Involuntary Bankruptcy Petitions — A Cautionary Tale to Aggressive Creditor' Tactics

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Introduction

Involuntary bankruptcy petitions are a powerful tool that creditors may utilize against a debtor that is generally not paying its debts as they become due. If not properly handled by the petitioning creditors and their counsel, such a weapon can backfire on the petitioning creditors as was illustrated by the recent decision from the Bankruptcy Court for the District of Delaware *In re Diamondhead Casino Corporation*[1] *("Diamondhead Casino")* which dismissed the involuntary Chapter 7 bankruptcy case on the grounds that the case was filed in bad faith, despite the fact that the petitioning creditors met the statutory criteria for the bankruptcy filing. This article will provide an overview of the requirements to file an involuntary bankruptcy petition, examine the facts and circumstances of the *Diamondhead Casino* decision, and practical takeaways for creditors.

Statutory Requirements Pursuant to the Bankruptcy Code

Section 303(b)(1) of Title 11 of the United States Code (the "Bankruptcy Code") sets forth the requirements creditors must meet in order to commence an involuntary Chapter 7 or 11 case against a debtor. Section 303(b)(1) provides that "[a]n involuntary case against a person is commenced by the filing with the bankruptcy court a petition under Chapter 7 or 11 of this title – 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,…,if such noncontingent, undisputed claims aggregate at least $15,325…."[2] Section 303(h)(1) further provides that the bankruptcy court shall order relief against the debtor under the chapter into which the petition was filed, only if "the debtor is generally not paying such debtor's debts as such debts become due unless such debts are the subject of a bona fide dispute as to liability or amount…." Section 303(i)(2) also provides, among other things, that if the court dismisses the petition other than on the consent of all petitioners and the debtor, the bankruptcy court may grant judgment against any petitioning creditor that filed the petition in bad faith. "Bad faith" is not defined in the Bankruptcy Code.

***Diamondhead Casino*[3]**

In *Diamondhead Casino*, the Bankruptcy Court dismissed the involuntary Chapter 7 petition commenced by a group of noteholders (who also were stockholders of the company) because it was filed in bad faith. The bad faith determination was based on the fact that the main goal of the petitioning creditors was to effect a change in management while collecting on their debts remained a secondary purpose.

On August 6, 2015, David A. Cohen, Arnold J. Sussman and F. Richard Stark (the "Original Petitioning Creditors") filed an involuntary Chapter 7 petition against Diamondhead Casino Corporation ("Diamondhead" or the "Company"). Later, on September 11, 15, and 17, Robert F. Skaff, David J. Towner, and DDM Holdings, LLC joined the petition (together with the Original Petitioning Creditors, the "Petitioning Creditors"). On August 28, 2015, the Company filed a motion to dismiss the involuntary Chapter 7 petition.

Factual Background

Prior to August 2000, Diamondhead operated ship-based gambling operations out of ports located in Florida. In August 2000, Diamondhead divested itself of its ship-based operations and focused on the development of a land-based casino resort in Diamondhead, Mississippi. Diamondhead's only tangible asset is a wholly owned subsidiary, Mississippi Gaming Corporation, which owns 404 acres of undeveloped land (the "Property"). The Property has never been developed.

In 2010, pursuant to a private placement memorandum, the Company completed two financings: (i) Diamondhead raised $475,000 in March 2010 and (2) $475,000 in November 2010. In exchange, Diamondhead signed promissory notes (collectively, the "Notes") with maturity dates in 2012. Despite the Company's failure to develop the Property or pay the Notes at maturity, the Court was not presented with any evidence before 2015 that any of the Petitioning Creditors initiated litigation against the Company.

However, in 2014, five troubling events eventually led the Petitioning Creditors to commence an involuntary Chapter 7 proceeding against the Company. First, Diamondhead's stock was delisted by the Securities and Exchange Commission and the Petitioning Creditors were not alerted of this event. Second, the Company granted a lien on the Property to the Company's chief executive officer Deborah Vitale (the

1 Case No. 15-11647 (LSS), 2016 Bankr. LEXIS 2450 (Bankr. D. Del. June 7, 2016).

2 The dollar amount is periodically adjusted by the Judicial Conference of the United States.

3 This article only discusses the Court's bad faith analysis.

"Executives Lien") and to certain board members in the aggregate amount of $2 million to secure outstanding amounts owed to them for past board services and future services. The Executives Liens were granted with the simultaneous granting of liens on the Property. This was the first time the Property became encumbered. Third, the Company's board ratified its lease of a townhouse owned by Ms. Vitale that also served as the Company's corporate headquarters. Fourth, the Company refused to appoint two additional board members requested by the Petitioning Creditors. Fifth, the Petitioning Creditors lost faith in the Company's management because the Property had not been developed.

Prior to January 2015, the Company had not held an annual stockholder meeting in seven years. As a result of a decision of the Delaware State Chancery Court, the Company was ordered to hold a shareholders' meeting on June 8, 2015. One of the Petitioning Creditors enlisted a proxy service firm to solicit votes for its own sake and oust the incumbent board. Despite these efforts, the incumbent board prevailed and remained in control of the Company. By March 2015, another shareholder had commenced a breach of duty lawsuit against the Company's board. By August and early September 2015, the Petitioning Creditors had commenced an involuntary Chapter 7 against the Company.

Primary Motivations of the Petitioning Creditors

The Petitioning Creditors admitted that losing the proxy contest at the June 2015 shareholders' meeting was the primary driving force for commencing the involuntary bankruptcy proceeding. Specifically, the Petitioning Creditors testified that their main goal for the filing was to "take control away from the current management of Diamondhead." Furthermore, the Petitioning Creditors believed that the Property would receive a high price if sold through the provisions of the Bankruptcy Code and that the Executives Liens could be avoided as fraudulent transfers.

Bad Faith Analysis

After discussing the statutory requirements of an involuntary bankruptcy filing, the Court focused the majority of its decision on whether the bankruptcy was filed in bad faith. The Bankruptcy Court examined the Third Circuit's decision of *In re Forever Green Athletic Fields, Inc.,*[4] which held that even if the petitioning creditors and the debtor met the statutory prerequisites for involuntary bankruptcy relief, the case should be dismissed if the petitioning creditors did not act in "good faith." After determining that the Petitioning Creditors satisfied the criteria for filing the involuntary bankruptcy case, the Bankruptcy Court then analyzed the involuntary bankruptcy filing by the Petitioning Creditors under the Third Circuit's "totality of the circumstances" test. The totality of the circumstances test is a fact intensive determination that requires a court to examine the following, non-exhaustive, list of factors, whether:

> the creditors satisfied the statutory criteria for filing the petition; the involuntary petition was meritorious; the creditors made a reasonable inquiry into the relevant facts and pertinent law before filing; there was evidence of preferential payments to certain creditors or of dissipation of the debtor's assets; the filing was motivated by ill will or a desire to harass; the petitioning creditors used the filing to obtain a disproportionate advantage for themselves rather than to protect against other creditors doing the same; the filing was used as a tactical advantage in pending actions; the filing was used as a substitute for customary debt-collection procedures; and the filing had suspicious timing.[5]

The Bankruptcy Court began its analysis by noting that the Petitioning Creditors wore two hats – one as noteholder and one as stockholder. The Court needed to examine whether the Petitioning Creditors were motivated by their status as a creditor, equity holder, or both. The Court noted that the evidence was "overwhelming" in that the Petitioning Creditors sought a change in management and perceived an involuntary bankruptcy filing as the only way to accomplish that goal after a failed proxy contest. Further, each Petitioning Creditor held their stock for fifteen years, and expressed frustration with the lack of development of the Property and non-payment of their Notes.

The *Diamondhead Casino* Court, in following a long line of bankruptcy cases, explained that stockholder disputes are not appropriately remedied by filing an involuntary bankruptcy petition when state law remedies are readily available. Moreover, the Court explained that the Petitioning Creditors offered no analysis in connection with the avoidance of the Executives Liens by failing to take into account potential affirmative defenses and the litigation hurdles a trustee would have to overcome in order to avoid the Executives Lien. Similar to the lack of analysis in connection with the potential avoidance of the Executives Lien, the Court noted that the Petitioning Creditors provided no analysis in connection with their allegations of insolvency of the Company, and whether the Property would generate enough proceeds to pay all creditors in full.

Continuing through the totality of circumstances factors, the Court explained that although the involuntary petition was not filed as an attempt by the Petitioning Creditors to gain a disproportionate advantage over other creditors, the Court did find that the filing was an attempt by the Petitioning Creditors to obtain a disproportionate advantage over other stockholders. The filing of the involuntary bankruptcy petition was to undo the results of the proxy contest when the appropriate course of action was to file a lawsuit in Delaware state court utilizing Delaware General Corporation Law. The Court, therefore, concluded that this was analogous to an attempt by a creditor to gain a tactical advantage over another creditor.

The Bankruptcy Court ultimately concluded that the Petitioning Creditors' primary goal in filing the involuntary bankruptcy petition was to effect a change in management to benefit their investments as stockholders, which the Court found to be an improper use of the bankruptcy court.

4 804 F.3d 328 (3d Cir. 2015).

5 *Diamondhead*, 2016 Bankr. LEXIS, at *49-50 (citations omitted).

The Petitioning Creditors' secondary concern was to collect on their notes, which the Court found inappropriate where they were looking to vindicate their equity interests where a myriad of state law remedies were available. As a result, the Bankruptcy Court dismissed the involuntary bankruptcy case on bad faith grounds.

Takeaways

The *Diamondhead Casino* decision illustrates that despite meeting the statutory requirements of commencing an involuntary bankruptcy petition against a debtor that is not paying their debts as they become due, creditors must be mindful of non-bankruptcy options as a means to collect on their debts and proceed in a manner that cannot be construed as bad faith.

As a practical matter, most involuntary bankruptcy petitions filed by unsecured trade creditors are filed on good faith grounds, but a creditor must take into account various issues including the absence of disputes on their debt, payments within ninety days, and any efforts expended outside of bankruptcy court, all of which are designed to minimize the creditor's risk and maximize the effectiveness of an involuntary bankruptcy petition in order to enhance recovery.

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