UNITED STATES BANKRUPTCY COURT
DISTRICT OF VERMONT

In re: Involuntary Chapter 7

Harry L. Alexander Case # 00-10500 cab #239-1

MEMORANDUM OF DECISION
DENYING MOTION FOR BIFURCATION OF TRIAL AND DISCOVERY

The petitioning creditors herein, the Small Business Administration ("SBA"), by and through Charles R. Tetzlaff, United States Attorney for the District of Vermont; McNew Water Treatment Systems, Inc. and First Community Bank f/k/a Bank of Woodstock ("the Bank"), by and through Ryan Smith & Carbine, Ltd.; and Randall and Shelley Pippin, by and through Ryan Smith & Carbine, Ltd. and Peter Flanagan, Esq., as co-counsel; (hereinafter referred to as "the Petitioning Creditors"), filed a joint motion dated August 2, 2000 seeking bifurcation of the trial and a limitation on discovery primarily to segregate issues of bad faith from consideration at this time, pursuant to F.R.Civ.P. 42(b) and Bankruptcy Rule 7042(b). As counsel further articulated at oral argument on August 22, 2000, the petitioning creditors seek to limit the issues at the trial of this involuntary petition, and consequently the discovery related to the trial, to four issues: (1) whether the correct number of creditors initiated the petition; (2) whether the joinder of the SBA was proper; (3) whether any of the petitioning creditors holds a debt that is the subject of a bona fide dispute; and (4) whether the Debtor was paying his debts as they became due as of the date of the petition. Specifically, the petitioning creditors seek an order of this Court excluding both from the scope of discovery and from trial, the issues of the Debtor's domicile, whether this Court has subject matter jurisdiction and whether the petition was filed in good faith.[1] The Debtor opposes the bifurcation motion. For the reasons set forth below, the motion of the petitioning creditors is denied.

[1] The petitioning creditors also seek to exclude evidence relating to damages due under 303(i) but the Debtor does not object to that request, and therefore that is not considered a part of the motion before the Court.

Jurisdiction

This Court has jurisdiction over this motion under sections 157, 1334 and 1411 of Title 28 U.S.C.

Procedural History

This involuntary chapter 7 case has a long, peculiar and tortured history. It has been pending for over 20 months, bounced back and forth between the District of Vermont Bankruptcy Court and the Southern District of New York Bankruptcy Court, twice, and has not yet gone to trial.

On December 8, 1998, a joint involuntary petition was filed in this Court against Harry L. Alexander and Stephanie Alexander. On December 23, 1998, before an answer to the involuntary petition was filed, the petitioning creditors filed a motion to amend the joint petition and to replead it as two separate involuntary petitions, one against Harry Alexander and one against Stephanie Alexander. On December 29, 1998, Harry and Stephanie Alexander filed a joint voluntary petition in the Bankruptcy Court for the Southern District of New York. On December 31, 1998, Harry and Stephanie Alexander moved this Court for (i) dismissal of the joint involuntary petition on the grounds that the Court lacked subject matter jurisdiction over a joint involuntary petition (the "First Dismissal Motion"), and (ii) transfer of venue to the Southern District of New York. By Order dated January 11, 1999, this Court (Conrad, J.) granted the petitioning creditors' motion to amend and replead the joint involuntary petition as two individual involuntary petitions, both to be deemed filed as of December 8, 1998. By Order dated February 16, 1999, this Court (Conrad, J.) dismissed the separate involuntary petition against Stephanie Alexander because it lacked the requisite number of petitioning creditors. By Order dated April 20, 1999, based upon a Memorandum of Decision dated April 14, 1999, this Court (Conrad, J.) transferred venue of Harry Alexander's involuntary petition to the Southern District of New York. On April 28, 1999, this Court (Conrad, J.) denied Harry Alexander's motion to vacate the April 20, 1999 Order.

On or about May 20, 1999, Harry Alexander filed a motion in the Bankruptcy Court for the Southern District of New York to dismiss the involuntary petition for lack of subject matter jurisdiction (the "Second Dismissal Motion"). The Second Dismissal Motion reasserted that the court had no subject matter jurisdiction over the joint involuntary petition and that Judge Conrad's January 11, 1999 Order authorizing the corrective amendment of the joint involuntary petition was improper and should be remedied by that court. The Second Dismissal Motion also contended that Judge Conrad's April 14, 1999 Memorandum of Decision was incorrect in its findings and conclusions concerning the Alexanders' domicile. No order was issued by the Southern District Bankruptcy Court with respect to the Second Dismissal Motion and by Order dated April 11, 2000, the Bankruptcy Court for the Southern District of New York (Blackshear, J.) transferred venue of Harry Alexander's involuntary petition back to this Court.

On May 2, 2000, petitioning creditor, First Community Bank moved this Court for appointment of an interim trustee pursuant to 11 U.S.C. § 303(g) and, further, for entry of an order for relief against Harry Alexander based upon his default. On June 1, 2000, Harry Alexander moved this Court for an order authorizing the use of funds in an IRA account. On June 13, 2000, the SBA moved the Court for entry of an order for relief against Harry Alexander based upon his default. On June 15, 2000, this Court entered an Order (1) finding that the Second Dismissal Motion mooted the First Dismissal Motion; (2) denying the Second Dismissal Motion; (3) denying requests for reconsideration or other relief with respect to the findings and rulings concerning domicile contained in Judge Conrad's April 14, 1999 Memorandum of Decision or the April 20, 1999 Order issued pursuant thereto; (4) ruling that Harry Alexander's time to answer the involuntary petition had not yet expired but would expire ten (10) days from the date of the entry of that Order; (5) denying the SBA's and the Bank's motions for entry of an order for relief upon default; (6) denying without prejudice the Bank's motion for appointment of an interim trustee; and (7) denying Harry Alexander's oral motion for a stay pending appeal of the Court's oral ruling on the Second Dismissal Motion.

On July 21, 2000, a Scheduling Order was entered setting October 16, 2000 as the date by which all discovery must be completed, and setting October 26-27, 2000 as the dates for trial of the involuntary petition. On August 1, 2000, the instant motion for bifurcation was filed.

The Issue

The fundamental issue raised by this motion is whether a finding that the petitioning creditors acted in bad faith authorizes dismissal of the involuntary petition, even if all elements of 11 U.S.C. §§ 303(b) and 303(h) are met, and therefore whether evidence relating to bad faith is properly included at the trial of §§ 303(b) and 303(h) issues. This Court finds that such a dismissal is permitted and therefore that proof regarding the good faith, or lack of good faith, on the part of the petitioning creditors is relevant to the trial of the involuntary petition and accordingly is an appropriate area for discovery at this time.

Discussion

The decision whether to bifurcate a trial and limit discovery is necessarily committed to the discretion of the bankruptcy judge. See Surf Walk Condominium Association v. Wildman, 84 B.R. 511, 514 (N.D. Ill. 1988); In re Analytical Systems, Inc., 71 B.R. 408 (N.D. Ga. 1987). Whether bifurcation is appropriate here turns on the question of whether evidence of bad faith is directly relevant to proof of the petitioning creditors' case under §§ 303(b) and 303(h).

Although § 303(b) does not mention the term good faith, all bankruptcy filings must be undertaken in good faith. See Carolin Corp. v. Miller, 886 F.2d 693 (4th Cir. 1989). It has long been recognized that using the bankruptcy process to promote individual interests not consistent with the legislative purposes of the Bankruptcy Code is an abuse of the bankruptcy courts; and hence that involuntary petitions filed in bad faith should be dismissed. See Basin Electric Power Cooperative v. Midwest Processing Company, 47 B.R. 903 (D.N.D. 1984), aff'd 769 F.2d 483 (8th Cir. 1985), cert. denied, 474 U.S. 1083 (1986); see also *Collier on Bankruptcy*, § 303.06. Thus, it would be incongruous if bad faith petitions could be enforced and the petitioning creditors be immune to sanctions merely upon a showing that they could prove their case under 11 U.S.C. §§ 303(b) and (h), as petitioning creditors argue here. While neither party has referenced any case law specifically on point decided by the Second Circuit Court of Appeals, it appears that the judicially implied good faith filing requirement for involuntary petitions is recognized in this Circuit. See FDIC v. Cortez, 96 F.3d 50 (2nd Cir. 1996).

The two bankruptcy court cases from within the Second Circuit cited by the Debtor, In re Landmark Distributors, Inc., 189 B.R. 290 (D.N.J. 1995) and In re Reveley, 148 B.R. 398 (S.D.N.Y. 1992), both appear to address the question of bad faith sanctions in the context of an unsuccessful trial on the merits, i.e, they address sanctions and/or dismissal available under § 303(i). The question before the Court, however, is whether dismissal is available as a remedy upon a showing of bad faith; and more specifically, if bad faith is relevant and/or a basis for dismissal even if the petitioning creditors would otherwise be successful, i.e, under §§ 303(b) and (h). The case cited by petitioning creditors, In re Automatic Typewriter & Service Co., 271 F. 1 (2nd Cir. 1921) is also not helpful since it was decided in 1921 under the Bankruptcy Act, which contained dramatically different provisions than the current involuntary scheme set forth in section 303 of the Bankruptcy Code.

The case of In re United States Optical, Inc., No. 92-1496, 1993 WL 93931, 1993 U.S. App LEXIS 6960 (4th Cir., 1993)*(per curiam)* is on point, well reasoned and persuasive on the question of whether good faith is relevant to the filing of the petition and is a ground, in and of itself, for dismissal of an involuntary petition. As the Fourth Circuit Court makes clear in that decision, bad faith filings are to be dismissed:

> Courts are duty bound to conduct an inquiry, if requested, to determine whether an involuntary petition has been filed in good faith. See In re Matter of Winn, 49 Bankr. 237, 239 (Bankr. M.D. Fla. 1995). Bad faith filings are to be dismissed. Id. The finding of bad faith in an involuntary bankruptcy proceeding is a factual issue. [citations omitted] A filing is presumed to be in good faith, and the existence of bad faith must be proven by the Debtor by a preponderance of the evidence. [citations omitted] Id. at 5-6.

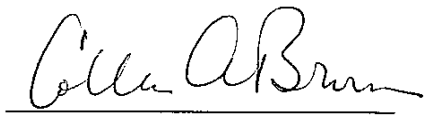
See also In re Atlas Machine & Iron Works, Inc. v. Bethlehem Steel Corp., 986 F2d. 709 (4th Cir. Va. 1993) where the Fourth Circuit Court of Appeals held that a petition filed in bad faith is properly dismissed without giving petitioning creditors an opportunity to cure a deficiency, thus reinforcing the concept that dismissal is an appropriate remedy for bad faith filings.

The Debtor herein has not presented any admissible evidence of bad faith and the question of whether the petition was filed in bad faith is not presently before this Court. Rather, the question before the Court is whether the inquiry into, and trial of, bad faith issues is properly severed from the trial on the merits of the petition, in this particular case. In light of the procedural history of this case, the fact that the putative Debtor has a voluntary case pending in another district, and the fact that the Debtor has raised the issue of bad faith in this case, bifurcation does not seem appropriate. If anything, to postpone consideration of bad faith issues would most likely complicate the trial, and probably extend the duration of this case. Since, once the Debtor raises the issue, this Court has both the obligation to find whether the involuntary petition was filed in bad faith and the authority to dismiss the case in the event bad faith is proven by a preponderance of the evidence, presentation of proof on this issue at trial and discovery into this question prior to trial is appropriate. See Basin Electric Power Corp. v. Midwest Processing Co., 769 F2d. 483 (8th Cir. 1985) *cert denied* 474 U.S. 1083. Contrary to the argument of the petitioning creditors, the Court does not believe efficiency would be promoted by bifurcation in this case, and finds no basis to justify bifurcation here.

Therefore, the motion to bifurcate all issues of bad faith, and to limit discovery to exclude issues of bad faith, is denied. The trial to determine whether Mr. Alexander should be adjudicated a Debtor will proceed commencing on October 26, 2000, on the premise that the petition is filed in good faith. The petitioning creditors will first present their evidence, pursuant to sections 303(b) and (h), with respect to whether the requisite number of creditors initiated the petition, whether the joinder of SBA is proper, whether any of the petitioning creditors hold debts that are subject to a bona fide dispute, and whether the Debtor was paying his debts as they became due on the date of the petition. The Debtor will then have an opportunity to present his evidence on each of these points as well as on the issue of whether the petition was filed in bad faith. If the petition is dismissed and the Debtor moves for an award of monetary damages under section § 303(i), then discovery into damages will be scheduled and a subsequent hearing will be set to consider the appropriateness of awarding monetary damages under § 303(i).

The Court will address disputes with respect to the scope, appropriateness or relevance of discovery demands relating, for example, to issues of domicile, if and when one of the parties files an objection to a specific discovery demand.

So ordered.



August 29, 2000
Rutland, Vermont

Colleen A. Brown
United States Bankruptcy Judge