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Involuntary Bankruptcy Cases and Discretionary "For Cause" Dismissals

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INTRODUCTION

This article addresses whether a bankruptcy court has the discretionary power to dismiss an involuntary bankruptcy case filed under chapters 7 or 11 of title 11 of the United States Code (the "Bankruptcy Code") for cause when there is a finding of bad faith or a lack of good faith on behalf of the petitioning creditor or creditors. In short, it is unclear because there is insufficient authority on this issue in the involuntary context, and the issue remains split among the courts in the voluntary context.

This article first addresses the statutory requirements of an involuntary petition. Next, it examines the court's basis for relief or dismissal of involuntary bankruptcy cases, focusing specifically on "for cause" dismissals. Lastly, it reviews how various jurisdictions have considered the issue of whether a lack of good faith or a finding of bad faith is grounds for dismissal under section 707(a) of Bankruptcy Code.

I. Involuntary Petitions

Involuntary petitions "help ensure the orderly and fair distribution of an estate by giving creditors an alternative to watching nervously as assets are depleted, either by the debtor or by

rival creditors who beat them to the courthouse."[1] Notwithstanding these benefits, the filing of an involuntary petition can result in "'serious consequences [for] the alleged debtor, such as loss of credit standing, inability to transfer assets and carry on business affairs, and public embarrassment."[2]

Creditors may initiate involuntary bankruptcy cases under chapters 7 or 11 of the Bankruptcy Code against any entity that would be eligible to file a voluntary case under the applicable chapter, subject to limited exceptions for farmers, family farmers, and nonprofit or charitable corporations.[3] To file an involuntary bankruptcy petition, certain requirements must be satisfied, such as the number of petitioning creditors, the types of claims these creditors hold, and the amount of the claims.[4]

a. Minimum Number of Creditors

Section 303 states that three or more entities, each of which is a holder of eligible claims against a debtor, or an indenture trustee representing such holder, can file an involuntary petition so long as those eligible claims aggregate to at least $16,750 more than the value of any lien on the property of the debtor securing such claims held by the holders of such claims.[5] If less than twelve creditors hold qualified claims against the debtor, then one or more of these creditors holding in the aggregate at least $16,750 in eligible claims may file an involuntary case, subject to certain exceptions.[6] Thus, an involuntary bankruptcy case can be initiated by only one creditor

[1] *See In re* Murray, 900 F.3d 53, 59 (2d Cir. 2018).
[2] *See id.* (citing *In re* Forever Green Athletic Fields, Inc., 804 F.3d 328, 335 (3d Cir. 2015)). For these reasons, involuntary cases involving only one creditor may be reviewed with stricter scrutiny than other cases. *See In re* Mt. Dairies, Inc., 372 B.R. 623, 635 (Bankr. S.D.N.Y. 2007) ("The Bankruptcy Court is not a collection agency."). *But see In re* Corrline Intern., *LLC*, 516 B.R. 106, 143 (Bankr. S.D. Tex. 2014) (declaring that heightened scrutiny is not warranted when a single creditor files an involuntary petition because the [Bankruptcy] Code does not state such a rule).
[3] *See* 11 U.S.C. § 303(a) (2012).
[4] *See id*. § 303(b).
[5] *See id*. § 303(b)(1).
[6] *See id*. § 303(b)(2)

if that creditor is one of less than 12 creditors and has an eligible claim worth at least $16,750 as of the petition's filing date.[7] Section 303 also qualifies members of a partnership and foreign representatives of the estate to file an involuntary petition.[8]

b. Eligible Claims

Petitioning creditors must hold eligible claims to file an involuntary petition. Eligible claims are neither contingent as to liability nor the subject of a bona fide dispute as to liability or amount.[9] First, a contingent claim under the Bankruptcy Code refers "to obligations that will become due upon the happening of a future event that was within the actual or presumed contemplation of the parties at the time the original relationship between the parties was created."[10] Second, a majority of courts use an objective standard to determine whether claims are subject to a bona fide dispute by examining if there is a genuine, material factual or legal issue as to the validity of the debt amount or a legitimate factual basis for the debtor not paying the debt.[11]

c. Minimum Amount of Claims

Eligible claims must aggregate at least $16,750.[12] This amount will change due to inflation every three years to reflect the change in the Consumer Price Index.[13] This amount recently changed from $15,775 to $16,750 on April 1, 2019.[14]

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[7] *See In re* Cohn-Phillips, Ltd., 193 B.R. 757, 763 (Bankr. E.D. Va. 1996) (explaining that the total number of the debtor's creditors is to be determined as of the date the petition is filed).
[8] *See* 11 U.S.C. § 303(b)(3), (4).
[9] *See id*. § 303(b).
[10] Ogle v. Fid. & Deposit Co. of Maryland, 586 F.3d 143, 146 (2d Cir. 2009) (internal quotation and citation omitted).
[11] *See, eg., In re* TPG Troy, LLC, 793 F.3d 228, 234 (2d Cir. 2015) ("Courts apply an objective test in determining whether a bona fide dispute exists."); Matter of Sims, 994 F.2d 210, 220-221 (5th Cir. 1993) (adopting an objective standard, similarly to the Third, Seventh, Eighth, and Tenth Circuits); *In re* Vortex Fishing Sys., Inc., 277 F.3d 1057, 1062 (9th Cir. 2002) (joining other circuits and adopting the objective test for determining bona fide disputes regarding liability or amount).
[12] *See* 11 U.S.C. § 303(b)(1)(2).
[13] *See id*. § 104(a)(1).
[14] *Id*.

II. Basis for Relief or Dismissal

A court may grant involuntary relief against the debtor for a variety of reasons, such as the debtor's failure to timely contest the involuntary petition, the debtor's general failure to pay its debts as they become due, or whether within 120 days before the petition was filed, a custodian was appointed to take possession of substantially all of the debtor's property, other than for the purpose of enforcing a lien against the debtor's property.[15]

Just as the court may grant involuntary relief, the court may also deny the petition and dismiss the case. Dismissal generally restores the pre-bankruptcy status quo and reestablishes the rights of the parties as they existed when the petition was filed.[16] Involuntary bankruptcy cases can be dismissed on a motion to withdraw, if all the petitioners and the debtor consent to dismissal, or for lack of prosecution.[17] The Bankruptcy Code and Federal Rules of Bankruptcy Procedure unambiguously provide that the debtor named in the involuntary petition may contest the petition, other than in a partnership situation.[18] A debtor may file a responsive pleading and "utilize section 303(j) of the Bankruptcy Code as grounds for dismissal."[19] Additionally, bankruptcy courts may dismiss or suspend an involuntary case and abstain from taking jurisdiction at any time.[20] However, courts rarely abstain, and consider abstention an extraordinary remedy because these decisions are not reviewable by appeal.[21]

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[15] *See id*. § 303(h).
[16] *See In re* Serrato, 214 B.R. 219, 227 (Bankr. N.D. Cal. 1997).
[17] *See* 11 U.S.C. § 303(j).
[18] *See In re* Jr. Food Mart of Arkansas, Inc., 234 B.R. 420, 421 (Bankr. E.D. Ark. 1999).
[19] *Id.*
[20] *See* 11 U.S.C. § 305(a).
[21] *See id*. § 305(c); *In re* Pallet Reefer Co., 233 B.R. 687, 694 (Bankr. E.D. La. 1999) ("Because the power of abstention is not reviewable by the courts of appeal [], courts have determined that abstention under section 305 is an extraordinary power that is to be used only in extraordinary circumstances.").

Courts are also empowered to dismiss involuntary cases "for cause" pursuant to section 707(a). The Bankruptcy Code does not define "cause" for dismissal.[22] Pursuant to section 707(a), the court may dismiss a chapter 7 case, "only after notice and a hearing, and only for cause," which includes the following: (1) unreasonable delay by the debtor that is prejudicial to creditors; (2) nonpayment of specified fees; and (3) only by motion of the U.S. Trustee, failure of the debtor in a voluntary case to file within a specified time frame the information required under section 521(a).[23]

Section 707(a)'s three enumerated examples of cause are "illustrative, not exhaustive."[24] Due to this non-exhaustive nature, courts use a variety of factors and engage in a holistic fact-sensitive inquiry to determine whether cause exists to warrant dismissal.[25] For example, the Second Circuit recently affirmed a *sua sponte* for cause dismissal of an involuntary bankruptcy case based on the following nine factors identified by the bankruptcy court: (1) the bankruptcy court was the most recent battlefield in a long-running, two-party dispute; (2) the creditor brought the case solely to enforce a judgment; (3) there were no competing creditors; (4) there was no need for *pari passu* distribution; (5) assuming there were fraudulent transfers to be avoided, the creditor could do so in another forum; (6) the creditor had adequate remedies to enforce its judgment under non-bankruptcy law; (7) the creditor invoked the bankruptcy laws solely to secure a benefit that it did not have under non-bankruptcy law and without a creditor

[22] *See In re* Murray, 900 F.3d 53, 58 (2d Cir. 2018).
[23] 11 U.S.C. § 707(a).
[24] *In re* Murray, 900 F.3d at 58; *see In re* Padilla, 222 F.3d 1184, 1191 (9th Cir. 2000) ("The grounds that § 707(a) lists as providing "cause" for dismissal are illustrative and not exhaustive."); *In re* Huckfeldt, 39 F.3d 829, 831 (8th Cir. 1994) (stating that the enumerated grounds for dismissal under section 707(a) are "nonexclusive"); *In re* Zick, 931 F.2d 1124, 1126 (6th Cir. 1991) (declaring that the word "including" in section 707(a) "is not meant to be a limiting word").
[25] *See In re* Murray, 900 F.3d at 60 ("Cause is a fact-specific inquiry as to which a variety of factors may be relevant, including the purpose for which the petition was filed and whether state proceedings adequately protect the parties' interests.").

community to protect; (8) no assets would be lost or dissipated in the event that the bankruptcy case did not continue; and (9) the debtor did not want or need a bankruptcy discharge.[26]

The application of these factors will inevitably vary depending on the facts of the case at issue and the jurisdiction where the petition is filed. However, the Second Circuit's affirmance of the bankruptcy court's application of the above factors highlights the policy recognized by every circuit: to ensure the efficient and proper use of the bankruptcy system as the arbiter of bona fide bankruptcy disputes; the system is not a "collection agency" for disgruntled creditors.[27]

One main split among the courts, however, is whether a finding of bad faith or a lack of good faith constitutes cause for dismissal under section 707(a).[28] This area of the law is still developing. In the involuntary context, there is a lack of authority as to whether a petitioning creditor's bad faith or lack of good faith is sufficient grounds for dismissal pursuant to section 707(a). Many of the cases that grapple with this issue have been addressed in the context of a debtor's voluntary case.

The Sixth Circuit appears to be the first circuit court to confront this issue in the voluntary context in *In re Zick*, where it affirmed the dismissal of a debtor's case and held that a lack of good faith is valid cause for dismissal under section 707(a).[29] In *In re Zick*, the debtor's pre-petition activities, such as a "malicious breach" of a noncompetition agreement, were sufficient to be considered bad faith motivation that warranted dismissal for cause.[30] However,

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[26] *Id.* at 57-58.
[27] *See In re* Murrin, 477 B.R. 99, 105 (D. Minn. 2012) (stating that involuntary petitions are "not intended to be used in an exclusively self-serving manner [by creditors] as a collection device").
[28] The distinction between a finding of bad faith or a lack of good faith is blurred, which adds to the confusion. *See In re* Snyder, 509 B.R. 945, 949-953 (Bankr. D.N.M. 2014) (discussing the contours of this split among the courts).
[29] 931 F.2d 1124, 1127 (6th Cir. 1991) ("We are persuaded that there is good authority for the principle that [a] lack of good faith is a valid basis of decision in a "for cause" dismissal by a bankruptcy court.").
[30] *Id.* at 1129.

the Sixth Circuit did not clarify whether dismissal was based on a lack of good faith or an affirmative finding of bad faith but instead conflated the use of both terms in its analysis.[31]

The Third and Eleventh Circuits agree that in the voluntary context, a debtor's lack of good faith is grounds for dismissal under section 707(a). However, the distinction, if any, between a lack of good faith or a finding of bad faith remains unclear. For example, in *In re Tamecki*, the debtor filed a petition for protection under chapter 7 of the Bankruptcy Code seeking to exempt equity in his home, even though he and his wife were estranged for quite some time and on the verge of divorce.[32] The trustee believed that the debtor would soon be entitled to his unencumbered share of the tenancy by the entirety and that the debtor acted in "bad faith" by filing his petition "knowing that he would soon be in a position to repay his debts."[33] The bankruptcy court found that the debtor had "failed to prove his good faith in filing for bankruptcy" and dismissed the petition for cause pursuant to section 707(a).[34] The Third Circuit affirmed the bankruptcy court's dismissal and declared that "[o]nce a party calls into question a petitioner's *good faith*, the burden shifts to the petitioner to prove his *good faith*."[35] Although the opinion reiterates that dismissal was based upon the debtor's failed showing of good faith, the facts indicate that the debtor's conduct could be considered bad faith.[36]

Relatedly, in *In re Piazza*, the Eleventh Circuit engaged in an extensive textual analysis of the Bankruptcy Code and considered whether, in the voluntary context, a lack of good faith or a finding of bad faith was grounds for dismissal under section 707(a).[37] In that case, the court rejected the debtor's argument that an *ejusdem generis* canon of interpretation of section 707(a)

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[31] *See id.* at 1127-1129 (intermingling the use of both "bad faith" and a "lack of good faith" in the opinion).
[32] *See In re* Tamecki, 229 F.3d 205, 206-207 (3d Cir. 2000).
[33] *Id.*
[34] *Id.*
[35] *Id.* at 207 (emphasis added).
[36] *See id.* at 207-208.
[37] 719 F.3d 1253, 1262-1265 (11th Cir. 2013).

precludes "bad faith" as grounds for dismissal because "the Supreme Court made clear bad faith is pertinent in all Chapters of the Bankruptcy Code, regardless of whether a provision contains an explicit good-faith filing requirement."[38] The *In re Piazza* court concluded that "[p]repetition bad faith unquestionably constitutes adequate or sufficient reason to dismiss a Chapter 7 petition."[39] Yet, the Eleventh Circuit failed to clarify: (1) whether a lack of good faith is grounds for dismissal under section 707(a); (2) what a lack of good faith is; and (3) whether there is any distinction between a lack of good faith and an affirmative finding of bad faith.

Many other lower courts have held that, in the voluntary context, a finding of bad faith or a lack of good faith constitutes cause for dismissal pursuant to section 707(a).[40] However, the Eighth and Ninth Circuits and several bankruptcy courts do not consider bad faith as grounds for dismissal under section 707(a) in the voluntary context.[41] These courts take the stance that since there is no mention of good faith or bad faith in section 707(a), a bankruptcy court electing to act under inherent judicial power to punish a bad faith litigant should act outside of section 707(a).[42]

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[38] *Id*.
[39] *Id*. at 1270.
[40] *See* First Capital Bank of Kentucky v. Blok, 2012 WL 1682042, at *4 (S.D. Ind. 2012) (addressing that the Seventh Circuit has not spoken on the issue in the Chapter 7 context but holding that bad faith constitutes cause for dismissal); McDow v. Smith, 295 B.R. 69, 74 (E.D. Va. 2003) (recognizing the bifurcated use of a lack of good faith and a finding of bad faith and holding that under section 707(a), "a debtor's bad faith acts or omissions may, in the totality of the circumstances, constitute cause for dismissal …."); *In re* Quinn, 490 B.R. 607, 614 (Bankr. D.N.M. 2012) (concluding that a "bad faith filing" may constitute "cause" for dismissal of a chapter 7 case and that a "lack of good faith on the part of a debtor, whether pre-or post-petition, or both, is a relevant consideration in determining whether to dismiss" a case); *In re* Smith, 229 B.R. 895, 897 (Bankr. S.D. Ga. 1997) (holding that a debtor's lack of good faith in filing constitutes cause for dismissal); *In re* Griffieth, 209 B.R. 823, 831 (Bankr. N.D.N.Y.1996) (justifying for cause dismissal pursuant to § 707(a) because the debtor's case was not filed in good faith).
[41] *See generally In re* Huckfeldt, 39 F.3d 829 (8th Cir. 1994); *See In re* Padilla, 222 F.3d 1184, 1191 (9th Cir. 2000) (holding that bad faith as a general proposition does not provide cause for dismissal under section 707(a)); *In re* Etcheverry, 242 B.R. 503, 506 (D. Colo. 1999) (holding that because there is no explicit "good faith" requirement in Chapter 7, bad faith cannot constitute cause for dismissal under section 707(a)); *In re* Landes, 195 B.R. 855, 855 (Bankr. E.D.Pa.1996) (holding that a good faith filing requirement cannot be read into section 707(a)).
[42] *In re* Huckfeldt, 39 F.3d at 832.

III. Conclusion

Certain statutory requirements must be satisfied if a creditor seeks to thrust a debtor into bankruptcy through the involuntary process. Once these requirements are satisfied, the court can grant involuntary relief, abstain from hearing the case, or dismiss the case and restore the pre-bankruptcy status quo of the parties. One basis for dismissal is "for cause" pursuant to section 707(a). While section 707(a) provides certain enumerated reasons a court can use to dismiss a case "for cause," these examples are not exhaustive and the courts may apply a wide array of factors, and have discretion to determine whether sufficient cause exists in a particular case to warrant dismissal. Whether a finding of bad faith or a lack of good faith constitutes cause depends on the jurisdiction where the petition is filed. Since most of the cases examining this issue are in the voluntary context, it is unclear whether a court's analysis of this issue would differ in the involuntary context.