'Watch Your Attitude, Petitioning Creditors!'

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The Bankruptcy Code contains relatively clear and straightforward requirements and standards regarding the eligibility of creditors to file an involuntary bankruptcy petition against a debtor, as well as when an order for relief on such petition shall be ordered by the court. If such criteria are met, do the creditors' intentions, which are not specifically referenced in this context in the statutory framework, come into play at all?

In the recent case of *In re Forever Green Athletic Fields, Inc.*, 804 F.3d 328 (3d Cir. 2015), the United States Court of Appeals for the Third Circuit held that, even if petitioning creditors and the debtor met the statutory prerequisites for involuntary bankruptcy relief, if the petitioning creditors had not acted in "good faith" in filing the petition, then the bankruptcy case should be dismissed and sanctions potentially awarded against the petitioning creditors. 804 F.3d at 333-35. This ruling could make pursuing involuntary bankruptcy a less attractive tactical alternative for creditors that are unsuccessful in attempting to collect upon unpaid claims and should certainly cause creditors to evaluate their and other petitioning creditors' motives (including prior conduct and statements) before commencing any involuntary bankruptcy proceedings.

Statutory Background

Bankruptcy Code § 303(b) provides, in relevant part, that an involuntary bankruptcy case under Chapter 7 or 11 may be commenced against a person (including most individuals, partnerships, and corporations) by the filing of a petition in bankruptcy court:

(1) by three or more entities, each of which is . . . 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 . . . if such noncontingent, undisputed claims aggregate at least $15,325 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims; [or] (2) if there are fewer than 12 such holders, . . . by one or more of such holders that hold in the aggregate at least $15,325 of such claims . . . .

Additionally, Bankruptcy Code § 303(h) provides, in relevant part, that if the petition is opposed, then:

after trial, the court shall order relief against the debtor in an involuntary case under the chapter under which the petition was filed, only if—(1) the debtor is generally not paying such debtor's debts as such debts become due unless such debts are the subject of a bona fide dispute as to liability or amount . . ..

Finally, Bankruptcy Code § 303(i) provides, in relevant part:

[i]f the court dismisses a petition under this section other than on consent of all petitioners and the debtor, and if the debtor does not waive the right to judgment under this subsection, the court may grant judgment— . . . (2) against any petitioner that filed the petition in bad faith, for—(A) any damages proximately caused by such filing; or (B) punitive damages [in addition to "costs; or a reasonable attorney's fee" under the prior subsection].

Factual Background and Pre-Bankruptcy Relationships

The parties had a complicated history of inter-connected relationships and had engaged in extensive litigation prior to the bankruptcy matter. See generally 804 F. 3d at 330-32.

Forever Green Athletic Fields, Inc. ("Forever Green"), was in the business of selling artificial turf playing fields. Its former sales representative, Charles Dawson, formed a different company called ProGreen Synthetic Grass ("ProGreen") to compete with Forever Green. In 2005, Forever Green filed an action against ProGreen in Bucks County, Pennsylvania (the "Bucks County Action"), for $5 million, alleging diversion of corporate assets. At about the same time, Mr. Dawson and his wife filed an action for unpaid wages and commissions against Forever Green in Louisiana (the "Louisiana Action"). In 2011, a consent judgment of approximately $300,000 was entered in favor of the Dawsons in the Louisiana Action. 804 F. 3d at 330-31.

The parties were scheduled to arbitrate the claims alleged in the Bucks County Action, but shortly after the consent judgment in the Louisiana Action was entered, ProGreen attempted to terminate the arbitration on the basis that Forever Green was insolvent, the expenses of the arbitrator would not be paid, and it expected to obtain judgment against Forever Green, which would render any amounts to be paid to the arbitrator subject to execution and garnishment. Shortly thereafter, the Dawsons transferred the consent judgment to Pennsylvania and obtained a writ of execution, at which point the arbitration was suspended. 804 F.3d at 331.

In response, Forever Green commenced a new action in Philadelphia, Pennsylvania (the "Philadelphia Action"), claiming, among other things, that Mr. Dawson had threatened to put Forever Green into bankruptcy if the arbitration was not terminated. Mr. Dawson nonetheless continued his attempts to collect upon the consent judgment, and the judge in the Philadelphia Action set a briefing schedule. No briefing took place, however, because Mr. Dawson, his wife, and a law firm joined together and filed an involuntary bankruptcy petition against Forever Green under Chapter 7 of the Bankruptcy Code. 804 F.3d at 331-32.

Procedural History

Even though the petitioners met the necessary statutory predicates to file an involuntary bankruptcy petition against Forever Green, and that petition was valid on its face, Forever Green moved to dismiss the involuntary petition, alleging that Mr. Dawson had acted in bad faith. The Bankruptcy Court ultimately granted the motion to dismiss and concluded that, "even though the petitioning creditors met the statutory filing requirements, Charles Dawson was a bad-faith creditor because he was motivated by two improper purposes: to frustrate Forever Green's efforts to litigate its claim against ProGreen and to collect on a debt." 804 F.3d at 332. Once it found that Mr. Dawson was acting in bad faith, the Bankruptcy Court dismissed the involuntary case because there were only two good-faith petitioning creditors that remained, which was one short of the three required by Section 303(b). 804 F.3d at 332.

The District Court affirmed, and the Dawsons appealed. The United States Court of Appeals for the Third Circuit reviewed the Bankruptcy Court's factual findings for clear error and its legal determinations *de novo*. 804 F.3d at 332.

Court of Appeals' Ruling and Reasoning

Noting that it was not disputed that the Dawsons and the law firm, as three distinct creditors with undisputed debts of more than $15,325, satisfied the statutory predicates to commence an involuntary bankruptcy, see 11 U.S.C. § 303(b)(1) (quoted above), and that Forever Green was generally not paying its debts as they became due, see 11 U.S.C. § 303(h)(1) (quoted above), the Court focused on "whether bad faith may serve as a basis for dismissal even where the criteria for commencing" and sustaining an involuntary bankruptcy case are satisfied. 804 F.3d at 333-34. Rejecting certain precedent reaching the opposite conclusion (see, e.g., In re WLB-RSK Venture, 2004 WL 3119789, at *6 n. 13 (B.A.P. 9th Cir. Nov. 24, 2004) ("good or bad faith of the petitioning creditor appears irrelevant"); In re Knoth, 168 B.R. 311, 315 (D.S.C. 1994) ("motivation of the petitioning creditor is irrelevant")), the Court ultimately concluded that it "disagree[d] that the text of [section] 303 forecloses bad-faith dismissals", and found that a bankruptcy court may require the good faith of involuntary bankruptcy petitioners. 804 F.3d at 334.

In reaching this conclusion, the Court noted that it is a court of equity and rejected arguments that the lack of a specific good-faith requirement in the Bankruptcy Code foreclosed a bankruptcy court from dismissing an involuntary case as a result of the bad faith of one of the petitioning creditors. The Court was not persuaded in this regard that the only reference to bad (or good) faith in the involuntary bankruptcy statutory scheme is in the context of the ability to sanction a petitioner found to have acted in bad faith in filing a petition that the court has determined to dismiss. See 11 U.S.C. § 303(i) (quoted above). In addition, after reviewing prior decisions, the Court contended that a majority of courts addressing the issue had reached similar conclusions. See In re U.S. Optical, Inc., 1993 WL 93931, at *3 (4th Cir. Apr. 1, 1993); In re Bock Transp., Inc., 327 B.R. 378, 381 (B.A.P. 8th Cir. 2005); In re Tichy Elec. Co., 332 B.R. 364, 373 (N.D. Iowa 2005); In re Alexander, WL 33951465, at *3 (D. Vt. Aug. 29, 2000); In re Manhattan Indus., Inc., 224 B.R. 195, 201 (Bankr. M.D. Fla. 1997). Finally, the Court also invoked policy considerations for further justification: "[a]llowing for the dismissal of bad-faith filings will encourage creditors to file petitions for proper reasons … ." 804 F.3d at 334, n. 5.

Having concluded that the bad faith of a petitioning creditor could be a basis to dismiss an involuntary petition, the Court then evaluated whether Mr. Dawson had, in fact, acted in bad faith. See 804 F.3d at 335-37. The Court employed a totality of the circumstances test, as opposed tests used by other courts, including an improper-use test (see In re K.P. Enter., 135 B.R. 147, 179 n. 14 (Bankr. D. Me.) (creditor attempted to obtain disproportionate advantages)), improper-purpose test (see In re Bayshore, 209 F.3d 100, 105 (2d Cir. 2000) (creditor motivated by ill will, malice, or desire to embarrass or harass)), or an objective test (see In re Wavelength, Inc., 61 B.R. 614, 620 (B.A.P. 9th Cir. 1986) (focused on what reasonable person would have believed and done in creditor's position)).

The Court affirmed because the Bankruptcy Court had determined that Mr. Dawson's "any means necessary" litigation strategy -- especially his aggressive actions with respect to the arbitration -- justified the bad-faith dismissal. 804 F.3d at 336. According to the Court, Mr. Dawson's actions "ran counter to the spirit of collective creditor action that should animate an involuntary filing", 804 F.3d at 336, and he put his interests above all others to extract payment on the consent judgment at the expense of other, higher-priority creditors. 804 F.3d at 336-37. The Court also emphasized the lack of diligence or investigation done prior to the involuntary filing and the unique timing of it (just days before a brief was due in the Philadelphia Action) as additional evidence of bad faith. 804 F.3d at 337. Finally, the Court noted the lack of any evidence of depletion of assets by Forever Green to conclude ultimately that "the record supports the Bankruptcy Court's decision to dismiss the petition as a bad-faith filing." 804 F.3d at 337.

Finally, the Court rejected an argument that an alternative, presumably good-faith creditor could have been found to replace Mr. Dawson as part of the involuntary petition and remedy any bad faith. See 804 F.3d at 337-38. Even though it declined to adopt the blanket "bar to joinder" rule of other jurisdictions that would have *per se* barred a subsequent creditor from joining the involuntary petition, the Court still found that the deficiency caused by Mr. Dawson's bad faith could not be cured, because no other creditor had in fact joined the petition, and doing so at that time would have been too late. 804 F.3d at 338.

Conclusion

Although it may appear from the face of the Bankruptcy Code that three creditors with sufficient *bona fide* claims are permitted to join together and commence an involuntary bankruptcy against a debtor that is not generally paying its debts as they become due, as a presumably legitimate means to collect upon an unpaid debt, such potential petitioning creditors should exercise caution in light of *Forever Green*. Not only must such creditors and the debtor meet the seemingly straightforward standards, but also the petitioners must insure that none of their group has acted in any way that could be characterized as bad faith, including in how any of them may have attempted to collect their debt or may have behaved in prior litigation.

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