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Last in Line

By Elizabeth B. Vandesteeg, Geoffrey L. Berman and Steven L. Victor[1]

Involuntary Bankruptcy Might Not Be the Right Tool for Aggrieved Creditors

Coordinating Editor Elizabeth B. Vandesteeg
Levenfeld Pearlstein, LLC; Chicago

Geoffrey L. Berman
Development Specialists, Inc. Los Angeles

Steven L. Victor
Development Specialists, Inc. Chicago

A recent *ABI Journal* article[2] suggested that involuntary bankruptcies are a tool that creditors should consider in limited situations when dealing with distressed debtors. There is no doubt that a well-thought-out involuntary case can preserve and even create value for creditors under certain circumstances, but as those authors noted, there are other considerations that creditors should take into account when looking seriously at the involuntary bankruptcy option. The authors of that article highlighted one particular issue that petitioning creditors should consider: potential liability for costs in the event of dismissal of the involuntary case. That is just one of several factors that creditors should consider when contemplating filing an involuntary bankruptcy case if they do not want to find themselves subject to abstention or dismissal, as well as the potential costs associated with those results.

To sustain an involuntary bankruptcy case, the petitioning creditor must show the following: (1) the debtor was eligible to be a debtor in a bankruptcy case; (2) the petitioning creditor has standing; (3) the debtor was generally not paying its debts as they became due (or liabilities exceeded assets); and (4) the debt was not subject to a *bona fide* dispute.[3] Under § 305 of the Bankruptcy Code, the court can then abstain or dismiss the involuntary proceeding at any time if "the interests of creditors and the debtor would be better served by such dismissal or suspension."[4] Among other reasons a court may dismiss or abstain from an involuntary petition are:

- a lack of documentation and inadequate showing that the debtor is not paying debts as they become due;[5]
- where there are disputed portions of the debt that do not stem from a separate transaction, such as disputed and undisputed portions of the debt that arose under a single contract between the creditor and the putative debtor;[6]
- involuntary petitions that are filed as litigation tactics in connection with other legal actions;[7] and
- the existence of an already pending proceeding in a state court or other forum, such as an assignment for the benefit of creditors.[8]

Recent cases shed further light on the involuntary analysis. In *In re Dillon Logistics Inc.*, certain creditors with potential Worker Adjustment and Retraining Notification Act claims filed an involuntary petition, notwithstanding the fact that the purported debtor, Dillon Logistics, was already the subject of an assignment for the benefit of creditors (ABC) pending in Delaware.[9] Applicable Delaware state law does not give these former employees a statutory priority for unpaid wages and benefits, and the general assignment document did not otherwise provide for a priority over general unsecured creditor

1 Ms. Vandesteeg is an associate editor for the *ABI Journal* and a 2017 ABI "40 Under 40" honoree. Mr. Berman is the author of ABI's *General Assignments for the Benefit of Creditors: The ABCs of ABCs (5th Edition)*, available for purchase at store.abi.org. He is also a past ABI President and a member of the ABI Commission for the Study of the Reform of Chapter 11. Mr. Victor was one of the editors of Mr. Berman's book and currently serves on ABI's Diversity and Inclusion Working Group.

2 Sheryl Giugliano & Michael Brandess, "With Lenders Asleep at the Wheel, Unsecured Creditors Should Consider Involuntary Bankruptcy," XLI *ABI Journal* 1, 56-57, 86, January 2022, *available at* abi.org/abi-journal.

3 *In re Gutierrez*, No. 20-50129, 2020 WL 3720234 (S.D. Miss. July 6, 2020).

4 28 U.S.C. § 305(a)(1).

5 *In re Navient Solutions LLC*, 625 B.R. 801 (S.D.N.Y 2021).

6 *In re Koffee Kup Bakery Inc.*, Inv. No. 21-10168, 2022 WL 141516 (Bankr. D. Vt. Jan. 14, 2022).

7 *In re Park Place Dev. Primary LLC*, No. 21-10849, 2021 WL 5072976 (Bankr. D. Del. Nov. 2, 2021).

8 *In re Bailey's Beauticians Supply Co.*, 671 F.2d 1063, 1067 (7th Cir. 1982).

9 *In re Dillon Logistics Inc.*, Case No. 21-B-13041 (CAD) (N.D. Ill. 2021). The authors were involved in the *Dillon* involuntary proceeding; a Development Specialists, Inc. affiliate was the assignee, and Levenfeld Pearlstein represented the assignee.

claims. The petitioning creditors presumably hoped to use the bankruptcy case as a vehicle to create a priority class for themselves, so as to obtain a recovery at least ahead of other general unsecured creditors. The problem for the former employees was that there were few to no unencumbered assets available in the estate to generate a recovery for unsecured claims.

The debtor and the assignee filed a joint motion to dismiss or abstain under 11 U.S.C. §§ 305 and 707 and 28 U.S.C. § 1334 because there was already a pending ABC, and dismissal or abstention was in the best interests of the creditors of the purported debtor. The movants were concerned about a potential disruption to the liquidation process already in process, particularly given the fact that there was no likelihood of recovery for the moving (or any other unsecured) creditors.[10] In *Dillon*, the court dismissed the involuntary proceeding pursuant to § 305 of the Bankruptcy Code warranted because:

- there already was a neutral, disinterested fiduciary (the assignee) who was well into the process of liquidating the secured lender's collateral;
- the assignee had already verified the validity of the lender's liens on the underlying collateral;
- the creditor whose claim was secured by a substantial majority of Dillon Logistics' assets had consented to the use of its cash collateral to fund the costs of the general assignment; and
- the evidence strongly demonstrated the practical near-impossibility of recovery by the former employees on their claims.[11]

The good news for the petitioning creditors in *Dillon* was that they were not ordered to pay the assignee's costs of defending the involuntary petition. Nonetheless, one could argue that petitioning creditors' counsel could have (or should have) looked more closely at the *facts* of the case before filing the involuntary petition, particularly given that the petitioning creditors had full knowledge and notice of the pending ABC. Alternatively, because state law did not provide for the equivalent to the Bankruptcy Code employee wage priority, counsel could have negotiated with the assignee for an addendum to the general-assignment agreement to provide for the sought-for priority, thereby greatly reducing the costs to the assignment estate in defending the involuntary.[12]

Similarly, in *In re Korean Radio Broadcasting Inc.*, the court carefully considered dismissal and abstention under both §§ 305 and 707.[13] Like in *Dillon*, there was already a pending ABC, overseen by an independent fiduciary.[14] Accordingly, the debtor argued — and the court agreed — that dismissal of the involuntary case was in the best interests of the creditors. Among other additional factors that the court considered and found to be weighing in support of dismissal, it specifically found that the debtor and petitioning creditor had been engaged in a dispute for several years, with the bankruptcy court the "most recent battlefield in a long-running, two-party dispute." Not only do creditors and their counsel risk dismissal or abstention of the involuntary bankruptcy case, like in *Dillon* or *Korean Radio Broadcasting*, but in some cases, along with a judgment for costs and fees, they also risk punitive damages or sanctions.

In *In re Topfer*,[15] the court dismissed the involuntary bankruptcy case that the claimant had filed against his ex-wife because it failed to meet the procedural requirements and was deemed "facially invalid"; the claimant was subsequently ordered to pay costs and fees. In addition, the court found that the timing of the involuntary filing was evidence of "misuse of the bankruptcy process as a litigation tactic to delay the conclusion of the Divorce Action," thereby ordering him to pay $2,000 in punitive damages.

In *In re Anmuth Holdings LLC*,[16] the court awarded sanctions when an involuntary petition was filed mere hours after creditors received an adverse decision in state court denying their request for a stay pending appeal of a draw on letters of credit, in order to invoke the automatic stay to prevent debtors from drawing down the letters of credit that the state court had refused to stay. After deeming the creditors' actions to be "egregious bad faith conduct," the court ordered them to pay the debtor $600,000 in punitive damages.

Conclusion

There are certain instances in which an involuntary bankruptcy petition may be appropriate. However, prior to filing an involuntary petition, creditors and counsel need to have a good understanding of the debtor's situation to make sure they have considered whether an involuntary would not be appropriate, and could instead subject them to dismissal, abstention or worse.[17] abi

Elizabeth Vandesteeg is a partner with Levenfeld Pearlstein, LLC in Chicago. Geoffrey Berman and Steven Victor are senior managing directors with Development Specialists, Inc. in Los Angeles and Chicago, respectively.

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10 *Dillon*, Dkt. 8.

11 In states where there is no statutory provision for employee wage claims similar to those under § 507(4)(a), this potentially leaves former employees without the ability to see some recovery for unpaid wages and benefits accrued in the 90-day period before the assignment case begins. As such, a potential assignee for an assignment case in such states should strongly consider adding a priority to the assignment agreement to provide for the right of employees to potentially see some recovery on these claims if the facts warrant a recovery.

12 A motion to amend Dillon's general assignment agreement was subsequently filed with and granted by the supervising Delaware state court to allow for just such relief.

13 *In re Korean Radio Broad. Inc.*, No. 19-46322-ESS, 2020 WL 2047990, (Bankr. E.D.N.Y. March 31, 2020). *See also* Geoffrey L. Berman, "Involuntary Cases Meet Abstention in ABC Cases," XXXIX *ABI Journal* 9, 30-31, September 2020, *available at* abi.org/abi-journal.

14 Like in *Dillon*, a principal of Development Specialists, Inc. was the assignee in control of the ABC of Korean Radio Broadcasting.

15 595 B.R. 52 (M.D. Pa. 2019).

16 600 B.R. 168 (E.D.N.Y. 2019).

17 For more information on the history behind involuntary bankruptcies and risks associated therewith, *see* Amir Shachmurove, "The Consequences of a Relic's Codification: The Dubious Case for Bad Faith Dismissals of Involuntary Bankruptcy Petitions," *ABI Law Review*, Vol. 26 (Winter 2018), *available at* abi.org/members/member-resources/law-review.