

TYPES NOT MAPPED YET April 03, 2017 | TTR not mapped yet | Brian W. Hockett

Caveat creditor: Risks of filing an involuntary bankruptcy

When faced with a recalcitrant debtor, clients sometimes move too quickly to put the debtor into an involuntary bankruptcy, especially when fraudulent transfers and other creditor avoidance attempts become apparent. But creditors considering filing or joining in the filing of an involuntary bankruptcy petition, and the attorneys that represent them, have much to deliberate before becoming involved in an involuntary bankruptcy filing.

Section 303 of the Bankruptcy Code governs involuntary bankruptcy petitions and sets forth the requirements necessary to file an involuntary petition. If the debtor has more than 12 creditors, there must be at least three petitioning creditors, with total unsecured claims of \$15,775 that are not contingent or the subject of a *bona fide* dispute as to liability or amount. 11 U.S.C. § 303(b)(1). If the debtor has less than 12 creditors, only one petitioning creditor is required. 11 U.S.C. § 303(b)(2).

After an involuntary petition is filed, the debtor has an opportunity to respond. If the debtor contests the involuntary petition, the petitioning creditor must establish that the debtor is generally not paying its debts that are not subject to a *bona fide* dispute as the debts come due. 11 U.S.C. § 303(h). After the petitioning creditor establishes the elements necessary for an involuntary petition, the bankruptcy court will enter an “order for relief” granting the involuntary petition. If, however, the petitioning creditor cannot establish the necessary elements, the petitioning creditor may be in for a serious reckoning.

The consequences for filing an involuntary petition that is dismissed can be significant. The bankruptcy court may enter judgment against the petitioning creditor for the debtor’s attorney’s fees and costs. 11 U.S.C. § 303(i)(1). In addition, if the bankruptcy court finds that the filing was in bad faith, the court can award compensatory and even punitive damages. 11 U.S.C. § 303(i)(2).

The serious consequences for an ill-fated involuntary petition are on full display in the involuntary bankruptcy saga of Maury Rosenberg.

The story begins with the filing of an involuntary petition by a group of institutional lenders based on claims they allegedly maintained against Rosenberg under his personal guaranty of certain obligations in connection with leases of equipment used in Rosenberg’s business enterprises. The leases were part of a complex securitization transaction, which ultimately involved a transfer of the leases to the petitioning creditors.

The petitioning creditors that filed the involuntary petition against Rosenberg, however, were not the beneficiaries of his personal guaranty. Rosenberg’s personal guaranty only guarantied obligations to a servicer of the lease obligations and agent for the trustee of the leases. *In re Rosenberg*, 779 F.3d 1254, 1257 (11th Cir. 2015), cert. denied 136 S.Ct. 805 (2016). The Rosenberg personal guaranty did not run to the petitioning creditors, so the petitioning creditors were not creditors of the alleged debtor at all. *Id.* The bankruptcy court determined that the petitioning creditors did not have standing to file the involuntary petition because they were not creditors of Rosenberg, and the involuntary petition was dismissed. *Id.* at 1259.

Having thwarted the involuntary petition, Rosenberg then filed an adversary proceeding seeking compensatory and punitive damages for the bad faith filing, and payment of his fees and costs for defending the involuntary petition, defending an appeal of the dismissal of the involuntary petition, the fees and costs in seeking recovery of his fees and costs (fees on fees), and the fees and costs incurred in seeking recovery of the actual and punitive damages based on the petitioning creditors’ bad faith.

Rosenberg was awarded his attorneys’ fees and expenses in defending the involuntary, and his attorneys’ fees and expenses for seeking recovery of the attorneys’ fees and expenses, and for defending appeals of the award of attorneys’ fees and expenses, which so far total more than \$1 million. *In re Rosenberg*, 779 F.3d 1254 (11th Cir.

2015). The costs and fees that can be awarded under 11 U.S.C. § 303(i)(1) are not just limited to fees incurred prior to the dismissal of an involuntary petition. A jury trial was held in the district court on Rosenberg's claim for actual and punitive damages. Because the filing was determined to be in bad faith, Rosenberg was awarded \$1,120,000 in actual damages for emotional distress, loss of reputation, and loss of wages and \$5,000,000 for punitive damages in a jury trial in the district court. The district court originally reduced the award to \$360,000 on a post-trial motion, but the 11th Circuit reversed the reduction because the post-trial motion seeking to reduce the award was late filed, and the 11th Circuit directed the district court to reinstate the full jury award. *Rosenberg vs. DVI Receivables XIV, LLC, et al.*, 818 F.3d 1283 (11th Cir. 2016). As of the date this article is posted, the petitioning creditors continue to fight in the district court to reduce the amount of the judgment.

The Rosenbergs were not satisfied with their recoveries in the bankruptcy court. Sara Rosenberg (Rosenberg's wife) and several companies affiliated with the Rosenbergs filed a lawsuit seeking recovery of damages they allegedly suffered as a result of the involuntary bankruptcy filing under a state law theory of tortious interference with contracts and business relationships. The petitioning creditors filed a motion to dismiss the state law claims raised by the plaintiffs. The petitioning creditors argued that the third-party claims were preempted by the Bankruptcy Code's provisions for damages resulting from an involuntary petition.

The petitioning creditors cited *In re Miles*, 430 F.3d 1083 (9th Cir. 2005). The 9th Circuit in *Miles* determined that 11 U.S.C. § 303(i) preempts any attempt by any party to recover damages outside of that permitted under 11 U.S.C. § 303. Section 303(i) only provides standing to the putative debtor. The district court agreed with the petitioning creditors and granted their motion to dismiss. But in August of 2016, the Third Circuit Court of Appeals held that the third-parties (not just the debtor) could pursue damages under a state law theory of tortious interference with contractual relations against the petitioning creditors arising out of the improvident involuntary petition filed against Mr. Rosenberg. *Rosenberg v. DVI Receivables, XVII, LLC, et al.*, 835 F.3d 414 (3rd Cir. 2016).

In making this determination, the 3rd Circuit split with the 9th Circuit *Miles* decision and opened up a significant additional potential avenue of recovery for those that believe they have been harmed by a dismissed involuntary petition. It is yet to be determined if the petitioning creditors will be liable to the third-parties for damages alleged to have been caused by the filing of the involuntary bankruptcy petition against Rosenberg, but the damages already awarded (in excess of \$7 million) and the threat of additional damages serves as a reminder of the steep consequences of filing an involuntary bankruptcy petition.

Courts have warned that the "filing of an involuntary petition is an extreme remedy with serious consequences to the alleged debtor, such as loss of credit standing, inability to transfer assets and carry on business affairs, and public embarrassment," *In re Reid*, 773 F.2d 945, 946 (7th Cir. 1985), so most courts in the right circumstances will not shirk from awarding serious damages to remedy bad faith involuntary petitions. Caveat creditors.

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