Ninth Circuit Splits From Fourth Circuit on Involuntary Bankruptcy Standard: *In re Marciano*

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A judgment creditor who is considering filing an involuntary bankruptcy petition against a debtor should consult venue-specific controlling law if the debtor has appealed the judgment. Depending on the jurisdiction, the debtor's appeal may or may not be a factor for the bankruptcy court to consider in determining whether the creditor's claim meets the involuntary petition requirements of the Bankruptcy Code. Generally, to be eligible as a petitioning creditor in an involuntary bankruptcy case, a creditor must hold a claim against the debtor that, among other things, "is not contingent as to liability or the subject of a bona fide dispute as to liability or amount." 11 U.S.C. § 303(b)(1). Under the approach of certain courts, when the creditor's claim is based on a state-court judgment that the debtor has appealed, and the judgment is not stayed during the appeal, the appeal could be deemed a "bona fide dispute" rendering the judgment claim ineligible to support the involuntary petition.

Earlier this year, the Ninth Circuit Court of Appeals considered this question as a matter of first impression in *Marciano v. Chapnick (In re Marciano)*, 708 F.3d 1123 (9th Cir. 2013). Adopting a stricter approach than that of the Fourth Circuit in *Platinum Fin. Servs. Corp. v. Byrd (In re Byrd)*, 357 F.3d 433 (4th Cir. 2004), the Ninth Circuit concluded that an unstayed, enforceable state-court judgment—despite an appeal—is per se a claim against the debtor that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount. The Fourth Circuit in *Byrd*, by contrast, rejected the per se rule in favor of an approach that is more

flexible and therefore potentially may inure to the debtor's benefit. Under this approach, the bankruptcy court may consider the details of the appeal and deem it to be a bona fide dispute.

Involuntary Bankruptcy-Filing Requirements

Section 303(b)(1) of the Bankruptcy Code provides, with certain exceptions, that an involuntary chapter 7 or chapter 11 case may be commenced against a "person" eligible to be a debtor under either chapter:

> by three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount, or an indenture trustee representing such a holder, if such noncontingent, undisputed claims aggregate at least $14,425 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims.

Because the phrase "bona fide dispute as to liability or amount" is not defined in the Bankruptcy Code, its meaning has been left to the courts.

The Fourth Circuit's *Byrd* Rule

In *Byrd*, the Fourth Circuit held that an appeal of a judgment might indeed qualify as a bona fide dispute. Under this approach (the "*Byrd* Rule"), an unstayed judgment—even if immediately enforceable under state law despite the appeal—remains subject to the debtor's opportunity to demonstrate to the bankruptcy court that the appeal is a bona fide dispute for purposes of section 303(b). Though the Fourth Circuit presupposed that an appeal might rise to the level of a bona fide dispute only in an "unusual" case, its holding in *Byrd* nevertheless recognizes this "unusual" possibility and states the premise that unstayed state-court judgments "do not *guarantee* the lack of a bona fide dispute" (emphasis added). Critically, in a proper application of the *Byrd* Rule, the bankruptcy court does not rule on the merits of the appeal. Rather, the court considers the more

limited question of whether the circumstances and merits of the appeal qualify as a bona fide dispute for purposes of section 303 of the Bankruptcy Code.

The Ninth Circuit's Decision in *Marciano*

The Ninth Circuit disagreed with this approach in *Marciano*. In *Marciano*, Georges Marciano sued five of his former employees in California state court, alleging theft. Three employees filed cross-complaints against Marciano, alleging defamation and intentional infliction of emotional distress. As a sanction for discovery abuses, the state trial court struck Marciano's answers to the cross-complaints. After a jury trial on damages, the trial court entered separate judgments in favor of the employees for $105 million in aggregate. Marciano appealed the judgments but did not post a bond to stay them during appeal. The appellate courts denied Marciano's requests for a stay pending appeal, and the California Supreme Court denied his petition for review.

While the appeals were pending, various creditors began collection efforts. The employee judgment creditors then filed an involuntary chapter 11 petition against Marciano in a California bankruptcy court. Marciano argued, among other things, that the employees were not eligible petitioning creditors under section 303(b)(1) because their claims were subject to bona fide dispute (i.e., his appeals). The bankruptcy court and a Ninth Circuit bankruptcy appellate panel successively held that an unstayed nondefault state-court judgment is a claim not in bona fide dispute as to liability or amount under section 303(b)(1).

The Ninth Circuit affirmed on appeal as a matter of first impression. In so holding, the court of appeals joined the majority view on this issue, which has become known as the "*Drexler* Rule" after a 1986 decision from the U.S. Bankruptcy Court for the Southern District of New York. *See*

In re Drexler, 56 B.R. 960 (Bankr. S.D.N.Y. 1986). According to this approach, an unstayed nondefault state-court judgment on appeal is never the subject of a bona fide dispute if the judgment is immediately enforceable under applicable state law.

The Ninth Circuit found the *Drexler* Rule to be more correct than *Byrd* "as a matter of both statutory interpretation and federalism." With respect to statutory interpretation, the court noted that although the Bankruptcy Code does not define "bona fide dispute," it does define "claim." *See* 11 U.S.C. § 101(5)(A). Under that definition, a claim is expressly not limited by "whether or not [the creditor's claim or right] is reduced to judgment." On the basis of this observation, the Ninth Circuit recognized a distinction between a judgment and the original, underlying claim that gave rise to it.

On the basis of that distinction, once a creditor reduces an underlying claim to judgment, any disputes the debtor may have raised against the claim (or may continue to raise in the appeal) have been sufficiently overcome for purposes of section 303(b)(1) of the Bankruptcy Code, so long as governing state law makes the judgment immediately enforceable absent a stay pending appeal. Thus, the Ninth Circuit stated, under the *Drexler* Rule, the immediate enforceability under state law of the unstayed judgment, despite the appeal, means the judgment claim is "plainly not contingent as to liability or amount." Consequently, under *Marciano* and *Drexler*, the judgment claim meets the requirements of section 303(b)(1).

According to the Ninth Circuit, the principles of federalism support this interpretation. Allowing a bankruptcy court to "inquire further as to the validity" of a claim based on a state trial-court

judgment rather than treating such a claim on "an objective basis" as being beyond bona fide dispute, the court explained, would be inappropriate for an Article I federal court. The Ninth Circuit wrote that permitting such an inquiry would render the principles of "full faith and credit . . . of little consequence." According to the court, "If the creditor is entitled to have the judgment treated as valid in the state courts, we see no reason why a bankruptcy court should be allowed to question the judgment."

Dissenting Opinion

The reasoning of the minority-view courts resonated with Ninth Circuit judge Ikuta, who dissented in *Marciano*. In her view, a per se rule that claims arising from unstayed state-court judgments can never be subject to bona fide dispute, even during a pending appeal process, does not provide debtors with sufficient protection against the "substantial consequences" of involuntary bankruptcy and "potential abuses" of that remedy by zealous creditors. She viewed the majority's approach as a "shortcut" that is contrary to section 303(b) and to earlier Ninth Circuit decisions.

Specifically, circuit judge Ikuta suggested that the Ninth Circuit's earlier decision in *In re Vortex Fishing Sys., Inc.*, 277 F.3d 1057 (9th Cir. 2001), echoed *Byrd* and adopted an "objective test" requiring courts to undertake "a factual, case-by-case inquiry into the nature of each claim," to determine "whether there is an objective basis for either a factual or a legal dispute as to the validity of the debt" (internal citations and quotations omitted). Instead, she explained, the majority opinion in *Marciano* distinguished *Vortex* briefly but completely for "deal[ing] with contract claims not yet reduced to judgment" and said nothing more about it. "Clearly, our articulation of the objective test in *Vortex* (expressly joining the other circuits that had adopted

the test)," circuit judge Ikuta wrote, "was not dependent on the facts of that case, but rather provided the circuit's construction of 'subject to a bona fide dispute' in § 303(b)."

On the issue of statutory interpretation, whereas the majority in *Marciano* read section 101(5) of the Bankruptcy Code (defining "claim") to support a focus on the judgment (as distinguished from the underlying claims), circuit judge Ikuta felt that the emphasis must remain on the underlying claims and whether they remain subject to bona fide dispute via the appeal. From this perspective, the immediate enforceability of the unstayed judgment was irrelevant to circuit judge Ikuta.

Finally, circuit judge Ikuta contended that her approach creates no federalism issue because it does not call upon the bankruptcy court to "relitigate the debtor's liability" under state law. Rather, she wrote, "the question whether a determination is *subject to* a genuine dispute is separate from determining the merits of that dispute."

Conclusion

In adopting the majority view, the Ninth Circuit has joined bankruptcy courts in New York, Delaware, Virginia, Louisiana, Pennsylvania, and South Carolina. *See*, *e.g*., *Drexler*, 56 B.R. at 967; *In re AMC Investors, LLC*, 406 B.R. 478 (Bankr. D. Del. 2009); *In re Cohn-Phillips, Ltd.*, 193 B.R. 757 (Bankr. E.D. Va. 1996); *In re Norris*, 183 B.R. 437 (Bankr. W.D. La. 1995); *In re Raymark Indus., Inc.*, 99 B.R. 298 (Bankr. E.D. Pa. 1989); *In re Caucus Distribs., Inc.*, 83 B.R. 921 (Bankr. E.D. Va. 1988); *In re Galaxy Boat Mfg. Co. Inc.*, 72 B.R. 200 (Bankr. S.C. 1986). Courts in Pennsylvania, meanwhile, have issued decisions following the minority *Byrd* Rule, as have bankruptcy courts in West Virginia and Texas. *See In re Tucker*, 2010 WL 4823917 (Bankr.

N.D. W. Va. Nov. 22, 2010); *In re Henry S. Miller Commercial, LLC*, 418 B.R. 912 (Bankr. N.D. Tex. 2009); *In re Graber*, 319 B.R. 374 (Bankr. E.D. Pa. 2004); *In re Prisuta*, 121 B.R. 474 (Bankr. W.D. Pa. 1990). In some of these latter decisions, such as *Prisuta*, the judgments in question had not yet been appealed, but the court was willing to entertain, and found, grounds for bona fide dispute. *See Prisuta*, 121 B.R. at 477 ("The disputes in this case concerning the debts owed by alleged debtors to petitioners appear bona fide . . . despite the uncontested, unstayed, unappealed judgments of record which gave rise to the debts.").

Interestingly—though ultimately irrelevant under the *Drexler* Rule—the state-court jury in *Marciano* never considered the merits of Marciano's answers and defenses to the cross-claims against him, because the state court struck them as a sanction for discovery abuses and proceeded as if he had defaulted. Even so, courts employing the majority *Drexler* Rule would say that the merits were sufficiently determined for purposes of eliminating any bona fide dispute within the meaning of section 303(b) of the Bankruptcy Code. Apparently, in *Marciano*, the state appellate court ultimately upheld the judgments but reduced their aggregate amount by two-thirds. Even in their reduced amounts, however, the claims totaled $30 million and therefore far exceeded the $14,425 minimum of section 303(b).

In any circuit, a group of creditors should consider its position carefully before commencing an involuntary bankruptcy case against a debtor. The creditors should confirm that all aspects of section 303(b)(1) are complied with, including whether the debtor could raise "a bona fide dispute as to [the] liability or amount" of the claims involved. If one or more of the claims are based on a state-court judgment that the debtor has appealed without obtaining a stay, the

creditor should confirm whether the applicable bankruptcy court is bound or likely to follow the majority *Drexler* Rule or the minority *Byrd* Rule with respect to the existence of a "bona fide dispute" regarding the underlying claim.

Under the *Drexler* Rule, the creditor may proceed without concern that the debtor will assert that the claim is subject to a bona fide dispute. Under the *Byrd* Rule, however, the debtor will have the opportunity to persuade the bankruptcy court that the appeal has sufficient merit to constitute a bona fide dispute, which would render the claim ineligible to support the involuntary petition if the bankruptcy court agrees.

Practically speaking, the outcome of a bankruptcy court's *Byrd* analysis might be the same as under the approach of *Drexler* and *Marciano*, and the existence of an appeal may be deemed insufficient to render the judgment claim ineligible under section 303. Indeed, in the *Byrd* decision itself, that was the outcome—although only after the analysis the court believed was necessary. Thus, the existence of an appeal is not necessarily a bar against relying on an unstayed court judgment on appeal to join an involuntary petition in *Byrd* Rule jurisdictions. Nevertheless, creditors in such jurisdictions should be forewarned that their involuntary petition might be subject to challenge on this basis, and they should be prepared to demonstrate to the bankruptcy court that such a claim is not in bona fide dispute.