may be deemed insufficient to render the judgment claim ineligible under section 303. Indeed, in the *Byrd* decision itself, that was the outcome — although only after the analysis the court believed was necessary. Thus, the existence of an appeal is not necessarily a bar against relying on an unstayed court judgment on appeal to join an involuntary petition in *Byrd* Rule jurisdictions. Nevertheless, creditors in such jurisdictions should be forewarned that their involuntary petition might be subject to challenge on this basis, and be prepared to demonstrate to the bankruptcy court that such a claim is not in bona fide dispute.

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