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A Creditor with a Partially Disputed Claim Risks Disqualification from an Involuntary Petition

Trade and other unsecured creditors may consider joining an involuntary bankruptcy petition as a means to obtain payment of their claims. However, they should carefully weigh their decision and consider section 303(b)(1) of the Bankruptcy Code, which conditions a creditor's eligibility to join an involuntary petition on its claim not being subject to a *bona fide* dispute as to liability or amount.

A recent decision by the United States District Court for the District of Nevada, in *State of Montana Department of Revenue v. Blixseth* (the “*Blixseth* Court”), has fleshed out the meaning of a *bona fide* dispute as to the amount of a petitioning creditor's claim and serves as a stark warning to creditors contemplating joining an involuntary bankruptcy petition. The *Blixseth* Court upheld the dismissal of an involuntary petition based on the disqualification of two petitioning creditors whose claims were found to be subject to a *bona fide* dispute as to amount because they were partially disputed. Bottom line, this decision raises the bar for creditors filing an involuntary bankruptcy petition. Creditors should make sure their claims are *wholly* undisputed or risk dismissal of the petition that can expose them to sanctions.

Grounds for an Involuntary Bankruptcy Petition

Section 303 of the Bankruptcy Code includes the requirements for obtaining relief on an involuntary bankruptcy petition. According to section 303(b)(1), where the debtor has 12 or more creditors, not less than three creditors holding unsecured claims totaling at least \$15,775, that are not contingent as to liability or the subject of a *bona fide* dispute as to liability or amount, must join in the filing of the involuntary bankruptcy petition.¹ The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”) amendments to the Bankruptcy Code changed 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 led to questions about the eligibility of petitioning creditors whose claims are partially disputed, even if the dispute is de minimis in relation to the entire claim amounts.

Although the issue was not specifically before the *Blixseth* Court, if a debtor contests an involuntary petition, the petitioning creditors have the burden of proving that the debtor is generally not paying its debts, not otherwise subject to a *bona fide* dispute as to liability or amount, as such debts become due.² When the petitioners have

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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.

When 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 (arising from the dismissal of an involuntary bankruptcy petition), enumerated 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 to discourage petitioning creditors from joining in a frivolous involuntary bankruptcy 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 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.

Facts and Procedural History

On April 5, 2011 (the “Petition Date”), the State of Montana Department of Revenue (“Montana”), the California Franchise Tax Board (“California”), and the Idaho State Tax Commission (“Idaho”) filed an involuntary bankruptcy petition against Timothy Blixseth (“Blixseth”) in the United States Bankruptcy Court for the District of Nevada (the “Bankruptcy Court”). Montana and California asserted tax claims against Blixseth in the amounts of \$219,258 and \$986,957.94, respectively.

Shortly after the Petition Date, Idaho and California reached settlements with Blixseth and withdrew their participation in the involuntary petition. Subsequently, another creditor of Blixseth, the Trustee of the Yellowstone Club Liquidating Trust (the “Yellowstone Trustee”), joined the involuntary petition.

Blixseth moved to dismiss the involuntary case. Blixseth argued that the petitioning creditors did not satisfy the requirements of Bankruptcy Code section 303(b)(1) because three creditors with non-contingent undisputed unsecured claims, totaling at least the minimum statutory threshold of \$14,425 on the Petition Date, did not join the involuntary petition.³

The Bankruptcy Court dismissed the involuntary petition. The court initially ruled that Blixseth had at least 12 creditors and, therefore, a minimum of three petitioning creditors with unsecured claims totaling at least \$14,425, not subject to

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a *bona fide* dispute as to liability or amount, had to join the involuntary petition. The Bankruptcy Court then disqualified Montana’s⁴ and California’s⁵ claims because they were partially disputed and were, therefore, subject to a *bona fide* dispute as to amount. Thus, even if the other two petitioning creditors, Idaho and the Yellowstone Trustee, had valid undisputed claims, they still needed a third petitioning creditor with a claim that was not subject to a *bona fide* dispute as to liability or amount. Participation in the involuntary petition, therefore, required a third petitioning creditor with a totally undisputed claim!

Blixseth and Montana then filed cross-appeals to the District Court for the District of Nevada.

The Blixseth Court's Decision

The *Blixseth* Court affirmed the Bankruptcy Court's dismissal of the involuntary petition, holding that Bankruptcy Code 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 none of the petitioning creditor's claims can be subject to a *bona fide* dispute as to amount.

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The *Blixseth* Court rejected Montana's argument that a claim is not subject to a *bona fide* dispute as to amount if only a portion of the claim is undisputed and the dispute does not reduce the aggregate amount of the petitioning creditors' claims below the statutory threshold (in this case, \$14,425). Montana relied on the holdings of some bankruptcy courts, after the 2005 BAPCPA amendments to the Bankruptcy Code, that a petitioning creditor should not be disqualified even if the debtor asserts a *bona fide* dispute regarding a portion of the creditor's claim. Montana argued that the 2005 BAPCPA amendments clarified the prevailing view that a dispute over the amount of a creditor's claim is *bona fide* only if it lowers the aggregate amount of the petitioning creditors' claims below the minimum statutory threshold (\$14,425 in the *Blixseth* case).

The *Blixseth* court disagreed, noting that section 303(b)(1) does not qualify its requirement that a petitioning creditor's claim must be free of any *bona fide* dispute as to the amount of the creditor's claim. Section 303(b)(1) also does not state that a *bona fide* dispute exists, or is relevant or material as to the amount of any petitioning creditor's claim, when the dispute reduces the aggregate amount of the petitioning creditors' claims below section 303's minimum threshold, \$14,425 in this case. Section 303(b)(1) clearly states that any *bona fide* dispute as to any portion of a petitioning creditor's claim disqualifies the creditor from participating in an involuntary petition.

Montana's contrary interpretation of section 303(b)(1) would require courts to read words into section 303—namely, relevant or material amounts (“i.e., those that reduce the petitioning creditors' claims below section 303(b)(1)'s minimum threshold”, \$14,425 in the *Blixseth* case), that Congress did not include or intend to include. The *Blixseth* Court relied heavily on the decision of the United States Court of Appeals for the First Circuit, in *Fustolo v. 50 Thomas Patton Drive, LLC* (the “*Fustolo* Court”). The *Fustolo* Court suggested, and the *Blixseth* Court agreed, that section 303(b)(1) unambiguously states that any partially disputed claim, regardless of the amount in dispute, is subject to a *bona fide* dispute.

The *Blixseth* Court suggested that while harsh, under certain circumstances, it would not be absurd to disqualify a creditor asserting a \$100,000 claim from participating in an involuntary petition where the debtor had disputed just \$100 of the claim. The court noted that conditioning a petitioning creditor's eligibility on its entire claim being undisputed would prevent a creditor from using an involuntary bankruptcy petition as a debt collection tool to coerce a debtor into paying a disputed claim.

Conclusion

The *Blixseth* Court held that creditors with partially disputed claims cannot join an involuntary bankruptcy petition. This decision could have a chilling effect on creditors' willingness to join involuntary bankruptcy petitions in Nevada and other jurisdictions due to their exposure to potential liability following dismissal of the petition as a result of their disqualification based on their partially disputed claims. A debtor seeking to contest an involuntary bankruptcy petition should have little difficulty contesting a creditor's claim, even where the principal amount is undisputed, based on a dispute as to the appropriate amount of interest or other charges the creditor is seeking to collect.

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Thus, an unsecured creditor must be sure that no portion of its claim is disputed prior to joining in an involuntary bankruptcy petition. Better safe than sorry! An alternative is for the creditor to assert only the undisputed portion of its claim in the involuntary petition. However, this raises the risk that the creditor cannot later assert the disputed portion of its claim as part of its proof of claim. ■

1. Where the debtor has fewer than 12 otherwise eligible unsecured creditors, excluding claims held by an employee, insider and any party that received a voidable transfer, such as a preference or fraudulent conveyance, one or two unsecured creditors, with a claim or claims totaling at least \$15,775, (based on the current statutory minimum), that are not contingent as to liability and not subject to a *bona fide* dispute as to liability or amount, may file an involuntary bankruptcy petition.
2. Courts rely on various factors when determining whether a debtor is not paying debts as they became due including: (a) the number of debts; (b) the amount of delinquency; (c) the materiality of non-payment by the debtor; (d) the total debt compared to the debtor's annual income; (e) the debtor's nonpayment of only the petitioning creditors' claims; and (f) whether the debtor has terminated its business and started liquidating its assets.
3. According to section 303(b)(1), on the Petition Date (April 5, 2011), the petitioning creditors' non-contingent and undisputed unsecured claims had to total at least \$14,425. Subsequent to the Petition Date, the Administrative Office of the United States Courts made periodic adjustments to the dollar amounts stated in various provisions of the Bankruptcy Code, including increases to the minimum aggregate amount of the non-contingent undisputed

unsecured claims of petitioning creditors to \$15,775 in cases filed on and after April 1, 2016.

4. With respect to Montana, the Bankruptcy Court determined that the amount of its claim was disputed after conducting a detailed analysis of the procedures that the Montana taxing authorities were required to follow (and the effect of those procedures) after an audit showed Blixseth owed more than he reported on his 2002 through 2006 tax returns.
5. With respect to California's claim, the Bankruptcy Court also determined there was an issue of material fact as to the amount of the claim because while California alleged Blixseth owed \$986,957.95 for the 2007 tax year, he also reported a loss of \$18,226,044 in 2008 that could have resulted in a large refund (e.g., a tax loss to carry back to 2007).

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