

Section 303 of the Bankruptcy Code: Friend or Foe?

January 23, 2024

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The Bankruptcy Code (the “Code”) provides different chapters for a debtor to voluntarily seek relief from its creditors. Most commonly, businesses use chapter 11 to reorganize and chapter 7 to liquidate. However, the Code also provides a unique tool to creditors to file an involuntary petition against a debtor when it is unable to pay its debts as they become due.^[1]

Bringing an involuntary petition against a debtor can have a dramatic impact beyond the debtor itself, affecting other creditors, secured lenders, and banks. The potential damage is why courts will examine such petitions carefully, as should the petitioners before they file. Our bank and trade creditor clients will contact us when they are involved in such a situation. The debtor will have the right to contest the petition, or to convert the case from the chapter which the petitioners sought.

A recent case in which three creditors filed such a petition, reminds us of the perils we have addressed in prior client alerts. [See Be Wary of Using Involuntary Bankruptcy as a Collection Tool](#); [See also Be Wary of Using Involuntary Bankruptcy as a Collection Tool: An Update](#).

Perhaps the most important concepts underlying Section 303, is that it should not be used as a debt collection tool on behalf of individual creditors, but rather, used as public policy to assist when an insolvent debtor is generally not paying its debts as they become due.

Section 303(h)(1) provides that the court shall order relief only if, (1) the debtor is generally not paying such debtor’s debts as such debts become due . . .”^[2] Moreover, the petitioning creditor’s or creditors’ debts must not be subject to a bona fide dispute.^[3] This discussion will focus on those two elements.

What is the meaning of generally failing to pay debts as they become due?

A recent case, *In re Navient Solutions, LLC*, defined the meaning of generally failing to pay debts as they become due. *Navient*, whose decision was affirmed by the Second Circuit Court of Appeals in 2023, stated that “generally not paying its debts’ does not mean ‘balance-sheet insolvent.’”^[4]

The Court explained that it does not mean that a “debtor *could not* pay its debts, but rather that the putative debtor *is not* doing so.” ^[5] This is a significant distinction.

In its discussion, the Court continued to explain that the District Court, as well as other courts within the Second Circuit, rely on 4 factors in determining whether a debtor is generally failing to pay its debts as they become due:

1. The number of unpaid claims;
2. The amount of such claims;
3. The materiality of the non-payments; and
4. The debtor’s overall conduct of its financial affairs.^[6]

Courts in the Second Circuit have found that a debtor will be considered generally not paying its debts when the debtor fails to pay one debt that makes up a substantial portion of its overall liability.^[7]

The *Navient* Court also explained that the Court does not look to the insolvency of the debtor. The Court ruled against the petitioners’ argument who presented a calculation of the debtor’s balance sheet showing insolvency. The Court found this irrelevant and boiled the issue down to a simple question: “whether [the debtor] is ‘generally not paying its debts.’” ^[8]

What is the meaning of not subject to a bona fide dispute?

As with many terms within the Code, “bona fide dispute” is not defined. Courts must determine whether a bona fide dispute exists as to a claim. However, a court need not determine the “outcome of any dispute, only its presence or absence.”^[9]

The test in the Second Circuit for determining whether there is a bona fide dispute was established by *Key Mechanical Inc. v. BDC 56 LLC (In re BDC 56 LLC)*, 330 F.3d 111 (2003), *abrogated on other grounds by Adams v. Zarnel (In re Zarnel)*, 619 F.3d 156 (2d Cir. 2010). In this case, the Second Circuit followed the Seventh Circuit’s formulation of an objective test which states that “[t]he bankruptcy court must determine whether there is an objective basis for either a factual or a legal dispute as to the validity of [the] debt.”^[10]

“Congress intended to disqualify a creditor whenever there was a legitimate basis for the debtor not paying the debt. Congress . . . did not intend to require a debtor to pay a legitimately disputed debt simply to avoid the stigma of bankruptcy.” ^[11]

Additionally, the Second Circuit adopted the Seventh Circuit’s burden-shifting framework for determining whether a bona fide dispute exists. The burden-shifting framework requires “that the petitioning creditor establish a prima facie case that no bona fide dispute exists. Once a prima facie case is established, the burden shifts to the debtor to demonstrate the existence of a bona fide dispute.”^[12]

But what do courts actually consider to be a bona fide dispute, and does a dispute arise just because a creditor brings a claim for an unpaid debt? This is an objective standard.

The Seventh Circuit has stated that “the mere existence of pending litigation or the filing of an answer is insufficient to establish the existence of a bona fide dispute.” [13] Compare that with courts in the Second Circuit, who have found where there are multiple litigations pending or extensive litigation over the same claim, gives rise to the possible existence of a bona fide dispute.[14]

Similarly, Courts have explained that outstanding factual issues “[make] clear that . . . a bona fide dispute” exists. [15] As the case law illustrates, determining whether there is a bona fide dispute is a complicated, fact specific inquiry that the court must carefully analyze.

What are the Perils Faced by Petitioning Creditors?

As we have discussed in prior client alerts, petitioning creditors need to be wary of filing an involuntary petition against a debtor. Using the Code as a litigation tactic or filing a petition in bad faith can result in severe penalties, such as costs, attorneys fees, damages, or even sanctions.

The Code will protect the “unfortunate debtor” from frivolous filing on the part of creditors.[16]

As illustrated throughout this alert, a court will look to every fact, aspect, and circumstance to make sure a creditor has satisfied the requirements of Section 303 and has used the tools provided by the Code properly when filing an involuntary petition.

As always: Think before you file!

Please note 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 the recipient. If you have any questions regarding the provisions discussed above, or any other aspect of bankruptcy law, please contact Michael H. Traison (mtraison@cullenllp.com) at 312.860.4230.

Footnotes

[1] 11 U.S.C § 303 states that “[a]n involuntary case against a person is commenced by the filing with the bankruptcy court of a petition under chapter 7 or 11 of this title (1) by three or more entities, each of which is a holder of a claim against such person that is not contingent as to liability or the subject to a bona fide dispute as to liability or amount. . . .”

[2] 11 U.S.C § 303(h)(1).

[3] *Id.*

[4] *In re Navient Solutions, LLC*, 21-CV-2897 (JGK), 2022 WL 863409, *5 (S.D.N.Y 2022), *aff'd In re Navient Solutions, LLC*, No. 22-1376, 2023 WL 3487051 (2d Cir. 2023) (internal citations omitted).

[5] *Id.*

[6] *Id.*

[7] *In re Amant*, 321 B.R. 30, 39 (Bankr. S.D.N.Y. 2005).

[8] *Navient Solutions, LLC*, 2022 WL 863409, *5.

[9] *In re 35th & Morgan Development Corp.*, 510 B.R. 832, 846 (Bankr. N.D. Illinois, 2014).

[10] *Key Mechanical Inc. v. BDC 56 LLC (In re BDC 56 LLC)*, 330 F.3d 111, 117 (2d Cir. 2003), *abrogated on other grounds by Adams v. Zarnel (In re Zarnel)*, 619 F.3d 156 (2d Cir. 2010); *see In re Busick*, 831 F.2d 745, 750 (7th Cir. 1987).

[11] *Id.*

[12] *BDC 56 LLC*, 330 F.3d at 118.

[13] *Id.*

[14] *In re TPG Troy LLC*, 492 B.R. 150, 158-60 (Bankr. S.D.N.Y. 2013); *see also Navient Solutions*, 2022 WL 863409 at *6.

[15] *Navient Solutions*, 2022 WL 863409 at *6.

[16] 11. U.S.C. § 303(i).

Practices

- Bankruptcy and Creditors' Rights

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