No Unwaivable Right to File an Involuntary Bankruptcy Petition

September/October 2010

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The ability to file for bankruptcy protection and receive a discharge of debts is sometimes perceived, rightly or wrongly, as a fundamental (if not constitutional) entitlement under U.S. law in keeping with the congressional mandate in Article I, Section 8, Clause 4 of the U.S. Constitution to establish "uniform Laws on the subject of Bankruptcies throughout the United States." For this reason, the general rule is that a debtor may not waive the right to file for bankruptcy protection, and a voluntary bankruptcy filing is prohibited only under the narrowly defined circumstances contained in the Bankruptcy Code.

A creditor's right to file an involuntary bankruptcy petition against a debtor, however, is less inviolable. A ruling recently handed down by the Second Circuit Court of Appeals illustrates that, under appropriate circumstances, creditors can be enjoined from filing an involuntary bankruptcy case against a debtor. In *Securities and Exchange Commission v. Byers*, the court of appeals affirmed a district court order denying a request to dissolve an anti-litigation injunction barring nonparties from filing involuntary bankruptcy petitions against entities whose property was subject to a Securities and Exchange Commission ("SEC") receivership. "Simply put," the Second Circuit ruled, "there is no unwaivable right to file an involuntary bankruptcy petition, and, even if there were, the receivership accomplishes what a bankruptcy would."

Limitations on the Right to File Bankruptcy Petitions

A debtor's ability to file for bankruptcy protection is a fundamental privilege. For this reason, any agreement purporting to waive that right is almost always unenforceable as a matter of public policy. Even so, the right to file a bankruptcy petition is not absolute. It may be abridged or limited by statute. For example, section 109 of the Bankruptcy Code, which governs eligibility for bankruptcy filings under all chapters (except chapter 15), prohibits certain entities, such as railroads, insurance companies, and banks, from being a debtor under certain chapters. Also, section 109(g) of the Bankruptcy Code, which was added to the Bankruptcy Code in 1984 to deter repetitious filings, provides that no individual or family farmer who has been a debtor in a case pending at any time during the preceding 180 days may be a debtor in a bankruptcy case under any chapter if the case was dismissed for willful failure of the debtor to abide by court orders or prosecute the case, or if the debtor requested and obtained voluntary dismissal of the case following a request for relief from the automatic stay.

Section 349(a) of the Bankruptcy Code, which provides that the dismissal of a bankruptcy case does not bar the issuance of a discharge of debts in a later case or "prejudice the debtor with regard to the filing of a subsequent petition . . . except as provided in section 109(g)," has also been interpreted by some courts as authority for barring future filings. There is, however, a conflict among the circuits as to the scope or validity of that empowerment. In addition, some courts have interpreted the broad equitable mandate contained in section 105(a) of the Bankruptcy Code, which provides that the "court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title," to preclude an entity from legitimately filing for bankruptcy in certain circumstances. However, this approach has been

criticized as being contrary to the understanding of section 105(a)'s limitation of scope to areas that are not otherwise expressly addressed by other sections of the statute.

Section 303 of the Bankruptcy Code provides that an involuntary chapter 7 or chapter 11 case may be filed by creditors asserting unsecured claims of specified minimum amounts that are neither contingent nor subject to bona fide dispute against "a person, except a farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation," so long as the "person" is otherwise eligible to be a debtor under the conditions specified in section 109. Other than section 303, no provision of the Bankruptcy Code expressly precludes a creditor from filing an involuntary bankruptcy petition against a debtor.

However, under certain limited circumstances, a handful of courts have ruled that voluntary or involuntary bankruptcy filings may be prohibited on grounds other than those expressly (or at least impliedly) contemplated by the Bankruptcy Code. As demonstrated in the Second Circuit's ruling in *S.E.C. v. Byers*, these circumstances have almost always been limited to situations involving debtors that have been placed into federal receivership, such that their assets are already subject to federal court administration.

S.E.C. v. Byers

On August 11, 2008, the SEC filed a complaint against Steven Byers and various other affiliated defendants, alleging a massive Ponzi scheme that operated in the U.S., the Middle East, and Africa and that reportedly defrauded investors of approximately $255 million. On the same day that it filed the complaint, the SEC obtained emergency relief, including a temporary restraining order freezing the assets of the defendants and appointing a receiver to ascertain the defendants'

financial condition and to determine whether any or all of them should file for bankruptcy protection. The receiver order issued by the district court also contained the following anti-litigation provision:

> No person or entity, including any creditor or claimant against any of the Defendants, or any person acting on behalf of such creditor or claimant, shall take any action to interfere with the taking control, possession, or management of the assets, including, but not limited to, the filing of any lawsuits, liens, or encumbrances, or bankruptcy cases to impact the property and assets subject to this order.

One month later, the district court modified its previous order to provide as follows:

> If in accordance with this order the Receiver determines that any of the [defendants] and entities they own or control should undertake a bankruptcy filing, the Receiver be, and he hereby is, authorized to commence cases under title 11 of the United States Code for such entities in this district, and in such cases the Receiver shall prosecute the bankruptcy petitions in accordance with title 11 subject to the same parameters and objectives as a chapter 11 trustee and shall remain in possession, custody, and control of the title 11 estates subject to the rights of any party in interest to challenge such possession, custody, and control under 11 U.S.C. § 543 or to request a determination by this Court as to whether the Receiver should be deemed a debtor in possession or trustee, at a hearing, on due notice to all parties in interest, before the undersigned.

On October 24, 2008, on the consent of all parties, the district court issued a preliminary injunction that incorporated the provisional remedies quoted above. Shortly afterward, two ad hoc creditors' committees requested that the court modify its orders to remove the bankruptcy-filing prohibition and the provision that authorized the receiver to prosecute a bankruptcy case as a chapter 11 trustee. The district court denied the relief requested but modified its injunction order to: (i) permit any party or nonparty to seek court permission to file a bankruptcy case against any of the defendants on three days' notice, based upon a showing that such a petition would be appropriate and benefit the receivership estate; and (ii) allow the bankruptcy court to

decide in the first instance any challenge to the receiver's continuing to serve as a debtor in possession. The committees appealed the order to the Second Circuit.

The Second Circuit's Ruling

A three-judge panel of the Second Circuit affirmed on appeal. Writing for the court, circuit judge Rosemary S. Pooler rejected the committees' argument that section 303 of the Bankruptcy Code grants them an absolute right, as creditors, to commence an involuntary bankruptcy case against a debtor. "[W]hile it is a power to be exercised cautiously," Judge Pooler remarked, "district courts may issue anti-litigation injunctions barring bankruptcy filings as part of their broad equitable powers in the context of an SEC receivership."

Judge Pooler also rejected the committees' contention that such injunctions cannot apply to bankruptcy petitions because the ability to file a bankruptcy petition is a right guaranteed by the Bankruptcy Code. The judge explained that the Sixth and Ninth Circuits have also approved the issuance of anti-litigation injunctions in federal receivership cases, albeit they did not expressly bar bankruptcy filings. Debtors, she wrote, "do not have an absolute right to file a bankruptcy petition," and creditors may waive the right to file an involuntary bankruptcy petition:

> Simply put, there is no unwaivable right to file an involuntary bankruptcy petition, and, even if there were, the receivership accomplishes what a bankruptcy would. The receivership protects the assets of the estate, just as a stay would in bankruptcy.
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> An anti-litigation injunction is simply one of the tools available to courts to help further the goals of the receivership. While such injunctions are to be used sparingly, there are situations in which they are entirely appropriate. In this litigation the receivership must manage hundreds of [defendants] that sprawl across the Middle East, Africa and the United States, many of which may have co-mingled assets. This is precisely the situation in which an anti-litigation injunction may assist the district court and receiver who will want to maintain maximum control over the assets. The current injunction prevents small groups of

> creditors from placing some entities into bankruptcy, thereby removing assets from the receivership estate to the potential detriment of all. We are persuaded that the powers afforded the receiver and the district court allow it to adequately protect the assets of the estate.

Finally, Judge Pooler found no merit in the committees' argument that the district court's order includes an improper de facto designation of the receiver as a debtor in possession or trustee in the event of a bankruptcy filing, principally because section 105(b) of the Bankruptcy Code prohibits courts from appointing a receiver in bankruptcy cases. According to the judge, nothing in the order conflicts with the Bankruptcy Code because the "order merely acknowledges that the receiver automatically becomes debtor-in-possession by operation of law." Moreover, she emphasized, the receiver's status can be challenged under section 543, or the parties can move to appoint a chapter 11 trustee under section 1104. There is no reason, Judge Pooler wrote, that "a district court cannot, pre-petition, appoint a manager for the entities, and there is nothing in the Bankruptcy Code that prevents that manager from continuing after the bankruptcy filing, subject to challenge by others."

Outlook

The ability to file an involuntary bankruptcy petition against a debtor that is not paying its obligations is an important remedy given to creditors under the Bankruptcy Code. In certain situations (*e.g.*, when a company's management is incompetent, there is dissension among the general partners of a partnership, or a potential debtor is transferring assets in anticipation of creditor collection proceedings), the filing of an involuntary case is a beneficial, and sometimes optimal, strategy for creditors. *S.E.C. v. Byers* illustrates that a creditor's right to file an involuntary bankruptcy, like a debtor's right to file for bankruptcy voluntarily, is protected but

not absolutely inviolate. According to the Second Circuit, creditors can be enjoined from filing an involuntary bankruptcy petition in cases where the debtor is in federal receivership.

As a statutory matter, why the pendency of a federal receivership should be a legitimate basis for banning a voluntary or involuntary bankruptcy filing with respect to the debtor is unclear. Section 543 of the Bankruptcy Code expressly contemplates that a bankruptcy filing will supersede any pending receivership by directing a "custodian," which is defined in section 101(11) to include a "receiver or trustee of any property of the debtor, appointed in a case or proceeding not under [the Bankruptcy Code]," to deliver to the bankruptcy trustee any property of the debtor in its possession as of the commencement of the debtor's bankruptcy case. A receiver in a federal receivership proceeding would appear to fall within the definition of "custodian." Although it does not expressly say so, perhaps the Second Circuit's decision draws a distinction between federal and state law receiverships. Courts have uniformly ruled that voluntary or involuntary bankruptcy filings may not be barred in cases involving debtors that are subject to receiverships under *state* law. The Supremacy Clause of the U.S. Constitution (Art. VI, § 1, cl. 2), however, can be interpreted in such a way that the Bankruptcy Code prevails in cases involving state, but not federal, receiverships. Moreover, bankruptcy courts do not represent an independent arm of the judicial branch but are merely units of the federal district courts. Thus, judicial economy and efficient use of resources arguably would dictate that a bankruptcy filing by or against a debtor that is already subject to federal receivership overseen by a district court would be wasteful and needlessly duplicative.

Securities and Exchange Commission v. Byers, 609 F.3d 87 (2d Cir. 2010).

Frieouf v. United States (In re Frieouf), 938 F.2d 1099 (10th Cir. 1991).

Liberte Capital Group, LLC v. Capwill, 462 F.3d 543 (6th Cir. 2006).

Securities and Exchange Commission v Wencke, 622 F.2d 1363 (9th Cir. 1980).

U.S. v. Vulpis, 961 F.2d 368 (2d Cir. 1992).

In re Casse, 198 F.3d 327 (2d Cir. 1999).

Colonial Auto Ctr. v. Tomlin (In re Tomlin), 105 F.3d 933 (4th Cir. 1997).

In re Cusano, 2010 WL 2593921 (Bankr. 6th Cir. June 25, 2010).

Giaimo v. Detrano (In re Detrano), 222 B.R. 685 (Bankr. E.D.N.Y. 1998).

In re Global Ship Systems, LLC, 391 B.R. 193 (Bankr. S.D. Ga. 2007).

In re McCullough and Co., 199 B.R. 179 (Bankr. W.D. Mo. 1996).

In re S & S Liquor Mart, Inc., 52 B.R. 226 (Bankr. D.R.I. 1985).

In re Newport Offshore Ltd., 219 B.R. 341 (Bankr. D.R.I. 1998).

In re Rite-Cap, Inc., 1 B.R. 740 (Bankr. D.R.I. 1979).

In re Segno Communications, Inc., 264 B.R. 501 (Bankr. N.D. Ill. 2001).