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Be Wary of Using Involuntary Bankruptcy as a Collection Tool

December 19, 2018

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On the first anniversary of an opinion of Judge Jennifer Dorsey of the United States District Court for the District of Nevada, we are reminded to use the involuntary bankruptcy petition as a collection tool only after careful consideration of both the language and the spirit of the law.

In the case of *State of Montana Department of Revenue v Blixseth, 581 BR 882 (D. Nevada 2017)*, four creditors ran afoul of this advice when trying to collect taxes owed by a debtor.

11 USC Section 303 lays out the basic requirements to file an involuntary petition, forcing a debtor into bankruptcy court. Among those requirements are that:

1. Three or more petitioners are needed if the debtor has 12 or more creditors (otherwise only 1 petitioner is required).
2. The debtor must generally be failing to pay its debts as they become due.
3. The debts owed to the petitioners must not be subject to bona fide dispute.

Beyond the “letter of the law,” the “spirit” underlying its presence in the Bankruptcy Code is to provide a method to bring to the bar a distressed and troubled situation for the general good, not a private right of action. This section was not provided as a substitute for litigation.

It is critical to meet the requirements of the statute. Should the debtor contest the involuntary, sanctions can be imposed. Moreover, if there is a finding of bad faith, sanctions will also include penalties which can be severe. When we consult with our Cullen and Dykman LLP clients, we remind them that filing an involuntary is akin to a lawsuit where they are plaintiffs and the debtor is a defendant.

The debtor has an opportunity to fight back and, if it wins, the results can be painful. Indeed, the two most problematic portions of the requirements are the phrases “generally failing to pay its debts as they become due” and “not subject to bona fide dispute.” In this case the issue was whether the debts were subject to dispute.

The United States District Court for the District of Nevada found that, if any portion of the debt owed to a petitioning creditor was in dispute, the creditor did not qualify to petition.

A second issue to be considered, but not highlighted in this particular case is how one measures “generally failing to pay debts as they become due.” Does one look at the number of debts or the amount of debt? If a debtor is paying 99% of its creditors but the 1% is owed 99% of the debtor’s total indebtedness, does it fall within the language of the statute?

The general rule: be careful! There is no absolute measure and different courts may find differing nuances in the language. Indeed, as Justice Potter Stewart once said, this may be a case where precise definition escapes us, and where you “know it when you see it.”

Consult consul. Let her worry about doing it right and protecting you!

Please note that this is a general overview of developments in the law, and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient. If you have questions regarding these provisions, or any other aspect of employment law, please contact Michael H. Traison at (312) 860-4230 or mtraison@cullenanddykman.com.

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