

**IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA**

IN THE MATTER OF:	:	CIVIL ACTION
R&A BUSINESS ASSOCIATES, INC.	:	No. 99-2171
	:	
Debtor.	:	(BKY. No. 98-36566)
_____	:	
	:	
R&A BUSINESS ASSOCIATES, INC.,	:	
	:	
Appellant.	:	

MEMORANDUM

Brody, J.

October , 1999

I. INTRODUCTION

This is an appeal from a final order of the United States Bankruptcy Court. Appellant R&A Business Associates, Inc. (“R&A”) argues that the Bankruptcy Court applied an incorrect standard to determine whether Appellee Crusader Bank, FSB (“Crusader”) filed an involuntary petition against R&A in bad faith. R&A also claims that the Bankruptcy Court erred by refusing to abstain from the bankruptcy proceeding, in favor of pending state court litigation.

I affirm the bankruptcy court ruling (1) to permit the joinder of R&A’s other creditors to Crusader’s involuntary petition against R&A under 11 U.S.C. § 303(c), and (2) to refuse to abstain pursuant to either Colorado River Water Conservation Dist. v. United States, 424 U.S. 800 (1982) or 11 U.S.C. § 305(a)(1).

II. STANDARD OF REVIEW

This court has appellate jurisdiction over final orders of the bankruptcy court pursuant to 28 U.S.C. § 158(a)(1). The legal conclusions of the bankruptcy court are subject to de novo review. See In re Benjamin Franklin Hotel Assocs., ___ F.3d ___, 1999 WL 592432, *2 (3d Cir. 1999). The bankruptcy court’s findings of fact are reviewed for clear error. Id.; Fed. R. Bankr. P. 8013. In reviewing an abstention decision, the determination of whether the bankruptcy court may use its discretion to abstain from the case is a matter of law; therefore, it is subject to de novo review.¹ See Trent v. Dial Medical of Florida, 33 F.3d 217, 223 (3d Cir. 1994) (quoting University of Maryland v. Peat Marwick Main & Co., 923 F.2d 265, 269 (3d Cir.1991)).

III. FACTS

In October, 1998, Crusader Bank, FSB (“Crusader”) filed a state court action against R&A Business Associates, Inc. (“R&A”) and Merchant Express Money Order Company (“MEMO”). The claim arose from money order transactions among the three parties. On December 30, 1998, while the state action was pending, Crusader, alone, filed an involuntary bankruptcy petition pursuant to 11 U.S.C. § 303(b) against R&A in the Bankruptcy Court in the Eastern District of Pennsylvania. R&A challenged Crusader’s sole petition as defective under Section 303(b)(1) because the petition must be initiated by at least three creditors. Pursuant to Section 303(c), nine of R&A’s creditors subsequently filed motions to join Crusader in the involuntary petition. R&A opposed the joinder of these creditors, claiming that joinder is barred because the initial petition was filed in bad faith.

1. If the matter is suitable for abstention, this court applies an abuse of discretion standard to review the bankruptcy court’s decision to abstain. See Trent, 33 F.3d at 223.

On February 11, 1999, the parties tried the case before the bankruptcy court. The bankruptcy judge ruled that petitioning creditors satisfied the joinder requirements of Section 303.² On appeal, R&A argues that the bankruptcy court erred (1) by equating “bad faith” under Section 303 with fraud, thus improperly requiring R&A to prove fraud in its bad faith contention, (Br. of Appellant, at 9), (2) by requiring R&A to prove bad faith by “clear and convincing” evidence, rather than by a preponderance of the evidence standard, (*id.* at 21), and (3) by abusing its discretion in declining to abstain from hearing this matter. (*Id.* at 22-3.) R&A has challenged neither the bankruptcy court’s findings of fact, which are adopted, nor the court’s legal conclusion that a bad faith exception exists under Section 303(b).

IV DISCUSSION

A. ‘Bad Faith’ Under Section 303(b)

Pursuant to Section 303(b), one creditor can initiate an involuntary petition only if the debtor has fewer than 12 qualifying creditors.³ See 11 U.S.C. § 303(b)(2). Otherwise, an involuntary petition must be initiated by at least three qualified creditors. See 11 U.S.C. § 303(b)(1). Because R&A had more than 11 creditors when Crusader filed the petition, R&A claimed that Crusader’s individual petition was deficient and should have been dismissed. Nine

2. The bankruptcy court also granted an order of relief under Chapter 7 of the Bankruptcy Code.

3. A qualifying creditor under Section 303 is “a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute, or an indenture trustee representing such a holder....” 11 U.S.C. § 303(b)(1).

qualifying creditors moved to join Crusader's petition and cure the deficiency pursuant to 11 U.S.C. § 303(c).⁴

Section 303(c) permits the joinder of other qualifying creditors to cure a defective petition under Section 303(b): "a creditor ... may join in the petition with the same effect as if such joining creditor were a petitioning creditor under subsection (b) of this section." 11 U.S.C. § 303(c). While conceding that its initial petition was defective, Crusader maintained that the subsequent joinder pursuant to Section 303(c) cured the deficiency.

R&A contended that the "bad faith" doctrine of Section 303(b) barred the joinder of additional creditors. Under the "bad faith" exception, courts have barred the subsequent joinder of qualified creditors under Section 303(c) if the initial petitioner filed an individual claim in "bad faith." See, e.g., Myron M. Navison Shoe Co., Inc. v. Lane Shoe Co., 36 F.2d 454, 459 (1st Cir. 1929); In re Nordbrock, 772 F.2d 397 (8th Cir. 1985); In re Petrallex Stainless, Ltd., 78 B.R. 738 (Bankr. E.D. Pa. 1987); see generally, 2 Collier on Bankruptcy, ¶ 303.06.; cf., In re Kidwell, 158 B.R. 203 (Bankr. E.D. Cal. 1993). The definition and scope of the judicially-created doctrine remain unclear. See Collier, ¶ 303.06[1](discussing five distinct standards for determining bad faith under Section 303(b)). Although the Third Circuit has not specifically adopted the "bad faith" doctrine under Section 303, courts in this district have consistently applied the exception. See, e.g., In re Claren, 1992 WL 346779 (E.D. Pa.); In re Petrallex Stainless, Ltd., 78 B.R. 738 (Bankr. E.D. Pa. 1987).

4. SEPTA asserts a claim for \$57,858.75 and the eight other movants maintain an aggregate claim for \$36,140.03. See Op., Section I ¶ 32-3, at 10. R&A does not dispute that the creditors involved in this case qualify under Section 303(b).

At trial, R&A contended that because Crusader filed the initial petition in “bad faith,” the joinder of additional creditors would be inappropriate and, without the requisite number of qualified petitioning creditors, that Crusader’s involuntary petition should have been dismissed. The bankruptcy judge rejected R&A’s bad faith argument and permitted the other creditors to join in the involuntary petition for relief against R&A.

The bankruptcy judge, R&A and Crusader agree that the court should bar the joinder of additional creditors if Crusader knew or should have known that R&A had more than 12 creditors. (See Op. at 28; Br. of Appellant, at 11(citing In re Alta Title Co., 55 B.R. 133 (Bankr. D. Utah 1985)); Br. of Appellee, at 18.) R&A contends that the bankruptcy court misapplied the “knew or should have known” standard by analogizing it to fraud. (Br. of Appellant, at 9.) Although the bankruptcy court quotes cases that link bad faith and fraud, see Op. at 25-7, citing In re Crown Sportswear, Inc., 575 F.2d 991, 993-4 (1st Cir. 1978), Matter of Crofoot, Nielsen & Co., 313 F.2d 170, 171-2 (7th Cir. 1963), In re Elsinore Shore Associates, 9 B.R. 238 (Bankr. D.N.J. 1988), the court actually applied the “knew or should have known” standard in its analysis of the facts. Id. at 25. The bankruptcy court found that “[t]here is no evidence that Crusader actually knew that R&A had more than eleven qualified creditors when it filed this involuntary petition.” Id. at 28. The court then found that “R&A has not demonstrated that Crusader should have known that there were more than eleven creditors.” Id. at 28.

While R&A concedes that Crusader did not actually know of any additional creditors, it argues that “[t]he facts adduced at trial conclusively established that Crusader should have known that R&A had more than twelve creditors at the time of the filing of the Involuntary Petition.” (Br. of Appellant, at 15.) It argues that the proper test for the “should have known”

standard is whether the petitioner made a “reasonable investigation into the facts and law surrounding the case prior to the filing of the involuntary petition,” (id., citing In re Elsub Corp., 66 B.R. 189 (Bankr. D.N.J. 1986)), and that Crusader’s investigation was not reasonable.⁵ The bankruptcy judge specifically rejected the “reasonable investigation” standard. See Op. at 27, n.9. Although he determined that a “more stringent” standard is required, the bankruptcy judge did not explicitly articulate the standard he applied. Regardless of which standard the bankruptcy judge used, I conclude from his findings of fact that R&A did not establish that Crusader’s investigation was unreasonable.

Crusader investigated R&A’s Dunn and Bradstreet reports, which revealed only two reporting creditors. See Op., ¶ 21, n.3 at 6. Further, Crusader attempted to contact potential creditors, such as Travelers Express, utility companies, and SEPTA. Id. Crusader also reviewed the contract that governed the sale of R&A’s assets. The contract’s provisions created the impression that “in the normal course of operating stores for items such as phone and utility and similar matters that normally would be paid by R&A, that those potential creditors could be paid by [the buyer], ...and therefore, these vendors would not be creditors of R&A.” Id.(quoting deposition of Crusader’s Vice President). The agreement also provided that the buyer would assume R&A’s lease obligations: “Buyer agrees to assume all rights and obligations under each of the leases for The Premises....” Id. at 5, n.1. R&A’s president attested that: “to the best of his knowledge there are no creditors with a lien, judgment or UCC filing against R&A.” Id. at n.2 (quoting the Bulk Sale Affidavit).

5. R&A concedes that it has the burden of proof on the issue. (Br. of Appellant, at 21.)

Throughout Crusader's investigation, R&A's affiliates assured Crusader that R&A had few creditors. For example, R&A's counsel told Crusader officials that "R&A was indebted to Travelers, may no longer have any unpaid obligation to MEMO, and had, to the knowledge of R&A counsel, no other debts except its obligation to Crusader." *Op.*, at 5 ¶ 16 (referring to October 26, 1998 meeting). In addition, a defendant in the state court proceeding represented that R&A had only a few creditors. *Id.* at 28. Crusader's investigation, in light of R&A's assurances, was reasonable.⁶

R&A also contends that the bankruptcy court erred by requiring that it to prove Crusader's bad faith by clear and convincing evidence. R&A asserts that a preponderance of the evidence standard is appropriate. (*Br. of Appellant*, at 21.) There is no indication that the bankruptcy judge applied any test other than that of the preponderance of the evidence. Although the judge stated that "evidence of bad faith must be clear," he never articulated an evidentiary standard. *Id.* at 24. The only time the phrase "clear and convincing evidence" appeared in the opinion was in a parenthetical citation supporting a completely different proposition of law. *See*, *Op.*, at 25 (citing *Crofoot*, 313 F.2d at 171-2). Reapplying the preponderance of the evidence standard, R&A failed to satisfy its burden. In addressing this issue, R&A disparages Crusader's efforts, but does not provide any factual evidence of Crusader's bad faith. The bankruptcy judge addressed R&A's contentions, and I concur with his reasoning. *See Op.*, at 29-33.

B. Abstention under Colorado River Water Conservation Dist. v. United States, 424 U.S. 800 (1982)

6. Even if Crusader had tried to examine the situation more thoroughly, it would have been largely fruitless because R&A was stonewalling Crusader. Twice, R&A's principals refused to answer Crusader's questions. *Id.* ¶ 17, 18 at 5 (stating "Crusader had been informed that [neither principal of R&A] would respond to questions posed by Crusader.").

R&A also contends that the bankruptcy court abused its discretion by refusing to abstain under Colorado River Water Conservation Dist. v. United States, 424 U.S. 800 (1982). In Colorado River, the Supreme Court acknowledged the “extremely limited circumstances in which a federal court may defer to pending state proceedings.” Ryan v. Johnson, 115 F.3d 193, 195-6 (3d Cir. 1997)(citing Colorado River, 424 U.S. at 817). With the caveat that “only the clearest of justifications will warrant dismissal,” the Court announced the following criteria for federal court abstention: (1) whether state court assumed in rem jurisdiction over property; (2) the inconvenience of the federal forum; (3) the desirability of avoiding piecemeal litigation; and (4) the order in which jurisdiction was obtained by the concurrent forums. See Colorado River, 424 U.S. at 818. The Court subsequently added two additional considerations: which forum’s substantive law governs the merits of the litigation and the adequacy of the state forum to protect the parties’ rights. See Moses H. Cone Memorial Hospital v. Mercury Construction Corp., 460 U.S. 1 (1983).

Before applying the Colorado River factors, a court must find that the federal and state proceedings are “parallel.” Ryan, 115 F.3d at 196. According to Ryan, cases are parallel “when they involve the same parties and claims.” Id. If the state and local proceedings are not parallel, the federal court cannot abstain. Id.

R&A contends that the federal and state litigations are parallel under the Colorado River test. (Br. of Appellant, at 23.) “The real parties in interest in the State Court Litigation – Crusader and MEMO – are also the parties with a financial stake in the present involuntary proceeding.” Id. It also asserts that the legal issues in the two claims are identical. Id. at 24.

Crusader is the sole plaintiff in the state action; the federal action, however, seeks to join nine of R&A's other creditors in the petition. Moreover, MEMO is a defendant in state court, but is not involved in the federal action. The state and federal claims pursue different relief because the state court action seeks damages for Crusader only, and the federal proceeding may distribute R&A's funds to all of its outstanding creditors. The bankruptcy judge found that the pending state litigation was not parallel to the instant matter, stating:

It is difficult to view [] an entire bankruptcy case as parallel to individual state court litigation. The parties to the bankruptcy case will involve creditors, the debtor, the bankruptcy trustee, and the United States trustee. The state court litigation typically will involve only the named plaintiffs and defendants.

Op., at 36. Because the federal and state claims are not parallel, the bankruptcy judge was correct in finding that R&A failed to meet this threshold requirement and then he properly refused to abstain under Colorado River.

C. Abstention under 11 U.S.C. § 305(a)

Also, R&A asserts that the bankruptcy court should have abstained under 11 U.S.C. § 305(a). Section 305(a) provides:

- (a) the court . . . may dismiss a case under this title, or may suspend all proceedings in a case under this title, at any time if –
 - (1) the interests of creditors and the debtor would be better served by such dismissal or suspension. . . .

11 U.S.C. § 305(a)(1). Citing In re J.M. Check Cashing Corp., 49 B.R. 273 (Bankr. E.D.N.Y. 1985), R&A claims that “the Bankruptcy Court should have dismissed this case under Subsection 305(a)(1) because the interests of R&A, MEMO and Crusader can best be served by litigating Crusader's claims of fraud in the State Court Litigation.” (Br. of Appellant, at 25.)

In J.M. Check Cashing, the court in dismissed an involuntary petition after disqualifying all of the petitioners. See In re J.M. Check Cashing Corp., 49 B.R. at 278. After finding that the main petitioner was not a creditor, the bankruptcy court disregarded one creditor's \$500 claim and two unsubstantiated tax claims by the State and City of New York. Id. at 277-8. No viable petitioners remained. In dicta, the court stated "even if the factors warranted a finding that [the main petitioner] was a creditor, I would have invoked the right of abstention as provided by Section 305, and dismissed the case in any event." Id. at 278. The court determined that the case was essentially an isolated dispute between three parties to a transaction. Because the claim was not related to bankruptcy, the judge determined that the bankruptcy court was an inappropriate forum. Id.

R&A contends that the instant matter is similarly narrow because it is a dispute purely between Crusader and MEMO. (Br. of Appellant, at 25-6.) J.M. Check Cashing, however, is not analogous to this case. In J.M. Check Cashing, no creditors other than the main petitioner were qualified under Section 303(b). Here, on the other hand, nine of R&A's creditors besides Crusader are qualified. With other qualified creditors maintaining claims against R&A, this is not a limited dispute between Crusader and MEMO; dismissal of this petition could detrimentally effect the interests of these other creditors. Further, R&A has not demonstrated that the other creditors will be 'better served' by dismissal under Section 305(a)(1) and, therefore, the bankruptcy judge properly refused to abstain pursuant to 11 U.S.C. § 305(a)(1).

The bankruptcy court ruling (1) to permit the joinder of R&A's other creditors to Crusader's involuntary petition against R&A under 11 U.S.C. § 303(c), and (2) to refuse to

abstain pursuant to either Colorado River Water Conservation Dist. v. United States, 424 U.S. 800 (1982) or 11 U.S.C. § 305(a)(1) are proper.

Order

And now, this day of October, 1999, IT IS ORDERED that the ruling of the bankruptcy court is affirmed.

ANITA B. BRODY, J.