CT Bankruptcy Beat
Legal Developments in Restructuring and Creditors' Rights

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Second Circuit Ruling Rejects Involuntary Bankruptcy Cases When Used for Debt Collection

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Imprisonment for debt has been abolished by all states, either by constitutional amendment, statute or common law, *see Pease v. Charlotte Hungeford Hospital,* 325 Conn. 363, 375-76 (2017); Note, "State Bans on Debtors' Prisons and Criminal Justice Debt," 129 Harv. L. Rev. 1024, 1034-35 (2016), but putting a debtor into involuntary bankruptcy remains an available option under federal law. *See* 11 U.S.C. §303. Generally, a debtor with 12 or more creditors and who is generally not paying debts as they become due can be put into involuntary bankruptcy by a petition signed by three or more creditors who are owed, in the aggregate, at least $15,775 on an unsecured basis and whose debts and not subject to bona fide dispute 11 U.S.C. §303(b)(1). If the debtor has fewer than 12 creditors, a single creditor with an unsecured claim that is free of bona fide dispute and is in the threshold amount has the ability to file an involuntary bankruptcy petition, 11 U.S.C. §303(b)(2), but the Second Circuit's recent decision in *Wilk Auslander, LLP v. Murray (In re Murray)*, 2018 WL 3848316 (2d Cir. Aug. 14, 2018) should serve as a cautionary warning for any creditor considering that option.

In *Murray,* the debtor, Matthew Murray, had suffered a $19 million judgment as the result of an arbitration that went in favor of his former employer, Rodman & Renshaw, LLC ("R&R"). R&R assigned the judgment to its law firm, Wilk Auslander, LLC, as part of a settlement for outstanding fees. Information acquired by Wilk Auslander suggested that Murray was dispossessing himself of assets, including transferring $169,000 to an offshore trust, and that his sole remaining asset was a residential cooperative apartment in Manhattan that he owned jointly with his wife in what is called a tenancy by the entirety. Generally, a tenancy by the entirety is a form of ownership between husband and wife

whereby, upon the death of either, the survivor spouse takes title to the entire property to the exclusion of deceased's heirs.

In bankruptcy, a bankruptcy trustee has the ability to sell property that is co-owned by the debtor and another as joint tenancy, tenancy in common or tenancy by the entirety, if, among other things, 1) partition in kind would be impracticable, 2) sale of the debtor's co-ownership interest would realize significantly less for the bankruptcy estate than sale of the entire property free and clear of the interests of co-owners, and 3) the benefit to the bankruptcy estate from a sale free of the ownership interests of the co-owner outweighs the detriment to the co-owner. 11 U.S.C. §363(h)(1), (2), (3). The co-owner, however, has a right of first refusal on any sale and, if not exercised, must be paid his or her share of the proceeds less costs of sale. 11 U.S.C. §363 (i), (j).

After learning of Murrays' asset transfers and co-ownership of the cooperative apartment, Wilk Auslander filed an involuntary petition in bankruptcy against Murray. It was undisputed that Wilk Auslander's purpose in filing the petition was to take advantage of bankruptcy remedies that would allow it to force a sale of the apartment—notwithstanding Murray's wife's interest, which would be recognized after the sale—rather than state law remedies that would permit it to execute on Murray's interest only. Murray moved to dismiss the petition for bad faith and alternatively under the abstention provision of the Bankruptcy Code, which essentially allows a Bankruptcy Court to abstain from taking a bankruptcy case if "the interests of creditors and the debtor would be better served" by dismissal of the case.

Although the Bankruptcy Court did not abstain, it dismissed the case for "cause" under 11 U.S.C. §707(a) for what it called "an improper exploitation of the bankruptcy system" by Wilk Auslander, essentially because it was using the bankruptcy system for its own parochial collection purposes when it had adequate state law remedies for seeking to recover any fraudulent transfers by Murray and for executing on Murray's interest in the apartment.

In resoundingly affirming the Bankruptcy Court's ruling, the Second Circuit cautioned that involuntary bankruptcy should not be used, as it was in the case before it, as means of collecting the petitioning creditor's debt when adequate state law remedies exist for that purpose. In that regard, it observed that under New York law, Wilk Auslander was able to execute on Murray's interest in the apartment, although it could not affect his wife's interest.

While recognizing that in bankruptcy, there was a mechanism for selling the entire apartment free of Murray's wife's ownership interest, the Second Circuit observed that it was by no means clear that could be accomplished because Murray's "interest" was just a "survivorship right," meaning that unless he survived his wife, his interest was tantamount to a life estate in the property.

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For this reason, it further observed that his "interest" would likely be much less than 50 percent based actuarial data (i.e., which spouse would outlive the other based on actuarial data). Thus, it was highly questionable that a finding could be made that the sale of Murray's co-ownership interest would realize much less in bankruptcy than would a sale of the entire property free and clear of the interests of his wife, which is a requirement for a "free and clear" sale. The Second Circuit also noted that the "non-economic detriment" to the wife from a sale free and clear could outweigh the benefit to the bankruptcy estate from such a sale, which, if established, was another reason the bankruptcy sale could be defeated.

From a more philosophical perspective, the Second Circuit instructed that involuntary bankruptcies should not be used as a collection device for a single creditor, but rather, are to be used to protect or benefit all creditors when, *e.g.,* a single or several more aggressive creditors are gaining collection advantages *vis a vis* other creditors – or the debtor is depleting assets to the detriment of all creditors – and the involuntary bankruptcy would be used to undo the collection advantages or depletion of assets for the benefit of creditors as a whole.

The lesson of the *Murray* decision, therefore, is that an involuntary bankruptcy should not be used when there are adequate state law remedies for the debtor's creditors and the collective and community purpose of bankruptcy, from a creditor perspective, would not be served.