

**UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK**

IN RE:

**DONALD E. KRAFT,
Debtor.**

**BK. NO. 91-22937
DECISION & ORDER**

BACKGROUND

On October 21, 1991 Villager Construction, Inc. ("Villager Construction"), Insulation Concepts, Inc. ("Insulation Concepts") and Gino A. Affronti, Jr. d/b/a Hilltop Construction ("Affronti") filed an involuntary petition (the "Petition") against Donald E. Kraft ("Kraft") requesting the entry of an order for relief under Chapter 7 of the Bankruptcy Code. (Villager Construction, Insulation Concepts and Affronti are sometimes hereinafter referred to as the "Petitioning Creditors").

Kraft answered the Petition alleging that he was generally paying his debts as such debts became due, excluding debts in *bona fide* dispute, and that the claims of each of the Petitioning Creditors were the subject of *bona fide* disputes.

On September 29, 1992, after a trial on the issues raised by Kraft under Sections 303(b)(1) and 303(h)(1), the Court dismissed the Petition preserving Kraft's right to pursue a judgment under Section 303(i).¹

In its Decision and Order, the Court found that the claims of each of the Petitioning Creditors were in *bona fide* dispute and that Kraft was generally paying his debts as they become due, except

¹ This Court, as most other courts, believes that to the extent possible there should be a bifurcation of the issues and the hearings on the basic right to an order for relief under Section 303(b) and any discretionary awards under Section 303(i).

for debts which were the subject of *bona fide* disputes.²

On October 2, 1992, the attorney for Kraft requested that the Court establish a procedure so that it could determine whether, in its discretion, it would grant Kraft a judgment pursuant to Section 303(i). On December 23, 1992, after the time for the Petitioning Creditors to appeal the order of dismissal had passed, a pretrial conference was held with the attorneys for Kraft and each of the Petitioning Creditors. At that time, there was a discussion of the issues presented by Section 303(i) as they related to this case, and the parties were directed to present a joint Rule 7016 Pretrial Order by January 20, 1993 if the matter was not settled. When the matter did not settle, a joint Pretrial Order was filed which provided for the completion of discovery by March 1, 1993 and for the matter to be placed on the Court's Trial Calendar on March 15, 1993. After a series of adjournments to allow each of the parties to obtain substitute trial counsel so that their original counsel could testify as to various events surrounding the filing of the involuntary petition, a Section 303(i) evidentiary hearing was held on July 23, 1993.

DISCUSSION

Section 303(i) of the Bankruptcy Code³ allows the Bankruptcy Court in its sound discretion

² Kraft, an engineer, elected to act as a general contractor in connection with the construction of his personal residence. Each of the Petitioning Creditors had entered into oral agreements with him to perform work at the residence. In each case, Kraft alleged that the work performed was not done in a good and workmanlike manner. At the time of the filing of the petition, both Villager Construction and Insulation Concepts had actions in connection with their claims against Kraft pending in Rochester City Court. In those actions, answers and counterclaims had been interposed by Kraft, and discovery and settlement negotiations had taken place. A motion for summary judgment by Villager Construction had been denied in its action, and the Insulation Concepts action had been scheduled for trial two days after the involuntary petition was filed.

³ Section 303(i) provides:

to review the facts and circumstances surrounding the filing of an involuntary petition which has been dismissed and, if appropriate, to award costs and reasonable attorney's fees to a party successfully defending against the involuntary petition. If it has been proven by a preponderance of the evidence that the petition was filed in bad faith, the Court may award compensatory and even punitive damages against any individual petitioning creditor which filed the petition in bad faith.

Although the Court made every effort to limit the proof on the Section 303(i) issues at the time of the hearing on whether an order for relief should have been entered, because one of the principal issues presented at that hearing was whether the claims of any of the Petitioning Creditors were in *bona fide* dispute, a substantial amount of testimony regarding the history of the relationship of the parties and the motivations of the Petitioning Creditors in filing the involuntary petition was necessarily presented.

Each of the Petitioning Creditors at both of the hearings and the attorneys who represented Villager Construction and Insulation Concepts at the time of the filing of the petition at the Section 303(i) hearing testified that the involuntary petition was filed because: (1) the Petitioning Creditors, during the course of their efforts to collect what they believed was owed by Kraft, became aware that there were a number of other unpaid creditors in connection with the construction of Kraft's

If the court dismisses a petition under this section other than on consent of all petitioners and the debtor, and if the debtor does not waive the right to judgment under this subsection, the court may grant judgment-

- (1) against the petitioners and in favor of the debtor for
 - (A) costs; or
 - (B) a reasonable attorney's fee; or
- (2) against any petitioner that filed the petition in bad faith, for-
 - (A) any damages proximately caused by such filing; or
 - (B) punitive damages.

residence; (2) the Petitioning Creditors were concerned that these other creditors by their collection efforts would increase the costs of collection for all parties and thus reduce the possible recovery for all creditors; (3) the Petitioning Creditors and their attorneys believed that Kraft was acting in bad faith by delaying the collection efforts of the construction related creditors, not because he had *bona fide* disputes as to the amounts owed, but because he had run out of money to pay all of them and to complete the construction; (4) the Petitioning Creditors, in consultation with their attorneys, wished to take advantage of the ability in a bankruptcy proceeding to reach various assets of Kraft which they believed could not be reached through state court collection procedures; (5) the Petitioning Creditors, in consultation with their attorneys, believed that on the then existing facts and circumstances, in a bankruptcy proceeding they and all of Kraft's creditors could more efficiently and effectively collect the amounts due them; and (6) the Petitioning Creditors wished to obtain a forum where one judge could determine all of the disputes among Kraft and his construction related creditors, on the belief that this would promote both judicial and overall litigation economy, since that one judge could then clearly see the pattern of Kraft's delay and bad faith disputes. Each of the Petitioning Creditors also testified that there was no malice, spite, ill will or desire to harass or embarrass Kraft by the filing of the involuntary petition.

The testimony and arguments presented on Kraft's behalf alleged that the involuntary petition was filed to harass and embarrass Kraft, thus evidencing ill will, and to improperly use the Bankruptcy Court as a debt collection instrument. It was also argued on behalf of Kraft that there was bad faith, because the pre-filing inquiry by the Petitioning Creditors and their attorneys into the issue of whether Kraft was generally paying his debts as they became due, which should have considered all of his debts not just the construction related debts, was seriously deficient. It was further argued that the Petitioning Creditors acted in bad faith because they knew or should have known, notwithstanding any advice of their attorneys, that within the meaning and intent of Section

303(h) of the Bankruptcy Code, each of their debts was in *bona fide* dispute.

Section 303(i)(1) allows the Court, even in the absence of a finding of bad faith on the part of any of the Petitioning Creditors, in its sound discretion and based on the facts and circumstances of the case, to grant a party successfully defending against an involuntary petition a judgment for costs or a reasonable attorney's fee.⁴ On the other hand, for the Court to award compensatory or punitive damages under Section 303(i)(2) against any one of the Petitioning Creditors, the Court must make an affirmative finding that the involuntary petition was filed by that creditor in bad faith, and the Debtor bears the burden of proving the existence of bad faith by a preponderance of the evidence.⁵

This Court believes that a finding of bad faith under Section 303(i)(2) requires a determination that a petitioning creditor acted with spite, malice, vengeance or a specific desire to harass or embarrass a Debtor.⁶ Based upon all of the facts and circumstances and pleadings and proceedings in this case and particularly the testimony of the witnesses before the Court and their credibility, the Court finds that Kraft has not met his burden of proving by a preponderance of the evidence that any of the Petitioning Creditors acted in bad faith within the meaning and intent of Section 303(i)(2).

⁴ Some authorities have described Section 303(i)(1) as a "discretionary provision for redistribution of the costs of suit." Lawrence Ponoroff, The Limits of Good Faith Analyses: Unraveling and Redefining Bad Faith in Involuntary Bankruptcy Proceedings, 71 Neb.L.Rev. 209, 238 (1992).

⁵ *In re Reveley*, 148 B.R. 398, 406 (Bankr. S.D.N.Y. 1992).

⁶ *See In re Camelot, Inc.*, 25 B.R. 861, 864 (Bankr. E.D.Tenn. 1982), *aff'd sub nom. Camelot, Inc. v. Hayden*, 30 B.R. 409 (E.D.Tenn. 1983). The courts are in disagreement as to the standard to apply in determining bad faith for purposes of Section 303(i)(2). *See In re K.P. Enterprise*, 135 B.R. 174, 179 (Bankr. D.Maine 1992) (for a summary of the different standards used by the courts).

Notwithstanding the Court's finding that none of the Petitioning Creditors acted in bad faith in filing the involuntary petition, based upon all of the facts and circumstances and pleadings and proceedings in this case, the Court finds, in its discretion, that an award of attorney's fees and disbursements to Kraft in the amount of \$7731.35 is appropriate.⁷ The nature and extent of the prepetition inquiries and the assessments into the issues of whether Kraft was generally paying his debts as they became due, whether the Petitioning Creditors' claims were in *bona fide* dispute and whether, upon all of the facts and circumstances presented, a bankruptcy proceeding was appropriate, may have been somewhat deficient and questionable in this case. Nevertheless, this Court does not believe that the Petitioning Creditors, in consultation with and in reliance on their attorneys, were without any reasonable basis when filing the involuntary petition, or that the petition was meritless or frivolous so as to warrant the awarding of sanctions under Rule 9011. However, given all of the facts and circumstances surrounding the involuntary petition and the resulting inconvenience, embarrassment and expense occasioned on Kraft, an individual, which some may feel was arguably unnecessary, this Court believes that in the interests of justice and in the exercise of its sound discretion the award of attorney's fees and disbursements is appropriate. A number of courts have held that the costs and attorney fees which can be awarded by the Court pursuant to Section 303(i)(1) are limited only to those in defending against the involuntary petition. *In re K.P. Enterprise*, 135 B.R. 174, 178 (Bankr. D. Maine 1992); *In re Leach*, 102 B.R. 805, 808 (Bankr. D. Kan. 1989). This Court believes that view is too restrictive and would unnecessarily limit the Court's discretion in appropriate circumstances. Here the Court believes that because of its insistence that there be

⁷ Bankruptcy Judge James B. Haines, Jr. in *K.P. Enterprise* set out a number of factors to be considered in granting a judgment under Section 303(i)(1), "Each request for an award of fees and costs invokes the court's discretion, informed by such factors as the reasonableness of the petitioners' actions, their motivation and objectives, and the merits of their view that the petition was proper and sustainable." 135 B.R. at 177.

