

# NEW LAW, NEW TOOLS FOR CREDITORS

## A Fresh Look at the Involuntary Bankruptcy Petition

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A seldom-used collection tool against individual debtors -- the involuntary bankruptcy petition -- may come into vogue as a result of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).

Creditors' risks for filing an involuntary petition, including costs, fees or even substantial damages, remain unchanged. However, the newly enacted benefits for creditors, namely, the ability (under certain circumstances) to satisfy a debt from otherwise exempt homestead property, certainly raises the stakes. Even notorious debtor havens such as Florida and Texas, where debtors have the right to an unlimited homestead exemption under state law, are affected by the new provisions.

However, there is no published case law to support the use of an involuntary bankruptcy petition to obtain otherwise exempt equity in homestead property for the benefit of creditors. As such, creditors and their lawyers must proceed with caution and must be prepared for substantial litigation to establish their rights under BAPCPA's new homestead exemption limitations.

The ability to file an involuntary bankruptcy petition against an individual is nothing new to the bankruptcy code. A creditor can do so, as long the creditor meets the requirements of 11 U.S.C. § 303. In particular, a single creditor with a claim of at least \$12,300 can file a petition for involuntary bankruptcy, and when a debtor has 12 or more creditors, any three creditors together may petition for involuntary bankruptcy.

The bankruptcy code is careful, however, about making involuntary filings too easy because of the obvious burdens imposed on debtors. Thus, the petitioning creditor must prove that its claim is not subject to a bona fide dispute and that the debtor is generally not paying its undisputed debts as they become due. If a petitioning creditor fails to meet these requirements, the creditor can be slapped with costs, fees and substantial monetary damages.

Until now, the bankruptcy code was also careful about making involuntary filings too attractive, in part, because of the potential interference with state debtor-creditor law. The pre-BAPCPA code allowed debtors to "opt-out" of the federal exemptions (if their state of residency permitted) and retain their state law exemptions, which were frequently more generous. Thus, an individual debtor in bankruptcy pre-BAPCPA still retained all property exempt under state law.

Given the high risks and limited benefits to an involuntary filing under these circumstances, there was little incentive for creditors to file involuntary petitions against individuals. A few bankruptcy practitioners went so far as to question whether the involuntary petition was "The World's Worst Debt Collection Device." See Godshall and Giluhy, "The Involuntary Petition: The World's Worst Debt Collection Device?" 53 Bus. Law. 1315 (August 1998).

BAPCPA's provisions significantly alter the landscape for creditors evaluating the costs and benefits of filing an involuntary bankruptcy petition. Debtors in bankruptcy can still choose their state's exemptions (again, if the state of residency makes such choice available), but now every debtor in bankruptcy is stuck with certain new federal homestead exemption limits, which may make available to unsecured creditors equity in homestead property that is otherwise exempt under state law.

As such, even though the risks of filing an involuntary petition remain virtually unchanged, the potential benefits are now substantial and may shift a creditor's cost benefit analysis in favor of filing an involuntary petition.

The remainder of this article is intended to familiarize creditors and their lawyers with the three BAPCPA sections that may make otherwise exempt equity in homestead property available to unsecured creditors, and the applicability of these new provisions to involuntary petitions.

First, newly enacted 11 U.S.C. § 522(o) gives creditors access to funds that were fraudulently converted by a debtor into his homestead. Specifically, the provision limits the value of a debtor's homestead by the amount of nonexempt property transferred into the homestead within 10 years prior to the petition date if the funds were transferred with the intent to hinder, delay or defraud a creditor.

This provision reverses the law in some states, which protected debtors who transferred nonexempt funds out of the reach of creditors and into an exempt

homestead -- even on the eve of bankruptcy. The amendments not only preclude transfers made on the eve of bankruptcy but, with a 10-year lookback period, debtors will have to think a decade ahead to prevent creditors from reaching applicable homestead assets.

To reduce the value of a debtor's protected homestead exemption under § 522(o), a creditor need only prove that the conversion of nonexempt funds into the otherwise exempt homestead was intended by the debtor to "hinder, delay or defraud" creditors. Courts likely will rely on parallel language used in Bankruptcy Code Sections 548(a)(1) and 727(a)(2) to interpret the requisite intent under § 522(o). Under these provisions, well-established case law provides that the requisite intent can be inferred from evidence of certain "badges of fraud" and the circumstances surrounding the transfer.

For example, "badges of fraud" include: (1) before the transfer was made the debtor had been sued or threatened with suit; (2) the debtor transferred substantially all the debtor's assets; and (3) the transfer occurred shortly before or after a substantial debt was incurred.

This protection against fraudulent conversion is not limited to any specific group of creditors. Even a creditor whose debt arose after the fraudulent conversion can take advantage of the limitation -- a somewhat odd result. Further, as with the other homestead limitations discussed in this article, this provision is clearly intended to apply retroactively (under § 522(o), for 10 years!). Thus, § 522(o) may make assets available for creditors who have been unable to collect debts that are long past due.

Any creditor that considers filing a petition to obtain some or all of a debtor's homestead equity should be aware that the newfound nonexempt equity (under any of the provisions discussed here) would accrue to the benefit of all unsecured creditors pro rata after the payment of administrative expenses, and not just the petitioning creditors. Still, the amount of money available to each creditor under this fraudulent conversion provision may be substantial because the homestead exemption limit makes all funds fraudulently transferred into the homestead available to the estate. Thus, this new section can be a useful debt collection device.

Therefore, to the extent a creditor can prove "badges of fraud," the creditor should consider whether the costs and risks of pursuing an involuntary petition will be outweighed by the creditor's pro rata share of the amount of funds fraudulently transferred into the homestead.

While Section 522(o) (discussed above) prevents debtors from fraudulently converting nonexempt assets into an exempt homestead, newly enacted 11 U.S.C. § 522(p) prevents out-of-state debtors from protecting their assets from creditors by moving them into debtors' havens such as Florida and Texas.

Specifically, the section places a \$125,000 limitation on the homestead exemption for a debtor who purchased a home less than 1,215 days prior to the date of filing the petition. Thus, with relative ease, creditors can determine whether this provision may apply by examining the deed to the debtor's property to establish when a debtor purchased his homestead.

However, Section 522(o)'s \$125,000 cap does not apply to debtors who move intra-state within the 1,215-day period. Thus, creditors must further ascertain that the source of funds for the homestead purchase was not proceeds from a prior homestead within the same state. Again, creditors can determine this by searching the property records in the debtor's current state to determine whether the debtor owned a homestead in that state prior to the 1,215-day period.

There has been some dispute in the case law as to whether the \$125,000 limitation would apply in states where a debtor does not have a choice between state and federal exemptions. The majority of the bankruptcy courts who have reported decisions on this issue, however, have relied on legislative history to conclude that the limit applies to debtors in all states.

See *In re Kane*, 336 B.R. 477 (Bankr.D.Nev. 2006); *In re Kaplan*, 331 B.R. 443 (Bankr.S.D.Fla.2005); *In re Virissimo*, 332 BR 201 (Bankr.D.Nev. 2005); cf. *In re McNabb*, 326 B.R. 785 (Bankr.D.Ariz.2005) (holding that homestead limitation does not apply to debtors in opt-out states). Unfortunately, no appellate courts have considered the issue.

To the extent a creditor's investigation shows that equity in a homestead in excess of \$125,000 was acquired within the past 1,215 days -- for a debtor in any state -- the creditor should weigh the costs and benefits of an involuntary filing as a means to claim that nonexempt equity for the benefit of all unsecured creditors.

Since the amount of money available to the estate under § 522(p) is not limited by funds "reasonably necessary" for the support of the debtor or any dependent of the debtor (unlike § 522(q) discussed below), creditors evaluating the costs and benefits of pursuing this collection tool should focus on the amount of excess homestead equity and the number of unsecured creditors likely to share in such excess versus the costs of pursuing the petition.

The third new tool, Section 522(q)(1)(B) also reduces the available homestead exemption to \$125,000 where the debtor has a debt arising from certain civil or criminal misconduct, specifically: (1) the violation of federal or state securities laws; (2) fraud, deceit or manipulation in a fiduciary capacity or in connection with the purchase or sale of any registered security; (3) a civil remedy in connection with the Racketeer Influenced and Corrupt Organizations Act; or (4) any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding five years.

This exemption reduction, however, does not apply to the extent that an interest in property is "reasonably necessary for the support of the debtor and any dependent of the debtor." Thus, in addition to the other risks highlighted throughout this article, creditors pursuing an involuntary petition to obtain otherwise exempt equity in homestead property according to § 522(q) must be cautious because of the substantial uncertainty regarding the amount of homestead equity that will be available to the estate under this provision.

Still, given the new language and potentially wide-reaching scope of Section 522(q)(1)(B), creditors who are owed debts arising from civil or criminal misconduct should keep a close watch on how courts interpret the provision going forward.

For example, § 522(q)(1)(B)(iii)'s limitation, which applies any time a debtor has a debt arising from "fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any registered security," may be relevant to a broad set of debts arising from a breach of fiduciary duty by officers or directors of corporations, by managing partners of partnerships, or other breaches arising out of principal-agent relationships. Alternatively, courts may look to the well-established and narrow meaning of "fiduciary capacity" under Section 523(a)(4), which requires an express or technical trust between the debtor and creditor.

Likewise, one bankruptcy court has already interpreted the language of Section 522(q)(1)(B)(iv) in a broad manner holding that a criminal conviction was not necessary to apply the \$125,000 homestead exemption cap for a debt arising from a criminal act.

Hopefully, at this point, creditors and their lawyers are intrigued by BAPCPA's new homestead caps. Still, the new homestead limitations are only useful as collection tools if the caps can be forced on to debtors. Can this be done by filing an involuntary bankruptcy against the individual debtor?

Unfortunately, no court has yet had occasion to determine whether the new tools discussed in this article apply in the context of an involuntary filing. Until then, creditors who pursue an involuntary petition can expect substantial litigation and uncertainty, because BAPCPA is poorly drafted and is not clarified by any reliable legislative history.

However, BAPCPA's new homestead limitations should be irrelevant to the validity of an involuntary bankruptcy petition -- so long as a creditor meets the requirements of § 303, which have not been materially changed, and the creditor is entitled to the entry of an order for relief.

Petitioning creditors can expect debtors to argue that the involuntary filing is improper because a creditor's motive, to limit the debtor's homestead, is an "improper use" of the petition that constitutes "bad faith." However, courts have held previously that an involuntary petition is not filed in bad faith where the remedy does not exist under state law (such as a preference action under Section § 547), as would be the case here, since the otherwise exempt homestead equity would only be available to satisfy a creditor's claim in bankruptcy.

Furthermore, the rationale for the new homestead limitations already adopted by a majority of bankruptcy courts, that is, closing the "mansion loophole," should similarly lead courts to conclude that the homestead exemption limitations apply whether a petition is voluntarily or involuntarily filed. Otherwise, the "mansion loophole" will remain open with debtors living in multi-million dollar homes while creditors remain unpaid, so long as the debtor does not choose to file.

When the issue finally arises, and courts enter orders for relief, debtors may still argue that the homestead caps do not apply in the involuntary bankruptcy context because such debtors did not "elect" to file for bankruptcy, as needed to trigger applicability of the homestead caps. However, creditors will point out that, once in bankruptcy, debtors will elect to claim a homestead exemption and election of the exemption is all that is necessary to trigger the homestead caps.

Finally, involuntary debtors might try to avoid the jurisdiction of the bankruptcy court by failing to attend the mandatory credit counseling course under amended 11 U.S.C. § 109. However, because § 109 only applies to a "petition by such individual [debtor]," a debtor's failure to complete credit counseling should not affect the court's jurisdiction over an involuntary petition.

Thus, Sections 522(o), (p), or (q) may provide unsecured creditors of homestead-rich debtors with previously unavailable homestead equity, such that the costs and benefits of an involuntary petition now weigh in favor of filing. An involuntary petition continues to carry risks, and creditors must weigh these risks carefully before determining whether the potential recovery from the homestead will be worthwhile.

That is especially true in the unknown and untested post-BAPCPA world where there is no appellate case law (let alone trial court case law) to provide creditors with comfort that they will prevail in obtaining the previously exempt equity in homestead property for the benefit of the estate.

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