American College of Bankruptcy

Seventh Circuit Educational Seminar

Ethical Issues in Involuntary Bankruptcy Cases

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- **General Overview of Involuntary Bankruptcy Cases**
  - **What are involuntary cases?**
    - Chapter 7 or 11 cases filed by a group of creditors against an insolvent debtor (called the alleged debtor).
    - Governed primarily by Section 303 of the Bankruptcy Code, which sets forth certain requirements for filing, including, for example:
      - Eligibility requirements for creditors to commence an involuntary case;
      - Grounds for obtaining an order of relief;
      - Grounds for dismissal; and
      - Various other requirements.
  - **Involuntaries historically were infrequent, but are becoming more common.** It is important to understand the ethical implications of commencing an involuntary bankruptcy case.
- **Prefiling Diligence and Investigations by Petitioning Creditors**
  - **Pre-filing diligence/investigation standard:** Reasonable inquiry requirement under Bankruptcy Rule 9011 applies to *all* factors in filing an involuntary bankruptcy, including, for example, the eligibility of the petitioning creditors as well as the insolvency of the alleged debtor (discussed further below).
    - **Bankruptcy Rule 9011 Standard:** "The task of determining the legal sufficiency of a position under Bankruptcy Rule 9011 requires investigation of both the facts and the law prior to the signing and submission of a pleading." *In re McDonald Trucking Co.*, 7 B.R. 513 (Bankr. W.D. Pa. 1987). Is there a reasonable, good faith basis based on such investigation to believe grounds exist to file the involuntary petition? *See, e.g., In re Midwest Processing Co.*, 41 B.R. 90, 103 (Bankr. D. N.D. 1984).
      - **Precise extent of investigation into facts and law that is necessary depends on the particular circumstances.** *See, e.g., In re TCI Ltd.,* 769 F.2d 441, 447 (7th Cir. 1985). For example, where a petition must be filed on short notice with limited resources, courts will excuse some "attorney sloppiness" and will also not require an "experienced practitioner" to "undertake exhaustive research for every new case handled"—but the Rule 11 buck stops with the attorney preparing the petition. *See, e.g., id.*
    - **Timing:** As the phrase 'pre-suit investigation' indicates, the prospective petitioning creditors *must* conduct such investigation *before* the filing, not after. *E.g., In re K.P. Enterprise*, 135 B.R. 174, 182 (Bankr. D. Ma. 1992).
    - **Application of the Rule:** How this rule might apply to the various information necessary to file an involuntary case is discussed specifically in conjunction with the discussions of the various legal issues individually below.
  - **Advice of Counsel**
    - **Obtaining advice of counsel is generally considered a step in the due diligence/investigation process before filing.** *See, e.g., Pyke v. Funnel Sci. Internet Mktg., LLC* 551 B.R. 262 (E.D. Texas 2016).

- Moreover, in accordance with the general rule in federal courts, **creditors other than natural persons *must* be represented by counsel in order to file or sign on to an involuntary petition.** *See, e.g.*, *In re Spencer C. Young Invs./The Courtyard of Chapel Hill*, No. 08-81852, 2009 Bankr. LEXIS 869, at *9 (Bankr. M.D.N.C. Feb. 4, 2009); *In re ICLNDS Notes Acquisitions, L.L.C.*, 259 B.R. 289, 293–95 (Bankr. N.D. Ohio 2001).

- **Number of Petitioning Creditors and Size of Claims**
  - **General Rule:** If the alleged debtor has more than twelve creditors, at least three creditors must commence the involuntary bankruptcy case. In addition, the aggregate dollar amount of the noncontingent, undisputed claims held by the petitioning creditor(s) must be at least $16,750 (in the aggregate if there are three petitioning creditors). *See* 11 U.S.C. § 303(b).
  - **Good faith investigation into the size of the alleged debtor's business and the number of creditors is necessary before filing.** Creditors also need to confirm the amount of their own claims to ensure the dollar threshold is met. Such an investigation need not be exhaustive. Such an investigation can be fairly limited (or even "cursory")—so long as it yields enough information to form a good faith belief as to whether the alleged debtor has more or less than twelve creditors. *Basin Elec. Power Coop. v. Midwest Processing Co.*, 769 F.2d 483 (8th Cir. 1985).
  - **Such good faith can be found lacking in some situations despite the conduct of a pre-suit investigation**—where, for example, the investigation yields results that would cause a reasonable person to inquire further, but the petitioning creditor(s) ignored such flags—or where an alleged debtor is a large company that it must have more than twelve creditors. *See, e.g.*, *In re Mylotte*, 2007 Bankr. LEXIS 2375, at *29–30 (Bankr. E.D. Pa. 2007). In other words, courts require petitioning creditors and their counsel to use common sense to determine, from publicly available information and after a short investigation, whether an alleged debtor is more likely to have greater or fewer than twelve creditors.
    - As a general rule, most businesses will have more than twelve creditors by the time you count utility companies and the like.
  - **Joinder of Additional Petitioning Creditors:** While (as discussed further below) notice of a motion to dismiss need only be served on the petitioning creditors and others who are already party to the case, the petitioning creditors are allowed to join other creditors as petitioners postpetition; indeed, the court *must* "assure that other creditors have a 'reasonable opportunity' to exercise their § 303(c) statutory power to join as petitioners." *In re Vortex Fishing Syst., Inc.*, 277 F.3d 1057 (9th Cir. 2001); *see also* Fed. R. Bankr. P. 1003(b).
- **Disputed Status of Claims of Petitioning Creditors**
  - **General Rule:** As noted above, claims must not be subject to a *bona fide* dispute if such claims are to be used to qualify a petitioning creditor under Section 303(b) of the Bankruptcy Code.
    - For a claim to be subject to a *bona fide* dispute, there must be "an objective basis for either a factual or a legal dispute as to the validity

of the debt." *In re Busick*, 831 F.2d 745, 750 (7th Cir. 1987); *accord Vortex*, 277 F.3d at 1064.

- There is a split among circuits (and bankruptcy courts) regarding whether a dispute with regard to only a portion of a claim disqualifies the entire claim, or whether only the disputed portion is disqualified—the majority rule among the circuits is that a creditor's entire claim is disqualified if *any* portion of its claim is disputed. *See, e.g.*, *State Dep't of Rev. v. Blixseth*, 942 F.3d 1179, 1184–87 (9th Cir. 2019) (siding with the majority of cases and collecting lower court cases on both sides of the split).

- **Case law on the necessary investigation into this requirement is sparse**, but applying the above case law by analogy, and the general Rule 11 standard, petitioning creditors need to obtain enough information to hold a good faith belief that their claim(s) are not subject to a good faith dispute. *See In re John Richards Homes Bldg. Co., LLC*, 291 B.R. 727, 731 (Bankr. E.D. Mich. 2003) (dismissing involuntary petition where creditors "knew or should have known" their claims were subject to good faith disputes).
- Thus, **common sense is also necessary here.** For example, where active litigation or any other dispute resolution process is pending, or demand letters or other correspondence regarding the validity of the claim(s) has been exchanged, and the alleged debtor has taken non-frivolous positions disputed the claim(s), most courts would probably hold that the petitioning creditor should have known its claim was disputed. It is not enough that the petitioning creditor is convinced its arguments are right, if the alleged debtor has *some* good faith basis to dispute the claim.

- **Insolvency of Alleged Debtor**
  - **General Test:** For an involuntary petition to be valid, the debtor must not be *generally* paying its debts as they come due *as of the petition date*. The petitioning creditors cannot merely show that a few debts are unpaid, such as the debts of the petitioning creditors, or that debts were unpaid *after* the petition date; rather, they must show that the majority or at least a substantial portion of the alleged debtors' debts were not being paid as of the time of filing. *See, e.g.*, *In re Vortex Fishing Sys., Inc.*, 277 F.3d 1057 (9th Cir. 2001).
    - Note: As with the size of claims and the qualification of individual creditors to serve as petitioners, a good faith dispute regarding a claim may be used by the alleged debtor to remove such claim from the debts considered by the court in determining whether a debtor is generally paying its debts as they come due. *See, e.g.*, *In re Covey*, 650 F.2d 877, 883 (7th Cir. 1981).
  - **The exact level of investigation is muddy under the case law, but it is clear that petitioning creditors "[m]ust make *at least some* inquiry into whether the debtor is paying their debts as they come due."** *In re Cannon Express Corp.*, 280 B.R. 450 (Bankr. W.D. Ark. 2002) (emphasis added). Such an investigation may be difficult to accomplish, as petitioning creditors likely will not have access to an alleged debtor's financial records;

however, there must still be "at least some" minimal investigation into the alleged debtor's insolvency.

- As a practical matter, **such an investigation could mirror the research into the size of the alleged debtor and number of creditors.** For example, when soliciting other potential petitioners, it would be prudent to at least inquire into missed payments to such potential petitioning creditors by the alleged debtor, as well as the size, disputed status, etc. of such potential petitioner's claims, if any, against the alleged debtor.

- **Bad Faith Filings and Other Abuse or Misuse of the Involuntary Process**
  - **Essentially the same set of 'bad faith filing' tests as in the voluntary context, under Sections 305(a), 707(a), and/or 1112 of the Bankruptcy Code.**
  - **Subjective Test, or bad faith based on improper purpose: why the petitioning creditor sought to file the involuntary case.**
    - May not use an involuntary as a substitute for ordinary debt collection. *E.g.*, *MAG Bus. Servs. v. Whiteside (In re Whiteside)*, 240 B.R. 762, 766 (Bankr. W.D. Mo. 1999).
    - May not use an involuntary purely to gain a strategic/tactical litigation advantage over other creditors. *In re Silverman*, 230 B.R. 46, 53 (Bankr. D. N.J. 1998).
    - May not use an involuntary as a means of revenge or purely to cause reputational harm to an alleged debtor. *John Richards Homes*, 291 B.R. at 732.
    - May not use an involuntary solely as a means of temporarily preventing the dissipation of assets where there otherwise is no basis to file. *Cannon Express*, 280 B.R. at 455.
  - **Objective Test, or bad faith based on whether a reasonable creditor in a similar position to the petitioner would have commenced an involuntary**
    - These cases essentially look at whether (a) the petitioning creditors properly conducted their pre-suit investigation and (b) there was *some* basis in reason to commence the involuntary. *See, e.g.*, *In re Midwest Processing Co.*, 41 B.R. 90, 103 (Bankr. D. N.D. 1984).
  - **Combined Test. Some courts consider both tests; whether there was a proper purpose for filing the involuntary and whether the petitioning creditors acted reasonably in deciding to commence the case.** *See, e.g.*, *In re Tichy Elec. Co.*, 332 B.R. 364 (Bankr. N.D. Iowa 2005) (discussing both tests as being complementary).

- **Claim Acquisition Before Filing**
  - It is possible for a creditor who has acquired a claim against the debtor to commence an involuntary case, assuming all other requirements are met under Section 303 of the Bankruptcy Code, and *so long as* the claim was not been purchased for the purpose of commencing the involuntary case. *See* Fed. R. Bankr. P. 1003(a); *see also, e.g.*, *Kelly v. Herrell*, 602 F. App'x 642, 647 (7th Cir. 2015); *In re Banner Res., LLC*, No. 21-60016, 2021 Bankr. LEXIS 1452, at *2–3 (Bankr. N.D. Tex. May 28, 2021).
  - **Bankruptcy Rule 1003** requires petitioning creditors to disclose whether they have acquired their claim(s) and the terms of such acquisition, and to state under penalty

of perjury that the purchase was not made in order to commence an involuntary case. Fed. R. Bankr. P. 1003(a)

- **Service Requirement for Summons and Involuntary Petition**
  - The summons and petition must be served on the alleged debtor in accordance with Bankruptcy Rules 7004(a) or (b)—the rules for serving the summons and complaint in an adversary proceeding. *See* Fed. R. Bankr. P. 1010(a). If such service cannot be accomplished, copies can be mailed (on order of the court) to the last known address of the alleged debtor. *See id.*
  - Thus, in essence, service of the summons and involuntary petition must be conducted in the same manner as serving a complaint in an adversary proceeding and any of the regular methods for serving a complaint under Federal Rule of Civil Procedure 4 or applicable nonbankruptcy law, as well as mail service via Bankruptcy Rule 7004(b), will suffice.
  - Failure to properly serve the alleged debtor has been considered as one indicator that the petition was filed in bad faith or otherwise that the petitioning creditors have some improper motive for commencing the involuntary. *See In re Cadena*, 634 B.R. 1038, 1052 (Bankr. C.D. Cal. 2022).
- **Penalties for Statutory or Ethical Violations in Connection with an Involuntary Case**
  - If the court dismisses an involuntary petition, without the consent of all petitioners and the alleged debtor, the court may award costs or reasonable attorney's fees to the alleged debtor. Moreover, if the petitioner filed in bad faith, the court may order payment of any damages proximately caused by such filing or punitive damages. *See* 11 U.S.C. § 303(i)(1).
  - Bankruptcy Rule 9011 requires the imposition of sanctions against an attorney, the represented party, or both, with respect to signed pleadings which are not "warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law." 11 U.S.C. § 303(i)(2).
  - Thus, to prevent abuse, the Bankruptcy Code essentially incorporates the Rule 11 standard into Section 303 of the Bankruptcy, via subsection (i) and allows for the recovery of damages by an alleged debtor for an improperly filed case. While such damages and sanctions are relatively rare, the potential for them raises the stakes for petitioning creditors and cautions against filing an involuntary without conducting the sort of investigation discussed above and forming a good faith belief as to the various legal elements required for the involuntary case to move forward. *See* 11 U.S.C. § 303(h), (i).
  - The above penalties and sanctions under Section 303(i) of the Bankruptcy Code do not apply, according to the express terms of that subsection, where an involuntary petition is dismissed "on consent of all petitioners and the debtor." 11 U.S.C. § 303(i). Thus, "if the debtor and all other parties to an involuntary petition unequivocally consent to its dismissal, the language of Section 303(i) of the Bankruptcy Code bars a subsequent damage claim regardless of whether the debtor sought to preserve such a claim." *In re City Ctr. Complex, LLC*, No. 10-20820, 2012 Bankr. LEXIS 6205, at *11 (Bankr. N.D. Ind. Feb. 28, 2012) (internal quotation marks and citation omitted).

- **Dismissal—Alleged Debtor's Responsive Pleadings in an Involuntary Case**
  - The alleged debtor may answer the petition and/or move to dismiss the involuntary case (or otherwise contest the petition). *See* 11 U.S.C. § 303(d); Fed. R. Bankr. P. 1011(a)–(e). Defenses and objections to the petition are governed, in essence, by Federal Rule of Civil Procedure 12 and the same rules that would apply to an answer in a regular lawsuit. *See* Fed. R. Bankr. P. 1011(b). Moving to dismiss, therefore, extends the time to answer. *Id.* 1011(c).
  - To succeed on such a motion to dismiss, the alleged debtor must establish that the petitioning creditors have not met the requirements of Section 303 of the Bankruptcy Code. *See, e.g.*, *In re Holco Capital Grp., Inc.*, No. 10-30006, 2011 Bankr. LEXIS 988, at *7–8 (N.D. Ind. Bankr. Mar. 29, 2011); *In re West Side Cmty. Hosp., Inc.*, 112 B.R. 243, 256 (Bankr. N.D. Ill. 1990). In addition, or in the alternative, the alleged debtor or another party in interest may show, as with the dismissal of any bankruptcy case, "cause" for dismissal or that dismissal would be in the "best interest of creditors and the estate." *In re 318 Retail, LLC*, No. 22-02485, 2022 Bankr. LEXIS 1569, at *8 (Bankr. N.D. Ill. May 27, 2022) (citing 11 U.S.C. §§ 707(a) and 1112(b)).
    - Dismissal pursuant to Section 305 of the Bankruptcy Code, which employs an "interests of the debtor and creditors would be better served by dismissal" standard, may also be used in the context of a motion to dismissal an involuntary case. *See, e.g.*, *In re Monitor Single Lift I, Ltd.*, 381 B.R. 455, 464 (Bankr. S.D.N.Y. 2008); *In re Int'l Zinc Coatings & Chem. Corp.*, 355 B.R. 76, 82 (Bankr. N.D. Ill. 2006).
  - Responsive pleadings by the alleged debtor, such as an answer or motion to dismiss generally do not need to be served on all creditors, but rather (usually) need only be served on the petitioning creditors and any creditors who have joined the petition. *See, e.g.*, *In re Golden Ocala P'ship*, 50 B.R. 552, 558 (Bankr. M.D. Fla. 1985).
  - The burden on a motion to dismiss rests with the alleged debtor, especially on a motion to dismiss for bad faith. *See, e.g.*, *In re Squillante*, 259 B.R. 548, 554 (Bankr. D. Conn. 2001).
  - In responding to an involuntary petition, the alleged debtor cannot intentionally hide the ball from the petitioning creditors. Cases on information withheld by an alleged debtor are rare, but at least one court has declined to award fees and costs under § 303(i) where the alleged debtor had "refuse[d] to supply the [petitioning creditor] with current financial information, including the names of his creditors[.]" *Squillante*, 259 B.R. at 554.
- **Settlement**
  - It is possible for an involuntary case to be dismissed upon the agreement of all parties, but the court must approve any such settlement before an order to dismiss may be entered. *See* 11 U.S.C. § 303(j); *see, e.g.*, *In re Spaulding & Co.*, 131 B.R. 84, 86 (Bankr. N.D. Ill. 1990). Such settlement may be sought via Bankruptcy Rule 9019 and may provide for the dismissal of the involuntary case, but may not violate or skirt other provisions or requirements of the Bankruptcy Code, for example, by providing for a structured dismissal. *See In re Positron Corp.*, 556 B.R. 291, 292–96 (Bankr. N.D. Tex. 2016).

- Once an involuntary petition is filed, the petitioning creditors may not withdraw the petition on their own, and the parties cannot on their own agree to dismiss, absent approval of such an agreement or settlement by the court upon a finding that the same is in the best interests of the estate and all parties in interest. *See, e.g.*, *In re Warren*, 18 B.R. 136, 137–39 (Bankr. N.D. Ala. 1995).
- It is unclear what notice and disclosure is required for purposes of dismissing an involuntary petition upon agreement and/or settlement among the creditors and alleged debtor. Does notice need to be given to all creditors? Do the creditors and alleged debtor need to disclose the terms of any settlement, including any monetary terms of such settlement. *See* 11 U.S.C. § 303(j).

Additional Cases Addressing Issues in an Involuntary:

- *Tate v. Navient Sols., LLC (In re Navient Sols., LLC)*, No. ,21-cv-2897, 2022 U.S. Dist. LEXIS 52583 (S.D.N.Y. Mar. 23, 2022)
  - Dismissal below was proper based on failure to meet requirements of Section 303(b) of the Bankruptcy Code as well as bad faith.
    - Petitioners failed to even allege that the alleged debtor was generally not paying its debts as they came due, but rather stated only the legal conclusion that the alleged debtor "is insolvent" and supported such allegation with the alleged debtor's balance sheet.
    - Extensive litigation regarding and the existence of colorable defenses to the claims of the petitioners also rendered such claims disputed for the purposes of Section 303(b) and (h) of the Bankruptcy Code.
    - Dismissal for bad faith under Section 1112(b)(1) of the Bankruptcy Code was also proper under the improper use, improper purpose, objective test, *and* subjective test.
  - In light of the extremely lacking petition, the award of attorneys' fees by the bankruptcy court (as limited to those fees of the alleged debtor the bankruptcy court found to be reasonable) was proper.
- *In re 35th & Morgan Dev. Corp.*, 510 B.R. 832 (Bankr. N.D. Ill. 2014)
  - The alleged debtor was a single asset real estate debtor owned and controlled by its parent company and the property held by the alleged debtor was in disrepair and generated no income. Obligations were allegedly outstanding as of the petition date to certain banks that had loaned funds for the development of the property and a law firm that had provided services to the alleged debtor (which joined the petition after it was filed).
    - Certain insiders and others were also claimed to be creditors, but either their status as insiders or the fact that they could not be demonstrated to actually be owed any amounts by the alleged debtor disqualified them.
    - Moreover, many of the supposed creditors, including, for example, various vendors and purported employees, were actually creditors of the parent company, not the alleged debtor itself, and therefore did not qualify.
  - Nevertheless, the involuntary case was *not* dismissed for the following reasons.
    - The two banks held claims not subject to bona fide disputes as the amounts were owed by the alleged debtor based on the plain language and terms of the notes involved.

        - There was no assignment of such claims as the only 'transfer' as it were thereof was via a merger, not an assignment.
        - The law firm also held a valid claim not subject to bona fide dispute as the alleged debtor failed to offer sufficient prove of its alleged counterclaim for malpractice. Further, the joinder of the law firm was proper.
    - The alleged debtor's attempts to argue it had more than 12 creditors failed for, as stated above, too many of the creditors on the alleged debtor's list were insiders, not owed any amounts at all, or the creditors were actually creditors of the parent company.
- *Liberty Tool v. Vortex Fishing Sys. (In re Vortex Fishing Sys., Inc.)*, 277 F.3d 1057 (9th Cir. 2001)
    - Petitioners commenced involuntary case based on disputed claims and were only able to show balance sheet (not equitable) insolvency.
    - Addresses, among other points: (i) whether claims are subject to a *bona fide* dispute; (ii) insolvency of the alleged debtor; and (iii) whether notice required to be given to all creditors.
    - *See also, e.g., In re Reid*, 773 F.2d 945 (7th Cir. 1985) (similar).
- *In re Smith*, 243 B.R. 169 (Bankr. N.D. Ga. 1999)
    - Petitioner commenced involuntary based on sufficient, non-disputed claim and proved up insolvency, but failed to show the numericity requirements of Section 303 of the Bankruptcy Code were met and had, in any case, filed in bad faith.
    - Addresses, among other issues: (i) standard for numerical requirements for creditors; (ii) standard for insolvency; (iii) standard for *bona fide* disputes as to claims; (iv) proper and improper bases for alleged debtor to assert that a claim is subject to a *bona fide* dispute; (v) contingent claims; (vi) parallel state-court actions; and (vii) bad faith filings.
- *In re Kearney*, 121 B.R. 642 (Bankr. M.D. Fla. 1990)
    - Petitioner commenced involuntary upon meager, if any, pre-suit diligence.
    - Address, among other points: (i) the scope and extent of damages (compensatory and punitive) awardable under Section 303(i) of the Bankruptcy Code; (ii) the distinction between such damages and sanction pursuant to Bankruptcy Rule 9011; (iii) requirements for pre-suit diligence and investigation with respect to issues such as the number of creditors; and (iv) bad faith filings.
    - *See also, e.g., Nat'l Med. Imaging, LLC v. U.S. Bank, N.A. (In re Nat'l Med. Imaging, LLC)*, 570 B.R. 147 (Bankr. E.D. Pa. 2017) (similar).

Potential Liability of Non-Petitioners under 11 U.S.C. § 303

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I. Introduction

Unsecured creditors may petition the court to initiate a bankruptcy case against a debtor under Chapters 7 or 11 through the filing of an involuntary bankruptcy petition. There are three main requirements under § 303 for commencing an involuntary bankruptcy: (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 as to liability or amount; and (3) the petitioners' claims must aggregate at least $18,600 more than any liens they hold against the debtor's property.[1] Assuming the petition satisfies these three requirements, the petitioning creditors still must show that the "debtor is generally not paying such debtor's debts as such debts become due," which can be a fact-intensive issue.[2]

Once an involuntary petition in filed, the automatic stay of bankruptcy applies immediately to prevent creditor actions.[3] However, unlike a voluntary bankruptcy petition, an involuntary petition functions more like a complaint asking the court to declare that the debtor should remain in bankruptcy. The petition must be served together with a summons, and the debtor has 21 days after service of the summons to contest the involuntary petition (typically through filing an answer or motion to dismiss the petition).[4] Litigation over whether the eligibility requirements discussed above have been met can involve various pleadings, document and deposition discovery, status conferences, motions for summary judgment and an evidentiary hearing or trial. If the bankruptcy court ultimately rules in favor of the petitioning creditors, an order for relief is entered and the debtor is officially placed into bankruptcy, triggering all the Bankruptcy Code's provisions and bankruptcy court supervision.

If, on the other hand, after notice to all creditors and a hearing, the involuntary petition is dismissed, the petitioning creditors can be liable for the debtor's costs and attorneys' fees.[5] If the bankruptcy court determines that the involuntary petition was filed in bad faith, the petitioning creditors can also be held liable for the damages caused by the involuntary filing and even for

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[1] 11 U.S.C. § 303(b)(1) (this number was adjusted for inflation as of April 1, 2022). If the debtor has fewer than 12 creditors, then only one unsecured creditor with a qualifying claim is needed. *Id.*
[2] 11 U.S.C. § 303(h)(1).
[3] 11 U.S.C. § 362(a) ("[A] petition under section . . . 303 of this title . . . operates as a stay.").
[4] Fed. R. Bank. P. 1011.
[5] 11 U.S.C. § 303(i); *Higgins v. Vortex Fishing Sys., Inc.*, 379 F.3d 701, 707 (9th Cir. 2004).

punitive damages.[6] Sanctions under § 303(i)(2) are usually awarded against creditors who "abuse . . . the power given to[them] . . . to file an involuntary bankruptcy petition."[7]

This article addresses the ways in which courts have imposed liability on individuals and entities other than the petitioning creditors, including petitioners' lawyers, under § 303(i). In short, while the majority view is that the plain language of § 303 allows relief only against the actual petitioning parties, some courts have held individuals other than the petitioning creditors liable under § 303(i) as "de facto petitioners." In these instances, however, the liable individuals were the agents and principals of the petitioners who orchestrated the filing and, in some instances, signed the petition; they were not the petitioning creditors' lawyers. On the other hand, most cases specifically addressing the issue of the petitioning creditors' lawyers' liability under § 303(i) have declined to impose liability on the lawyers. There are, however, at least two cases where the courts held the petitioning creditors' lawyers liable under § 303(i).

II. Overview of 11 U.S.C. § 303(i)

Section 303(i) provides:

(i) If 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—

(1) against the petitioners and in favor of the debtor for—

(A) costs; or

(B) a reasonable attorney's fee; or

(2) against any petitioner that filed the petition in bad faith, for—

(A) any damages proximately caused by such filing; or

(B) punitive damages.

11 U.S.C. § 303(i). The court "for cause" may require the petitioners to post a bond for any amounts the court may allow under § 303(i).[8]

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[6] 11 U.S.C. § 303(i)(2). Section 303(i)(2) requires a finding of bad faith for damages, with the debtor "having the burden of proving bad faith." *In re Bayshore Wire Prods.*, 209 F.3d 100, 105 (2d Cir. 2000). A "debtor may only recover actual and punitive damages upon a finding of bad faith." *In re Anmuth Holdings* LLC, 2019 WL 1421169 at *14 (Bankr. E.D.N.Y. Mar. 27, 2019).

[7] *Anmuth Holdings*, 2019 WL 1421169 at *14 (court awarded debtors' attorneys' fees, punitive damages, retroactive dismissal of the involuntary petitions to the dates on which they were filed, and an injunction against future filing by the petitioning creditors because the petition "lacked any merit.").

[8] 11 U.S.C. § 303(e).

When an involuntary bankruptcy petition is dismissed, the debtor is presumed to be entitled to reasonable fees and costs.[9] After the debtor demonstrates that the fees and costs are reasonable, the burden shifts to the petitioning creditors to establish, under the totality of the circumstances, that factors exist which overcome the presumption and support disallowance of fees. In exercising its discretion whether to award fees and costs, the bankruptcy court may consider factors such as the relative culpability among the petitioners, the motives or objectives of individual petitioners in joining in the involuntary petition, the reasonableness of the respective conduct of the debtors and petitioners, and other individualized factors.[10]

In apportioning liability among petitioners, a bankruptcy court must use its discretion and consider the totality of the circumstances, not principles of tort liability.[11] A bankruptcy court has discretion to hold some or all petitioners jointly or severally liable for costs and fees, to apportion liability according to the petitioners' relative responsibility or culpability, or to deny an award against some or all petitioners.[12]

Section 303(i)(2) can also come into play. In addition to seeking costs and fees under subsection (1), debtors can also seek damages, including punitive damages, if they can show "bad faith." The "totality of the circumstances" courts consider include whether the petitioner is attempting to obtain a disproportionate advantage over the debtor, whether it is motivated by ill will, malice or a desire to embarrass the debtor and whether its filing would violate Rule 9011.[13] T

To obtain fees and costs under subsection (1), there need not be a bad faith showing; indeed, there is a presumption of liability. But to seek damages under subsection (2), the movant must show bad faith on the part of the petitioners. Further, punitive damages may be awarded under § 303(i)(2)(B) even absent an award of actual damages under § 303(i)(2)(A).[14]

III. The Majority View Is That the Plain Language of Section 303 Allows Relief Against Only the Actual Petitioning Parties

Although there are some cases holding that non-petitioning parties can be sanctioned under § 303(i), as discussed below, the majority view is that § 303(i) does not permit the imposition of sanctions against non-petitioning parties. As one court stated, "the plain language of § 303 allows relief only against the actual petitioning parties who signed and filed or joined in the involuntary petition."[15]

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[9] *Higgins*, 379 F.3d at 707.
[10] *See id.*
[11] *Id.*
[12] *In re Maple-Whitworth*, 556 F.3d 742, 746 (9th Cir.), opinion corrected sub nom. *In re Maple-Whitworth, Inc.*, 559 F.3d 917 (9th Cir. 2009) (upholding bankruptcy court's application of *Higgins* in awarding attorneys' fees and costs against petitioning creditor).
[13] *See In re John Richards Homes Bldg. Co., LLC*, 439 F.3d 248, n. 2 (6th Cir. 2006)(citation omitted).
[14] *In re S. California Sunbelt Devs., Inc.*, 608 F.3d 456, 465 (9th Cir. 2010) ("*SCSD*").
[15] *McMillan v. Maestri (In re McMillan)*, 543 B.R. 808, 815 (Bankr. N.D. Tex. 2016) (following a "long line of cases" so holding); *In re Cadena*, 634 B.R. 1038, 1050 (Bankr. C.D. Cal. 2022) ("the plain language of § 303(i) seems to

The Fifth Circuit is the only circuit court to squarely address this issue and it follows the majority view. In *In re Walden*, the Fifth Circuit affirmed the district court's denial of a debtor's motion to file a third-party complaint against the petitioning creditor's attorney under § 303(i) because "that section authorizes awards against petitioners, not their attorney."[16]

IV. Some Courts Have Held That "Petitioner" Can Be Interpreted Broadly to Include Agents or Principals of a Petitioning Creditor

Several cases have held that individuals other than the petitioning creditors can be liable under § 303(i) as "de facto petitioning creditors" because they are the agents or principals who signed the petition, caused the petitioning creditors to file the petition, or are otherwise intertwined or intimately connected with the petitioners. In those instances, however, those held liable were not the petitioning creditors' lawyers. For example, the Ninth Circuit held that two individuals who controlled the petitioners could be liable under § 303(i) because of their deep involvement with the petitioning creditors and the filing of the petition.[17] In doing so, the Ninth Circuit affirmed a finding of joint and several liability of "two individuals who exercised control over the petitioning creditors" for § 303(i) fees and costs under the bankruptcy court's "inherent authority."[18] Further, the bankruptcy court's decision specifically found that the two principals acted in bad faith in orchestrating the filing.[19]

The Southern District of Florida Bankruptcy Court, in *In re Rosenberg*,[20] followed similar reasoning in holding that "the term '*petitioner*' must be construed to include those agents and/or principals who sign the involuntary petition for or on behalf of the Petitioning Creditors under principles of agency law and the doctrine of respondeat superior."[21] The bankruptcy court relied

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limit holding counsel for the petitioners responsible under that section . . . [a]ccordingly any award under § 303(i) will only apply against [the petitioner]."); *In re Glannon*, 245 B.R. 882, 892–93 (D. Kan. 2000) (concluding that attorneys for petitioning creditors cannot be liable under plain language of § 303(i); noting that attorneys may be liable under the Federal Rules of Civil Procedure instead); *In re Int'l Mobile Advert. Corp.*, 117 B.R. 154, 158 (Bankr. E.D. Pa. 1990) (attorney for petitioning creditor may be liable under Bankruptcy Rule 9011, but not under § 303(i), because counsel was not a petitioner); *In re Fox Island Square P'ship*, 106 B.R. 962, 967 (Bankr. N.D. Ill. 1989) (§ 303(i) "does not provide for an award against the petitioners' attorney."); *In re Advance Press & Litho, Inc.*, 46 B.R. 700, 706 (Bankr. D. Colo. 1984) (§ 303(i) not applicable to counsel: "When a judgment is entered against creditors whose actions were predicated upon faulty legal advice, the creditor's remedy is elsewhere to be resolved."); *In re Ramsden*, 17 B.R. 59, 61 (Bankr. N.D. Ga. 1981) ("The Court finds no authority to assess the costs and damages against the attorney whose acts of omission and commission caused these frivolous actions to be filed and heard. The judgment authorized under the statute seems directed only against offending petitioners."); *In re Commonwealth Sec. Corp.*, 2007 WL 309942, at *8 (Bankr. N.D. Tex. 2007) (noting that "Section 303(i) technically does not permit for a sanction against a petitioner's attorney").

[16] *In re Walden*, 787 F.2d 174, 174 (5th Cir. 1986).

[17] *SCSD*, 608 F.3d at 460.

[18] *Id.* The Ninth Circuit disapproved of the award of fees and costs, however, for post-dismissal litigation.

[19] *Id.* at 465-66. *See also In re Linton*, 631 B.R. 882, 898 (B.A.P. 9th Cir. 2021) (citing *SCSD* for the proposition that "the Ninth Circuit has affirmed a bankruptcy court's use of inherent powers to impose on non-petitioners liability for § 303(i) costs and fees incurred in obtaining dismissal of involuntary petitions.").

[20] 471 B.R. 307 (Bankr. S.D. Fla. 2012).

[21] *Id.* at 312. The Bankruptcy Court's decision was affirmed by the Eleventh Circuit. *In re Rosenberg*, 779 F.3d 1254, 1268 (11th Cir. 2015) ("the bankruptcy court did not clearly err in finding that Lyon and the DVI entities were

on *In re Oakley Custom Homes, Inc.*,[22] where the court specifically found an agency relationship between an individual and the petitioning creditors based on the individual holding himself out as an agent to both original petitioning creditors and for actively participating in events pertinent to the involuntary bankruptcy petition.[23] On appeal, the Eleventh Circuit held that it need not reach the issue as it found that the entity that signed the petition acted as a the de facto petitioner under the facts of the case.[24]

It should be noted, however, that in *Visium,* a different Southern District of Florida Bankruptcy Judge recently disagreed with *Rosenberg* and followed "other courts that have held the plain language of § 303 allows relief only against the actual petitioning parties who signed and filed or jointed in the involuntary petition."[25] The *Visium* court pointed out that while the bankruptcy court's decision in *Rosenberg* was largely affirmed on appeal, the Eleventh Circuit did not adopt the bankruptcy court's legal reasoning on the issue of holding others liable under § 303(i).[26] Then, the court went on to hold that Visium had not pled any facts remotely close to the "unique factual circumstances" that were present in *Rosenberg*.[27]

V. There Are At Least Two Cases That Have Held Petitioning Creditors' Lawyers Liable Under Section 303(i)

In *In re Navient Sols., LLC*,[28] relying on the *Rosenberg* case discussed above, the Bankruptcy Court for the Southern District of New York held the petitioner's lawyer liable as a "de facto creditor." However, the facts in *Navient* were unique in that the petitioning creditor's lawyer sent letters specifically agreeing to bear liability: "Smith and Smith alone will bear any and all liability resulting from an adverse finding of this Court absent a *sua sponte* determination of liability on any single Creditor."[29] At the fee hearing, the Court asked the lawyer about this, and he admitted that the letters constituted his acknowledgement that he was personally liable for any fees and expenses awarded to the debtor under § 303(i)(1).[30]

The court allowed lawyer liability under § 303(i) in *In re Exchange Network Corp.*,[31] stating that "[b]oth Petitioners and their counsel have an obligation to proceed in a responsible

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"intertwined," and that Lyon, through Fox, signed the involuntary petition albeit in the name of the DVI entities. Abundant evidence demonstrates that Lyon, the only entity that signed the petition and caused it to be filed, was the petitioning creditor within the meaning of § 303(i)(1).").

[22] 168 B.R. 232 (Bankr. D. Colo. 1994).

[23] *Rosenberg*, 471 B.R. at 312.

[24] *In re Rosenberg*, 779 F.3d 1254, 1269 (11th Cir. 2015).

[25] *Visium*, 635 B.R. at 432.

[26] *Id.*

[27] *Id.*

[28] 627 B.R. 581, 593 (Bankr. S.D.N.Y. 2021), aff'd, No. 21-CV-2897 (JGK), 2022 WL 863409 (S.D.N.Y. Mar. 23, 2022).

[29] *Id.* at 594.

[30] *Id.*

[31] 85 B.R. 128 (Bankr. D. Colo.), aff'd, 92 B.R. 479, 480 (D. Colo. 1988).

manner."[32] The bankruptcy court awarded damages for a bad faith filing because the petitioners filed the involuntary petition as a "substitute for customary collection procedures or as an alternative for civil litigation."[33] It awarded the damages against both the petitioners and their counsel, stating "[i]f the Petitioners, however, rely on counsel merely to collect a debt, then the onus is on the attorney to investigate the debtor's financial position *prior* to filing an involuntary petition in bankruptcy" and here, the court determined that counsel proceeded to file the petition *after* investigating the financial condition of the proposed involuntary debtor. The court determined that "[t]his particular conduct . . . constitutes culpable conduct justifying imposition of fees against counsel as well as the Petitioners."[34]

Section 303(i) is not the only basis on which attorneys may be liable for filing involuntary bankruptcy petitions. Every pleading executed by an attorney -- including an involuntary petition -- is subject to the strictures of Rule 11 and Rule 9011, such that the attorney certifies that to his or her knowledge after a reasonable inquiry the pleading is not being filed for an improper purpose, has or is expected to have sufficient factual support, and is justified under current law or a nonfrivolous argument for an extension of current law. Thus, a lawyer may be held jointly and severally liable with its client for damages caused by an improper involuntary bankruptcy petition.[35]

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[32] *Id.* at 132.
[33] *Id.*
[34] *Id.* at 133.
[35] *See Cadena*, 634 B.R. at 1056 (and cases cited therein).