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Expert Analysis

Eleventh Circuit Lends Guidance On Involuntary Bankruptcy Filings





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Bankruptcy relief is usually sought voluntarily by financially troubled companies seeking to reorganize or liquidate their businesses. However, the Bankruptcy Code also makes bankruptcy relief available as a creditor's remedy. In an economic downturn, frustrated creditors are likely to resort to involuntary bankruptcy relief with greater frequency as a way to protect or maximize the value of their recoveries against defaulting debtors with depreciating or disappearing assets.

Eligibility requirements for filing a voluntary bankruptcy petition are few and access to the bankruptcy system is relatively easy; having a residence, domicile, property, or a place of business in the United States is all that is required for most entities.[1]

However, recognizing the need to give creditors the ability to force an unwilling debtor into a liquidation or reorganization under the protection of the Bankruptcy Code where justified by the circumstances, while also recognizing that debtors need protection from unwarranted and stigmatizing involuntary petitions, Congress struck a balance by imposing strict requirements for the filing of involuntary petitions.

In particular, under §303(b) of the Bankruptcy Code, unless the debtor has fewer than twelve creditors, the petition must be signed by at least three creditors holding claims that are neither contingent nor subject to a bona fide dispute, and that aggregate at least $13,475 above the value of any liens held by the petitioners.[2]

Unlike a voluntary case where the petition is, in and of itself, the order for relief,[3] the debtor in an involuntary case has an opportunity to contest the petition by filing a responsive pleading, which ordinarily must be filed and served within 20 days after service of the summons commencing the case.[4]

If the debtor does not allege the petitioners' failure to satisfy the requirements of §303(b) in a timely, responsive pleading,[5] are those requirements waived? The answer to this question depends on whether such requirements define the scope of the court's subject matter jurisdiction or are merely in the nature of affirmative defenses. If jurisdictional, the §303(b) requirements cannot be waived; the court does not have the authority to extend its jurisdictional reach beyond its Congressional mandate.

A recent en banc circuit court decision addressing this issue is *Trusted Net Media Holdings LLC v. The Morrison Agency Inc.* (*In re Trusted Net Media Holdings, LLC*).[6] In 2002, The Morrison Agency Inc., one of Trusted Net's creditors, filed an involuntary bankruptcy petition against Trusted Net for relief under chapter 7 of the Bankruptcy Code. No other creditor signed the petition. Trusted Net did not file an answer to the petition, and the bankruptcy court entered an order for relief.

Two years later, David W. Huffman, an officer and controlling member of Trusted Net, filed a motion to dismiss the bankruptcy case for failure to satisfy the threshold requirements of §303(b). Huffman argued that the involuntary petition failed to satisfy §303(b) in two ways, alleging that The Morrison Agency's claim was subject to a bona fide dispute and that the single-creditor petition failed to meet the three-creditor minimum requirement because Trusted Net had more than 12 creditors.

The bankruptcy court denied the motion to dismiss as untimely despite Huffman's argument that the §303(b) requirements are jurisdictional and go to the heart of a bankruptcy court's power to hear a case.

Then, more than four years after the commencement of the case, Trusted Net filed a motion to dismiss the bankruptcy case for lack of subject matter jurisdiction. Like Huffman's motion two years earlier, Trusted Net based its arguments on the petitioner's failure to satisfy the §303(b) requirements. The bankruptcy court denied Trusted Net's motion, again holding that §303(b) is not jurisdictional and that the debtor's untimely arguments had been waived. The district court affirmed.

On appeal to the Eleventh Circuit, Trusted Net again argued that the §303(b) requirements are jurisdictional and, therefore, not waivable. Trusted Net cited the Second Circuit's decision, *Key Mechanical Inc. v. BDC 56 LLC*,[7] a case focusing on the issue of whether the claims of the petitioning creditors in that particular case were subject to a bona fide dispute so as to render them ineligible to be petitioning creditors under §303(b).

Though *Key Mechanical* did not involve the waiver issue, the court wrote "the more sound view is that the requirement is subject matter jurisdictional, and [we] now so hold."[8]

Apparently influenced by policy considerations, the court reasoned that "[a]ny creditor wishing to invoke the bankruptcy court's jurisdiction in an involuntary case should be required to demonstrate at the earliest practicable point that its petition satisfies this requirement. Otherwise, creditors could, on the basis of relatively untested claims, haul a solvent debtor with whom they have legitimate disputes into bankruptcy court and force it to defend an involuntary proceeding while the bankruptcy court leaves for a later merits determination whether the debtor is even properly before it."[9]

Supreme Court Analysis

Noting that the circuits are split on whether §303(b) is jurisdictional, the Eleventh Circuit in its en banc decision[10] sided with the Ninth Circuit's view that it is not jurisdictional[11] and rejected the Second Circuit's view that it is.

In contrast to the Second Circuit's policy-rooted decision, the Eleventh Circuit arrived at its decision using a roadmap for textual analysis provided by the Supreme Court in the employment discrimination case of *Arbaugh v. Y&H Corp.*[12]

To qualify as an "employer" for purposes of Title VII, the statute requires employment of fifteen or more employees.[13] The Supreme Court held that the employee-numerosity requirement is nonjurisdictional and, as a byproduct of its analysis, set out guidelines for interpreting statutes that are ambiguous as to their jurisdictional character.

At the outset, the Eleventh Circuit noted that the Supreme Court in *Arbaugh* reaffirmed a strong presumption against interpreting statutes

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as jurisdictional absent unambiguous language to the contrary.

This universal canon of statutory interpretation is vital to any analysis of a statute's jurisdictional character. The Eleventh Circuit found that the language of §303(b) gives no indication that Congress intended to implicate the subject matter jurisdiction of the bankruptcy courts and, accordingly, held that §303(b) is nonjurisdictional and waivable.

Eleventh Circuit's Analysis

The Eleventh Circuit then confirmed its conclusion with another textualist argument. The court noted that §303(b)'s language, "[a]n involuntary case against a person is commenced," is similar to the "commencement of a case" language found in §§546(a) and 549(d) of the Bankruptcy Code. Those sections establish limitations periods for commencing certain actions based on the trustee's avoidance powers, such as actions to avoid preferences and fraudulent conveyances.[14]

The court cited its own decision in *Pugh v. Brook*,[15] in which it had considered the statutory language, authority, legislative history, and overall statutory scheme, and had concluded that §§546(a) and 549(d) are nonjurisdictional and waivable. The court found that the same reasoning applies to §303(b) and that all "commencement of a case" language throughout the Bankruptcy Code should be interpreted as nonjurisdictional to promote coherence and avoid inconsistency.

The court next observed that its conclusion that §303(b) is not jurisdictional is consistent with the grant of bankruptcy jurisdiction under Title 28 of the U.S. Code. A district court, or a bankruptcy court if it is referred by the district court, may hear and determine "any or all cases under" the Bankruptcy Code, as well as other specified categories of proceedings.[16]

The court noted that subject matter jurisdiction is essentially class-centric; i.e., it inherently involves a court's ability to hear a class of cases. Involuntary bankruptcy cases constitute a class of cases that clearly arise under the Bankruptcy Code and, therefore, are within the statutory grant of subject matter jurisdiction to the bankruptcy courts.

The court, noting the general rule that subject matter jurisdiction requirements may be raised at any time sua sponte, also found support for its conclusion in the fact that the Code does not contemplate sua sponte dismissal for failure to satisfy the §303(b) requirements. In particular, §303(h) provides that if the petition "is not timely controverted, the court shall order relief against the debtor."[17]

Thus, the Code "contemplates that relief will be granted immediately if no timely response is filed…and belies any congressional intent to have courts sua sponte consider whether the §303(b) requirements have been satisfied."[18]

Moreover, §303(c) allows a creditor to join as a petitioning creditor during the case so that if a petition fails to satisfy the requirements of §303(b), the defects may be cured by joining other petitioners at any time before dismissal.[19]

The court found it "anomalous at best to conclude that a bankruptcy court, which lacks jurisdiction over an involuntary case because the petition was defectively filed, subsequently may create jurisdiction for itself by permitting additional creditors to join the petition."[20]

Second Circuit's View

As noted, the issue of the jurisdictional nature of §303(b) is the subject of a circuit split. The Ninth and Eleventh Circuits represent the majority view that such requirements are not jurisdictional.[21] The Second Circuit stands alone among circuit courts in its view that the requirements for an involuntary petition under §303(b) are jurisdictional.[22]

Though the court decision did not address the question of whether the requirements of §303(b) may be waived if not timely raised, if it continues to hold the view that such requirements are subject matter jurisdictional it could be argued that such waiver would be precluded.

However, a bankruptcy judge in the Southern District has limited the ramifications of the court's decision by interpreting it narrowly.[23] In an involuntary bankruptcy case not involving waiver, the bankruptcy court held that a creditor lacks standing to challenge the sufficiency of a bankruptcy petition based on the failure to satisfy the undisputed claim prong of §303(b).

> Unless the petitioning creditors are acting in bad faith, the failure of the debtor to timely raise objections based on §303(b) should foreclose such arguments.

The bankruptcy court took this position notwithstanding the court's view that the requirements of §303 are jurisdictional and that ordinarily any party has standing to challenge a court's subject matter jurisdiction.[24]

Conclusion

The reasoning of the Eleventh Circuit in *Trusted Net Media* is persuasive and should be followed by other courts. Treating the requirements of §303(b) as nonjurisdictional is also the better view from a policy perspective. Unless the petitioning creditors are acting in bad faith, the failure of the debtor to timely raise objections based on §303(b) should foreclose such arguments.

After the expiration of the time to appeal, the bankruptcy court's order for relief, whether entered by default or after a hearing on the debtor's contest to the petition, should become final and the case should proceed in the same manner as a voluntary case.

Otherwise, court orders entered after the order for relief regarding such matters as the sale of assets free and clear of liens, postpetition financing, assumption and assignment of executory contracts and leases, and confirmation of a chapter 11 plan,[25] would be jeopardized by a subsequent ruling that the bankruptcy court lacked subject matter jurisdiction only because the petitioning creditors had not satisfied the requirements of §303(b).

If the court finds that the petitioning creditors have acted in bad faith, the bankruptcy court, as a court of equity, should have discretion, but not the mandate, to dismiss the petition or impose other remedies after considering and properly safeguarding the rights of other parties.

1. See 11 U.S.C. §§109, 301.
2. 11 U.S.C. §303(b). Section 303(b) also provides for the filing of an involuntary petition by a foreign representative of the estate in a foreign proceeding or by a general partner against a partnership.
3. See 11 U.S.C. §301.
4. See 11 U.S.C. §303(d); Rule 1011 F. R. Bankr. P.
5. See Rule 1011 F. R. Bankr. P.; 12 F. R. Civ. P.
6. *Trusted Net Media Holdings LLC v. The Morrison Agency Inc.*, 550 F.3d 1035 (11th Cir. 2008).
7. *Key Mech. Inc. v. BDC 56 LLC* (*In re BDC* 56 LLC), 330 F. 3d 111 (2d Cir. 2003).
8. *Key Mech. Inc.*, supra note 7 at 118.
9. *Key Mech. Inc.*, supra note 4 at 118-119.
10. *Trusted Media Holdings*, supra note 6. The appeal was first heard by a panel of the circuit. *Trusted Net Media Holdings LLC v. The Morrison Agency Inc.*, 525 F.3d 1095 (11th Cir. 2008). The panel wrote that the better position is to treat §303(b) as nonjurisdictional yet was bound to hold that it is jurisdictional by the precedential effect of *All Media Properties Inc. v. Best*, 646 F. 2d 193 (5th Cir. 1981), which was a decision of the Fifth Circuit decided before part of the Fifth Circuit became the Eleventh Circuit. Subsequently, sitting on rehearing en banc with the power to overrule precedent, the Eleventh Circuit overruled *All Media Properties*.
11. *Rubin v. Belo Broad. Corp.* (*In re Rubin*), 769 F. 2d 611, 615 (9th Cir. 1985) ("We conclude that the undisputed claims requirement of the Bankruptcy Amendments is not jurisdictional. Rather, it goes to the merits—an element that must be established to sustain an involuntary proceeding.").
12. *Arbaugh v. Y&H Corp.*, 546 U.S. 500 (2006).
13. 42 U.S.C. §2000e(b).
14. See 11 U.S.C. §§546(a), 547, 548, 549(d).
15. *Pugh v. Brook*, 158 F.3d 530 (11th Cir. 1998).
16. See 28 U.S.C. §§157(a), 1334(a).
17. 11 U.S.C. §303(h).
18. *Trusted Net Media Holdings*, supra note 6, at 1044.
19. 11 U.S.C. §303(c).
20. *Trusted Net Media Holdings*, supra note 6, at 1044-45.
21. See *Trusted Net Media Holdings*, supra note 6, at 1041, for citations to district and bankruptcy court decisions that are consistent with the majority view.
22. See *Trusted Net Media Holdings*, supra note 6, at 1041, for citations to bankruptcy court decisions that are consistent with the minority view.
23. *In re MarketXT Holdings Corp.*, 347 B.R. 156 (Bankr. S.D.N.Y. 2006).
24. *In re MarketXT Holdings Corp.*, supra note 23, at 160-62.
25. See 11 U.S.C. §§363(f), 364, 365, 1129, 1141.

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