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Involuntary Judgment Creditors Beware 1st Cir. Peeks Behind State Court Judgment for Bona Fide Dispute



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Trade creditors often find themselves overextended with a debtor who cannot or will not agree to satisfactory repayment arrangements. Frustrated, the creditor decides to initiate state court lawsuits to collect on the debts. The debtor may or may not defend such lawsuits, but because the claims sound in contract and few viable defenses exist, judgments are ultimately entered. Judgment liens begin accumulating in public registries for the world to see, and a group of creditors begin talking about joint, post-judgment collection strategies. Inevitably, these discussions lead the creditors to a choice: Should they band together to force an involuntary bankruptcy, or should they race one another to the auction block to liquidate the debtor's assets?

Section 303(b)(1) of the Bankruptcy Code embodies a fundamental creditor right: Three or more creditors whose claims are "not contingent as to liability or the subject of a bona fide dispute as to liability or amount" may force a debtor into involuntary bankruptcy, provided that their aggregate claims exceed \$14,425. Creditors holding state court judgments generally assume that they hold claims that are unassailable and cannot be subject to bona fide dispute.

However, a recent decision from the First Circuit Court of Appeals should give such creditors (and putative debtors) pause. In *Fustolo v. 50 Thomas Patton Drive LLC*,¹ the First Circuit held that bankruptcy courts may "peek behind the curtain" of state court judgments, at least if such judgments are stayed from execution by a court order or by operation of law.

Background²

The claims from the creditor, 50 Thomas Patton Drive LLC (hereinafter, "Patton Drive"), against Steven Fustolo arose from four promissory notes issued to Patton Drive by Fustolo's affiliate companies. Fustolo personally guaranteed two of the notes, which totaled \$1.25 million, but did not guarantee the other two, which totaled \$1.5 million. The principal obligors on each of the notes defaulted, and Patton Drive sued Fustolo in Massachusetts state court on the guaranties. Ultimately, judgment was entered against Fustolo in the amount of \$6.76 million. He filed a timely appeal, arguing that the

judgment overstated his liability by approximately \$4 million because the trial court erroneously determined that Fustolo had guaranteed all four notes.

While the appeal was pending, three of Fustolo's creditors, including Patton Drive, filed an involuntary chapter 7 petition pursuant to § 303(b)(1) of the Bankruptcy Code. Challenging the petition, Fustolo argued that Patton Drive's claim was subject to a "bona fide dispute as to liability or amount."³ The bankruptcy court disagreed and entered an order for relief.

Merits-Based Approach

In making its determination that Patton Drive's state court judgment constituted a qualifying claim despite the pending appeal, the bankruptcy court relied on the Fourth Circuit's so-called "merits-based" approach set forth in *In re Byrd*.⁴ Following this approach, the court began with the rebuttable presumption that the state court judgment foreclosed any bona fide dispute, but then proceeded to assess the merits of Fustolo's pending appeal to determine whether it constituted the "rare circumstance where the amount of the judgment is in bona fide dispute."⁵ Upon review, the bankruptcy court found that no bona fide dispute existed with respect to the claims on the guaranteed notes, and thus Patton Drive qualified as a petitioning creditor.

Categorical Rule

Fustolo then appealed to the district court and, as the First Circuit observed, "found himself jumping from the frying pan into the fire."⁶ The district court arrived at the same conclusion as the bankruptcy court, but took a different route. The district court adopted the so-called "categorical" rule originally articulated by the U.S. Bankruptcy Court for the Southern District of New York in *In re Drexler*⁷ and later followed by the Ninth Circuit in *In re Marciano*.⁸

In *Drexler*, the bankruptcy court determined that an unstayed state court judgment, regardless of whether an appeal was taken, *per se* constitutes a claim that is not subject to a bona fide dispute.⁹

³ *Fustolo*, 2016 WL 732207, at *2 (citing 11 U.S.C. § 303(b)(1)).

⁴ 357 F.3d 433 (4th Cir. 2004).

⁵ *Fustolo*, 2016 WL 732207, at *2.

⁶ *Id.*

⁷ 56 B.R. 960, 966 (Bankr. S.D.N.Y. 1986).

⁸ 708 F.3d 1123, 1124 (9th Cir. 2013).

⁹ *In re Drexler*, 56 B.R. at 967.

¹ No. 15-1340, 2016 WL 732207 (1st Cir. Feb. 24, 2016).

² Additional details about the case can be found in both the bankruptcy court's decision, *In re Fustolo*, 503 B.R. 206, 207 (Bankr. D. Mass. 2013), and the district court's decision, *Fustolo v. 50 Thomas Patton Drive LLC*, No. CV 14-10248-RWZ, 2015 WL 4876075 (D. Mass. Feb. 17, 2015).

continued on page 61