

# Unsecured Creditors Beware: The Bona Fide Dispute Requirement of Bankruptcy Code Section 303(b)(1) is Still Evolving

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## Introduction

When traditional out-of-court debt-collection efforts fail, the Bankruptcy Code provides unsecured creditors with a potentially powerful, albeit infrequently used, tool to try to obtain payment from a financially distressed counterparty: commencing an involuntary bankruptcy proceeding. At least in theory, by forcing a putative debtor into an involuntary bankruptcy proceeding, creditors are able to apply additional pressure in an effort to secure more immediate payment of an outstanding debt.

The Bankruptcy Code's requirements for commencing an involuntary proceeding are included in Section 303(b)(1). This section provides that an involuntary petition may be filed if a debtor has 12 or more creditors, with at least 3 creditors holding unsecured claims that in the aggregate total at least \$18,600, which debts are not contingent as to liability or, as addressed in the *TV Azteca* case, the subject of a *bona fide* dispute as to liability or amount. Additionally, if a debtor contests an involuntary petition, Section 303(h)(1) of the Bankruptcy Code requires the petitioning creditors to prove that the debtor is generally not paying its debts that are not otherwise subject to a *bona fide* dispute as to liability or amount as they become due.

The petitioning creditors bear the initial burden of establishing a *prima facie* case that they meet the eligibility requirements set forth in Section 303 of the Bankruptcy Code. If these requirements are satisfied, the court will enter an order for relief on their involuntary bankruptcy petition. Under certain circumstances, the petitioning creditors can then assert an administrative priority claim for the fees they incurred prosecuting the petition, or alternatively, they can be subject to damages if the involuntary petition is determined to have been filed in bad faith.

As described in Section 303, the petitioning creditors must hold a "qualifying" debt, meaning the creditor must hold a distinct claim that is not contingent or the subject of a "bona fide dispute." Although the Bankruptcy Code does not define the phrase "bona fide dispute," courts utilize an objective standard, analyzing whether there is an objective basis for either a factual or a legal dispute as to the validity, and thus enforceability, of the underlying debt. Unsurprisingly, no matter how "objective" this standard may be, courts oftentimes differ on whether a dispute is truly "bona fide" for purposes of the section 303(b)(1) analysis.

As reflected in the November 20, 2023 holding by the Honorable Lisa G. Beckerman for the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") in *In re TV Azteca, S.A.B. de C.V.*, which dismissed an involuntary Chapter 11 proceeding because of a partial dispute concerning whether a claim was subject to a "bona fide dispute" as to amount, filing an involuntary petition can be a very risky proposition for creditors and may not further their efforts to collect a debt.

## Procedural Background and Facts

TV Azteca, S.A.B. de C.V. is a Mexican incorporated mass media and television company that produces and distributes Spanish-language television content ("TV Azteca"). Pursuant to an indenture dated August 9, 2017 (the "Indenture"), TV Azteca issued \$400 million (the "Notes Issuance") in unsecured notes (the "Notes") to various noteholders (the "Noteholders"). The Bank of New York Mellon served as the indenture trustee (the "Indenture Trustee") for the Notes Issuance. Of TV Azteca's 50 direct and indirect subsidiaries, 34 acted as contractual guarantors under the Indenture (collectively, the "Guarantors"). Three of the Guarantors were organized in the United States, while the remainder were organized in Mexico, Peru, Hondu-

ras, Guatemala, and Spain.

Pursuant to Section 11.7 of the Indenture, the Indenture and the Notes were governed by New York law and provided that any suit, action or proceeding arising out of or relating to the Indenture (including the Notes guarantees) or the Notes may be filed in any court sitting in the state of New York or any United States court sitting, in each case, in the borough of Manhattan, New York, and any appellate court with jurisdiction thereof.

### **The Default Under the Indenture and the Notes**

The Notes were scheduled to mature in 2024 and required TV Azteca to make semi-annual interest payments on August 9th and February 9th of each year at the rate of 8.25% per annum on the principal sum of \$400 million. TV Azteca made all required interest payments prior to February 9, 2021, but failed to make the interest payments on February 9, 2021, August 9, 2021, and February 9, 2022 (the "Defaulted Interest Payments"), and also on August 9, 2022, and February 9, 2023, respectively.

Following this default, several Noteholders made a demand on the Indenture Trustee to serve notices of acceleration of the Notes on TV Azteca. Thereafter, on May 3, 2022, a notice of acceleration was sent by certain beneficial owners of principal amounts of the Notes to TV Azteca and the Indenture Trustee (the "Holder Acceleration Notice"). In the Holder Acceleration Notice, the Noteholders cited to sections 6.1(a) and 6.2 (a) of the Indenture, which governed "Events of Default" and "Acceleration," respectively, to "declare the unpaid principal of (and premium, if any) and accrued and unpaid interest on all the Notes to be due and payable immediately."

On August 5, 2022, the Indenture Trustee issued a separate notice of acceleration on behalf of the Noteholders to TV Azteca (the "Trustee Acceleration Notice" and, together with the Holder Acceleration Notice, the "Acceleration Notices"). In the Trustee Acceleration Notice, the Indenture Trustee also cited to sections 6.1(a) and 6.2 (a) of the Indenture, demanding immediate payment of the unpaid principal of \$400 million, and accrued and unpaid interest on the Notes. On August 8, 2022, the Indenture Trustee issued an amendment to the Acceleration Notice, adding on an additional \$16.5 million owed as a redemption premium (the "Redemption Premium").<sup>1</sup>

### **The District Court Action**

On August 26, 2022, the Indenture Trustee filed a Notice of Motion for Summary Judgment in Lieu of a Complaint (the "Summary Judgment Motion") seeking \$469,783,272 in compensatory damages against TV Azteca in New York County Supreme Court, which was later removed, pursuant to a court order, to the U.S. District Court for the Southern District of New York (the "District Court"). Through the Summary Judgment Motion, the Indenture Trustee sought the payment of the principal, Redemption Premium, and accrued and unpaid interest due on the Notes and under the Indenture. Specifically, the Indenture Trustee requested: (i) payment of compensatory damages totaling the aggregate amount of accrued unpaid interest based on TV Azteca's failure to make the Defaulted Interest Payments, the full amount of interest up to the date of the acceleration of the Notes on August 5, 2022, and the full amount of principal due under the Indenture, collectively totaling \$469,783,272.00; (ii) the Redemption Premium at a rate of 104.125% of the principal due under the Notes as of August 5, 2022, the date of the acceleration; and (iii) the prejudgment interest from the date of acceleration of the Notes at a rate of 8.250%, as provided for in the Indenture, as well as post-judgment interest at the New York State statutory interest rate of 9%. The Summary Judgment Motion argued that the failure to make interest payments constituted an event of default under the Indenture, and that TV Azteca should be required to immediately pay the full amounts due and owing on the Notes.

<sup>1</sup> The Redemption Premium, which is an amount added to the principal loan amount (plus the interest) in the event of a default, and designed to penalize the defaulting party and make the lender whole, consists of 104.125% of the principal amount due under the Notes as of the date of the Trustee Acceleration Notice.

On September 30, 2023, TV Azteca and the Guarantors filed a motion to compel the Indenture Trustee to file a complaint, in lieu of the Summary Judgment Motion, in the District Court (the "Motion to Compel"). The parties engaged in motion practice for the next several months in connection with the Motion to Compel, eventually resulting in the District Court's denial of the Motion to Compel on December 13, 2023.

The Involuntary Petitions (as defined herein) were filed on March 20, 2023, commencing chapter 11 bankruptcy proceedings for TV Azteca and the Guarantors in the Bankruptcy Court. On March 21, 2023, a Suggestion of Bankruptcy was filed by the Indenture Trustee in the District Court action, which stayed the District Court action.

### Mexican Court Action

In parallel with the District Court Action, on July 8, 2022, TV Azteca filed a complaint (the "July 2022 Complaint") against certain Noteholders in the Ninth Civil Court of the Court of Justice for Mexico City (the "Mexican Court"). In response, on July 12, 2022, the Mexican Court issued a preliminary injunction, suspending the effects and consequences that could arise from the Acceleration Notices, and prohibiting the parties from pursuing any proceeding for the collection and/or payment of any amounts due under the Notes. The injunction was later amended to also include the Indenture Trustee, and subsequently extended to August 17, 2022, August 23, 2022, and May 17, 2023, respectively.

On September 22, 2022, TV Azteca filed another complaint in the Mexican Court against certain Noteholders (the "Complaint"), seeking further injunctive relief to prevent the holders of the Notes from enforcing any alleged obligation of TV Azteca and the Guarantors to pay any amounts due under the Notes, citing, among other things, the COVID-19 pandemic as a *force majeure* act under the Notes that rendered performance impossible for TV Azteca and the Guarantors.<sup>2</sup> In response, the Mexican court issued an *ex parte* injunction on September 27, 2022 (the "September 2022 Injunction"), prohibiting the Noteholders from enforcing TV Azteca and the Guarantors' payment of outstanding amounts under the Notes. On February 21, 2023, the Indenture Trustee was served with the July 2022 Complaint and the September 2022 Injunction. Thereafter, on May 15, 2023, the Indenture Trustee filed a motion to vacate the September 2022 Injunction, and on August 30, 2023, TV Azteca filed its opposition to the motion to vacate. This issue is currently being litigated before the Mexican Court.

### Commencement of the Involuntary Bankruptcy Proceeding

On March 20, 2023, certain holders of the Notes, Plenisfer Investments SICAV – Destination Value Total Return ("Plenisfer"), Cyrus Opportunities Master Fund II, Ltd. ("Cyrus"), and Sandpiper Limited ("Sandpiper," and collectively with Plenisfer and Cyrus, the "Petitioning Creditors") filed involuntary Chapter 11 petitions (the "Involuntary Petitions" or the "Chapter 11 Cases") in the Bankruptcy Court against TV Azteca and the Guarantors (collectively, the "Putative Debtors").<sup>3</sup>

The Petitioning Creditors' declarations in support of the Involuntary Petitions outlined the total amounts of their claims based on their respective holdings of the Notes, as follows: (a) Plenisfer stated that it held claims in the aggregate principal amount of \$11,600,000; (b) Cyrus stated that it held claims in the aggregate principal amount of \$27,477,000; and (c) Sandpiper indicated that it held claims in the aggregate principal amount of \$24,238,000.<sup>4</sup> Accordingly, taken in the aggregate, the amounts of the Petitioning Creditors' claims easily satisfied the aggregate claim amount requirement of section 303(b)(1) of the Bankruptcy Code.

<sup>2</sup> The Petitioning Creditors (as defined herein) allege that they were neither served with a copy of the July 2022 Complaint, nor the Mexican Court's order granting the September 2022 Injunction (as defined herein).

<sup>3</sup> Upon the commencement of the Chapter 11 Cases, the District Court litigation was stayed and remains unresolved.

<sup>4</sup> Significantly, in support of the Involuntary Chapter 11 Cases, the Petitioning Creditors only relied upon their debts for principal and interest that was due and owing and did not include their claim to the Redemption Premium.

The Petitioning Creditors asserted that the Bankruptcy Court had jurisdiction over the Putative Debtors' assets, wherever located, as the Indenture was governed by United States law and that certain Noteholders were from the United States. They also argued that prevailing case law supported how a Mexican court would recognize the U.S. bankruptcy proceedings, to the extent necessary, under the Mexican analog to chapter 15 of the Bankruptcy Code.

On March 27, 2023, the Petitioning Creditors filed a statement in support of the Involuntary Petitions and a motion for joint administration of the Chapter 11 cases. On April 11, 2023, the Court entered an order directing the joint administration of the Chapter 11 cases.

On April 25, 2023, the Putative Debtors filed a motion to dismiss (the "Motion to Dismiss"), asserting that the liability owed to the Petitioning Creditors was subject to a *bona fide* dispute as to the amount allegedly owed. The Putative Debtors also argued that the Involuntary Petitions should be dismissed for cause pursuant to Section 1112(b) of the Bankruptcy Code because they were filed as a "tactical maneuver" in connection with the dispute pending before the District Court. Third, the Putative Debtors argued that the Involuntary Petitions should be dismissed at the pleadings stage pursuant to Section 305(a)(1) of the Bankruptcy Code, because proceeding with the Chapter 11 cases in the United States would harm the Putative Debtors and their creditors. Finally, the Putative Debtors argued that the Involuntary Petitions should be dismissed on *forum non conveniens* grounds because Mexico is a necessary, and in fact, the only forum in which an in-court reorganization could be accomplished.

The Petitioning Creditors filed their opposition to the Motion to Dismiss on June 16, 2023. Following a hearing on the Motion to Dismiss, and in an effort to avoid further litigation and consensually resolve all of the underlying issues, the Petitioning Creditors and Putative Debtors stipulated to engage in mediation. The mediation lasted a total of sixty-seven days, but concluded without a settlement being reached.

### The Court's Decision

On November 20, 2023, the Court issued a decision on the Motion to Dismiss, ruling that the Chapter 11 Cases must be dismissed because the Petitioning Creditors' claims were, in fact, subject to a *bona fide* dispute. Although the Court found that the Petitioning Creditors, through the Involuntary Petitions and supporting declarations, met their initial burden of establishing a *prima facie* case, the Court nevertheless found that the Putative Debtors also met their burden of demonstrating a *bona fide* dispute as to the amount of the Petitioning Creditors' claims. The Court agreed with the Putative Debtors that the pendency of the District Court Action alone is evidence that the Petitioning Creditors' claims are subject to a *bona fide* dispute. In the District Court Action, the Putative Debtors did not dispute that the entire principal amount plus two and a half years of unpaid interest was due and owing under the Notes, but they argued that the Redemption Premium was not due and owing. Therefore, the Court reasoned that whether the Redemption Premium was due and owing was clearly in dispute in the District Court Action. The Court further observed that, even though the portion of the Petitioning Creditors' claims related to unpaid principal and interest was undisputed, the pending litigation in the District Court over the *total* amount – inclusive of the Redemption Premium – owed under the Notes and Indenture was sufficient to create a *bona fide* dispute (despite the exclusion of the Redemption Premium from the Petitioning Creditors' claims asserted in the Involuntary Petitions and supporting declarations).

The Bankruptcy Court further noted that, although the Second Circuit Court of Appeals (the "Second Circuit") has not ruled as to whether a dispute over part of a claim constitutes a "*bona fide* dispute," other circuit courts have held that a partial dispute falls within the "*bona fide* dispute" defense, and the "vast majority of decisions by courts within the Second Circuit have followed this approach." The Bankruptcy Court emphasized that relevant Second Circuit case law holds that while pending litigation itself is insufficient to establish the existence of a *bona fide* dispute, the existence of pending litigation over the amount of a claim strongly suggests the presence of a *bona fide* dispute.

Having found the existence of a *bona fide* dispute, the Bankruptcy Court dismissed the Chapter 11 Cases. However, in so doing, the Bankruptcy Court did not reach any of the other grounds that the Putative Debtors had argued as reasons for dismissal, including *forum non conveniens* in favor of Mexico, as it wanted to avoid hamstringing “another judge...in the future by ruling on the three remaining arguments as to why the involuntary petitions should be dismissed.”

## Conclusion

The TV Azteca decision adds to an increasing line of cases across the country that broadly interprets the *bona fide* dispute as to amount provision of Bankruptcy Code section 303(b)(1). As there was no binding Second Circuit precedent, the Bankruptcy Court followed the First, Fifth, and Ninth Circuits (the only three circuit courts to have decided the issue) in concluding that a creditor whose claim is the subject of a *bona fide* dispute as to the liability or amount – arguably, no matter how small a component of the claim – lacks standing to be a petitioning creditor under section 303(b)(1), even if a portion of their claim is undisputed. Accordingly, while commencing an involuntary bankruptcy remains a potentially effective means for a creditor to recover on account of its claim, it can be a risky proposition because, if taken to the logical extreme, a creditor would not be eligible as a petitioning creditor under section 303(b) if only one dollar of a creditor’s claim is disputed. As a result, creditors considering filing an involuntary petition should make sure to do their diligence as this uncertainty could expose them to material damages if the involuntary proceeding is determined to have been filed in bad faith.

## About the Authors



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Lindsay’s Chapter 11 representations have included creditors’ committees for Proterra Inc, Vital Pharmaceuticals, Inc. (dba Bang Energy), Century 21, GNC, Maines Paper & Food Service, the Northwest Company, Fred’s Inc., and Murray Metallurgical Coal Holdings. She has also represented securities class action plaintiffs’ interests in several complex Chapter 11 cases such as Tricida, Inc., Athenex, Inc., Lannett Co., Inc., and Genesis Global Holdco, LLC.