§ 303
Involuntary Petition
Fed. R. Civ. P. 37

In re Tenos Moses Pete, Case. No. 01-40347-elp7; BAP. No. 1166-MaHRy

2/12/2003 BAP, aff'g ELP unpublished

The BAP affirmed the bankruptcy court's entry of an order for relief in this involuntary chapter 7 case.

The BAP held that the bankruptcy court did not err in ruling that debtor had the burden of proving the existence of more than twelve creditors for purposes of determining the required number of petitioning creditors under § 303(b)(2).

The BAP held that the bankruptcy court did not abuse its discretion in imposing a discovery sanction under Fed. R. Civ. P. 37. As a sanction, the bankruptcy court precluded debtor from introducing evidence to establish the existence of debts for which debtor had repeatedly refused to produce documentary evidence. In upholding the sanction, the BAP observed that the debtor had intentionally withheld production and that the bankruptcy court had given multiple warnings prior to imposing the sanction.

The BAP also held that the bankruptcy court did not err in finding that the debtor was generally not paying his debts as they became due under § 303(h).

Finally, the BAP rejected the debtor's argument that the petitioning creditors filed the petition in bad faith, because they did not exhaust their state law collection remedies before they filed the involuntary petition.

NOT FOR PUBLICATION

FILED

FEB 12 2003

NANCY B. DICKERSON, CLERK
U.S. BKCY. APP. PANEL
OF THE NINTH CIRCUIT

UNITED STATES BANKRUPTCY APPELLATE PANEL

OF THE NINTH CIRCUIT

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| In re: | BAP No. OR-02-1166-MaHRy |
| TENOS MOSES PETE, | Bk. No. 301-40347-elp7 |
| Debtor. | |
| TENOS MOSES PETE, | |
| Appellant, | |
| v. | **M E M O R A N D U M**[1] |
| MICHAEL BATLAN, Chapter 7 Trustee; UNITED STATES TRUSTEE; ASA GEMIGNANI; GREG GEMIGNANI; BENJAMIN GOLDING; FRANCES GOLDING, | |
| Appellees. | |

Argued by Video Conference and Submitted on November 20, 2002

Filed - February 12, 2003

Appeal from the United States Bankruptcy Court for the District of Oregon

Honorable Elizabeth L. Perris, Bankruptcy Judge, Presiding.

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Before: MARLAR, HARGROVE,[2] and RYAN, Bankruptcy Judges.

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[1] This disposition is not appropriate for publication and may not be cited except when relevant under the doctrines of law of the case, res judicata, or collateral estoppel. See 9th Cir. BAP Rule 8013-1.

[2] Hon. John J. Hargrove, Chief Bankruptcy Judge for the Southern District of California, sitting by designation.

P03-2(33)

## INTRODUCTION

Debtor Tenos Moses Pete ("Pete") has appealed an order for involuntary relief under chapter 7,[3] entered after trial, in favor of two petitioning creditors. Pete contends that the court erred in ruling that he had the burden to prove that he had twelve or more creditors, after he averred their existence in his answer in an attempt to defeat the petition and require at least three petitioning creditors.[4] He also challenges the court's imposition of a discovery sanction that precluded him from producing evidence of additional creditors at trial. We AFFIRM.

## FACTS

As a result of two state court judgments, Pete owed Benjamin and Frances Golding and Asa and Greg Gemignani ("Petitioning Creditors") approximately $395,000 in unsecured

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[3] Unless otherwise indicated, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330, and rule references are to the Federal Rules of Bankruptcy Procedure ("Fed. R. Bankr. P."), Rules 1001-9036, which make applicable certain Federal Rules of Civil Procedure ("Fed. R. Civ. P.").

[4] A petition for involuntary relief requires only one petitioning creditor if a debtor has fewer than twelve creditors, but requires three creditors if the total number is twelve or more. See 11 U.S.C. § 303(b).

debt.[5] Their prepetition collection activities included a $65 garnishment and demand letters, to which Pete made no response or other payments.

On October 17, 2001, the Petitioning Creditors filed an involuntary petition against Pete, and commenced discovery regarding Pete's creditors. In November, the bankruptcy court issued two orders for Pete to appear for an examination and to produce documentary evidence of his debts, payment on debts, bank accounts, sources of income, and 1999-2000 state and federal tax returns, all by November 28, 2001. Pete missed the deadline and, on November 30, 2001, produced only income tax returns for 1999 and 2000 and several months' worth of his Discover Card statements.[6]

Pete then moved to dismiss the petition, asserting that he had more than twelve creditors and, thus, that the Petitioning Creditors were one creditor shy of the required minimum of three creditors.[7] The Petitioning Creditors opposed Pete's motion. At the hearing thereon, the court denied Pete's motion, and

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[5] The bankruptcy court found that because of their marital status the judgment creditors constituted two Petitioning Creditors, and that finding was undisputed.

The Petitioning Creditors filed affidavits stating that the debts were general unsecured claims. The debts were $225,632.14 and $169,335.14, respectively. See Letter Opinion (Feb. 1, 2002), at 6-7.

[6] While Pete's response has not been included in the excerpts of record, these facts are undisputed.

[7] The dismissal motion has not been made part of the excerpts of record.

found that his evidence of creditors was incomplete. See Tr. of Proceedings (Dec. 21, 2001), at 3-4. Facing possible discovery sanctions, Pete's attorney argued that he did not have the burden of proof on the creditor number issue. The court found that Pete simply had failed to comply with the discovery orders.

As a result, on December 27, 2001, the court issued a warning order directing Pete to file an answer and a proper creditor list pursuant to Rule 1003(b)[8] ("Rule 1003(b) List"). Pete was also ordered to complete his discovery response by January 4, 2002, including the production of additional enumerated documents, and to appear for a telephonic deposition. The order warned that if Pete failed to comply, the court would consider striking any answer and enter an order for relief. A trial was set for January 23, 2002.

Pete filed an answer. As defenses, Pete alleged that he was generally paying his debts as they came due. He also contended that the involuntary petition was filed in bad faith

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[8] Rule 1003(b) provides:

> **(b) Joinder of Petitioners After Filing.** If the answer to an involuntary petition filed by fewer than three creditors avers the existence of 12 or more creditors, the debtor shall file with the answer a list of all creditors with their addresses, a brief statement of the nature of their claims, and the amounts thereof. If it appears that there are 12 or more creditors as provided in § 303(b) of the Code, the court shall afford a reasonable opportunity for other creditors to join in the petition before a hearing is held thereon.

Fed. R. Bankr. P. 1003(b).

because the Petitioning Creditors had not exhausted their state law collection remedies and had filed for the improper purpose of ruining his business. His primary argument, however, was that the Petitioning Creditors were fewer than the required three in number because he had twelve or more creditors. Pete submitted a Rule 1003(b) List of twenty-seven creditors, but with a motion for permission to file it under seal and for in camera review only. In a January 4, 2002 order, the court denied Pete's motion to submit the creditor list under seal, and ruled that he had the burden of proving the existence of twelve or more creditors.

In another order issued on January 4, 2002, the court extended the deadline for Pete's production of documents, but warned him of possible sanctions. That order stated, in pertinent part:

> The alleged debtor is to complete the production of documents required under the discovery and December 27, 2001 orders by Tuesday, January 8, 2002. If he fails to do so, he will be precluded from introducing at trial any documents within the scope of those orders that were not produced. Additional sanctions may also be imposed.

Order Overruling Alleged Debtor's Objection (Jan. 4, 2002), at 2.

Despite the court's orders, Pete failed to produce any documents other than those he had already produced on November 30, 2001, including the tax returns and Discover Card statements. See Letter Opinion (Feb. 1, 2002), at 4.

On January 9, 2002, the Petitioning Creditors moved for

entry of an order for relief and to strike Pete's Rule 1003(b) List, arguing that, although Pete listed twenty-seven creditors, he had only provided documentary evidence as to the Discover Card debt.[9] At the January 17, 2002 hearing on the Petitioning Creditors' motion, Pete's attorney maintained that Pete had no additional documents to produce that were within the scope of the discovery orders. However, he proposed to obtain witness statements and to deliver such further evidence to opposing counsel by Monday, January 21, 2002, two days before trial. The court rejected this offer, finding that Pete's evidence should have been produced earlier.

Instead of imposing the ultimate sanction--a default entry of relief--for Pete's failure to comply with the discovery orders, the court orally ruled that Pete would be precluded from introducing at trial any evidence of the existence of other debts within the scope of the discovery orders.

Pete produced no more documents at his January 21, 2002 deposition. Because there was a pending criminal prosecution against him, Pete invoked the Fifth Amendment and refused to answer almost all questions concerning his income and any payments made to the creditors on the Rule 1003(b) List.[10] He answered, generally, that he earned enough to pay his creditors

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[9] As noted above, the court also found that Pete provided state and federal tax returns.

[10] The bankruptcy court stated that it did not draw a negative inference from Pete's invocation of the Fifth Amendment. See Letter Opinion (Feb. 1, 2002), at 8.

and was current in payments.

The trial went forward on January 23, 2002. Pete's attorney made an offer of proof of the Rule 1003(b) List. The court took the offer under advisement, and subsequently admitted it as evidence of only the nonprecluded debts. See Letter Opinion (Feb. 1, 2002), at 6-8.

The Petitioning Creditors and their attorney were the only witnesses to present evidence of their debts. A demand letter and the Pete deposition were admitted into evidence.[11]

The bankruptcy court entered the Order for Relief and a separate Letter Opinion on February 1, 2002. Pete timely filed a notice of appeal.

## ISSUES

1. Whether the bankruptcy court erred in ruling that Pete had the burden of proving the existence of twelve or more creditors.

2. Whether imposition of the discovery sanction, which precluded Pete from producing evidence of additional creditors, was an abuse of discretion.

3. Whether the court erred in finding that Pete had only

[11] The demand letter has not been made part of the excerpts of record.

five creditors.

4. Whether the court correctly found that Debtor was generally not paying his debts as they came due.

5. Whether the court abused its discretion in denying Pete's motion to dismiss the involuntary petition on the basis of bad faith.

## STANDARDS OF REVIEW

We review conclusions of law de novo and factual conclusions for clear error. Liberty Tool, & Mfg. v. Vortex Fishing Sys., Inc. (In re Vortex Fishing Sys., Inc.), 277 F.3d 1057, 1064 (9th Cir. 2002). The court's interpretation of the Bankruptcy Code is reviewed de novo. Grey v. Federated Group, Inc. (In re Federated Group, Inc.), 107 F.3d 730, 732 (9th Cir. 1997). A conclusion relative to the burden of proof is subject to de novo review. W. Wire Works, Inc. v. Lawler (In re Lawler), 141 B.R. 425, 428 (9th Cir. BAP 1992).

Discovery sanctions are reviewed for an abuse of discretion. Adriana Int'l Corp. v. Thoeren, 913 F.2d 1406, 1408 (9th Cir. 1990). Related findings of fact are reviewed under the clearly erroneous standard. Id. A court abuses its discretion if it does not apply the correct law, or if it rests its decision on a clearly erroneous finding of a material fact.

See Lopez v. Specialty Rests. Corp. (In re Lopez), 283 B.R. 22, 26 (9th Cir. BAP 2002).

Whether a debtor is paying his debts as they come due is a question of fact reviewed for clear error. Vortex Fishing Sys., 277 F.3d at 1072. We review a finding of whether an involuntary petition was filed in "bad faith" for clear error. Jaffe v. Wavelength, Inc. (In re Wavelength, Inc.), 61 B.R. 614, 620 (9th Cir. BAP 1986).

## DISCUSSION

### A. Burden of Proof As to Creditor Number

Under § 303(b)(2), if a debtor has fewer than twelve eligible creditors, an involuntary filing can be made by as few as one qualifying creditor. 11 U.S.C. § 303(b)(2);[12] 2 Collier on Bankruptcy ¶ 303.03[1] (Alan N. Resnick & Henry J. Sommer, eds., 15th ed. rev. 2002).

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[12] Section 303(b)(2) provides:

> (b) An involuntary case against a person is commenced by the filing with the bankruptcy court of a petition under chapter 7 or 11 of this title—
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> . . . .
>
> (2) If there are fewer than 12 such holders, excluding any employee or insider of such person and any transferee of a transfer that is voidable . . . , by one or more of such holders that hold in the aggregate at least $11,625 of such claims;

11 U.S.C. § 303(b)(2).

Only holders of claims that are not contingent as to liability or the subject of a bona fide dispute may be petitioning creditors. Collier on Bankruptcy, supra, ¶ 303.03[2]. Petitioning creditors must make a prima facie showing that they are entitled to relief under § 303 by establishing that they are proper holders of claims that are not in bona fide dispute. See id. ¶ 303.03[2][b][ii] (burden is on petitioning creditor to establish a prima facie case that there is no bona fide dispute).

Here, the Petitioning Creditors held final state court judgments. The bankruptcy court determined that the debts were neither contingent nor in bona fide dispute, and Pete has not challenged that ruling in this appeal. See id., ¶ 303.02[a] (providing that a state court judgment establishes a noncontingent claim).

Although the Petitioning Creditors did not allege the number of creditors of the estate in their involuntary petition and affidavits, the court found that there were only five proven creditors: the Petitioning Creditors; the Internal Revenue Service ("IRS"); the Oregon Department of Revenue; and Discover Card. Therefore, the Petitioning Creditors qualified under § 303(b)(2).

Pete moved to dismiss the petition on the grounds that he had more than twelve creditors and therefore at least three

qualifying creditors were required, pursuant to § 303(b)(1).[13] In essence, Pete contends that, after he filed the Rule 1003(b) List of twenty-seven alleged creditors, the Petitioning Creditors were required to prove the nonexistence of those additional creditors in order to make their prima facie case.

The bankruptcy court concluded that Pete had the burden of proving he had twelve or more creditors, and held: "Unless an alleged debtor proves that there are twelve or more creditors, the case must be treated as one involving fewer than twelve creditors, making additional petitioning creditors unnecessary." Order Denying . . . In Camera Review and Sealing, (Jan. 4, 2002), at 3. We agree with the bankruptcy court's holding in this case.

It is well established that if an involuntary debtor files an answer alleging as a defense that he has twelve or more creditors, then the burden of proving that fact rests with the debtor. Collier on Bankruptcy, supra, ¶ 303.04[8] (citing

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[13] Section 303(b)(1) provides:

> (b) An involuntary case against a person is commenced by the filing with the bankruptcy court of a petition under chapter 7 or 11 of this title—
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> (1) by three or more entities each of which is either 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, if such claims aggregate at least $11,625 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims;

11 U.S.C. § 303(b)(1).

Cunningham v. Rothery (In re Rothery), 143 F.3d 546 (9th Cir. 1998)).

In Rothery, the Ninth Circuit held that a debtor was "mistaken" when she argued that the burden of proof on the creditor number issue rested with the petitioning creditor, after she made only a bare allegation that she had more than twelve creditors. Rothery, 143 F.3d at 549. Pete's allegation that he had more than twelve creditors was in the nature of an affirmative defense. Thus, Pete had the burden of proof on the issue, and the Petitioning Creditors were not required to prove a negative.

Pete argues that the court in Rothery was merely applying a summary judgment standard, which requires more than a bare assertion to defeat summary judgment. This argument misses the point, for in a summary judgment proceeding, the parties retain the same burdens of proof that they would have at trial on the essential elements of their claims or defenses. See Celotex Corp. v. Catrett, 477 U.S. 317, 322 (1986). The Rothery court expected the debtor to meet her requisite burden of proof to defeat summary judgment. See Rothery, 143 F.3d at 549.

Pete also cites In re Braten, 99 B.R. 579 (Bankr. S.D.N.Y. 1989), for the proposition that, once the debtor files a Rule 1003(b) list showing more than twelve creditors, the burden of proof shifts to the petitioning creditors. That case is distinguishable on its facts because the Braten court admitted

the Rule 1003(b) list into evidence.[14] Therefore, the burden was shifted to the petitioning creditors to show that there were less than twelve creditors. Here, the bankruptcy court did not allow into evidence the full Rule 1003(b) List; it only accepted this evidence for purposes of identifying the five creditors.

Pete also maintains that decisions from outside the Ninth Circuit support his argument that the Petitioning Creditors have the burden of proving the number of creditors. See Atlas Mach. & Iron Works, Inc. v. Bethlehem Steel Corp., 986 F.2d 709, 715 (4th Cir. 1993) (stating that sole petitioner has burden of showing fewer than twelve creditors); In re Smith, 243 B.R. 169, 183 (Bankr. N.D. Ga. 1999) ("As the sole petitioning creditor, SDC has the burden of proving that Smith had less than twelve qualifying creditors as of the filing date."); Pleas Doyle & Assocs. v. James Plaza Joint Venture (In re James Plaza Joint Venture), 67 B.R. 445, 447-48 (Bankr. S.D. Tex. 1986) (finding that only one of three petitioning creditors had standing, and that it was the "plaintiffs' burden to demonstrate the number of creditors of a debtor's estate.").[15]

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[14] The bankruptcy court in Braten noted that the petitioning creditors objected to the debtor's Rule 1003(b) list but did not "put the debtor to the test," because they continued the hearing in pursuit of joining a third creditor. Braten, 99 B.R. at 583. Therefore, the court held that the creditors did not defeat the debtor's evidence and establish that the debtor had "fewer than twelve eligible creditors." Id.

[15] These cases involve sole petitioning creditors still involved in litigating the debt. Such cases are often analyzed differently because of the policy against using bankruptcy as a (continued...)

The cases cited by Pete generally refer to the petitioning creditors' burden of presenting a prima facie involuntary petition by establishing that they are qualifying creditors under § 303(b)(2). Such proof includes showing that the debtor has fewer than twelve creditors, although there is no requirement that the petitioning creditors allege that the debtor has fewer than twelve creditors.[16] See 9 Collier on

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[15](...continued)
forum to resolve a two-party dispute. See Collier on Bankruptcy, supra, ¶ 303.04[5]. For example, in Atlas Mach., the single creditor filed the petition, even though it had conducted discovery which showed that the debtor had sixty-six trade creditors. Atlas Mach., 986 F.2d at 714.

In a two-party dispute, abstention may be in order if the motivation of the petitioning creditor is simply to avoid litigating in state court. See Remex Elecs. Ltd. v. AXL Indus., Inc. (In re AXL Indus., Inc.), 127 B.R. 482, 484 (S.D. Fla. 1991), aff'd in part and appeal dismissed in part, 977 F.2d 598 (11th Cir. 1992) (table item) ("The bankruptcy courts generally grant motions to abstain in two-party disputes where the petitioner can obtain adequate relief in a non-bankruptcy forum. Courts consider the motivation of the petitioning creditor as a factor in making such a determination.").

This case is distinguishable because the subject claims were based on final judgments, and bankruptcy protected Pete from multiple collection activities by the two creditors.

[16] The Bankruptcy Code and Rules anticipate that petitioning creditors may not be correct in their initial assumption that there are fewer than twelve creditors, and provides that additional creditors may join in an involuntary petition, if necessary. See 11 U.S.C. § 303(c); Fed. R. Bankr. P. 1003(b), Advisory Comm. Note (1987)(providing for joinder of petitioners after filing of proper creditor list by the prospective debtor showing the existence of twelve or more creditors). These provisions are meant to "facilitate [the] bankruptcy proceedings regardless of the correctness of the originating petition." In re Crown Sportswear, Inc., 575 F.2d 991, 993 (1st Cir. 1978) (case discussing similar provision under the Bankruptcy Act). See also Vortex Fishing Sys., 277
(continued...)

Bankruptcy, supra, ¶ 1003.01.

When Pete moved to dismiss the petition, he thereby raised an issue of whether the Petitioning Creditors were qualifying creditors under § 303(b)(2). The Petitioning Creditors had been attempting to discover creditor information, but were stopped in their tracks by Pete's noncooperation. They eventually proved the existence of five creditors and thus presented a prima facie case for involuntary relief under § 303(b)(2). Once that was established, the court did not err in placing the burden of proving twelve or more creditors upon Pete, since he asserted the applicability of § 303(b)(1) and the three-creditor requirement as a defense in his answer to the involuntary petition. See Rothery, 143 F.3d at 549; 2 Collier on Bankruptcy, supra, ¶ 303.04[8].

**B. Discovery Sanction**

The gravamen of this appeal is whether the sanction of excluding the evidence of additional creditors was warranted. After Pete repeatedly failed to comply with at least two court orders to produce documentation related to Pete's debts with other alleged creditors, in addition to the few he had provided on November 30, 2001, the court sanctioned him by precluding

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[16](...continued)
F.3d at 1071 (stating that the rules for involuntary petitions "call for simplified litigation procedure consistent with expedition").

such additional and new evidence at trial. See Fed. R. Bankr. P. 7037, incorporating Fed. R. Civ. P. 37 ("Rule 37").

The court had discretion to exclude his documents and witnesses under Rule 37, which provides, in pertinent part:

> A party that without substantial justification fails to disclose information required by Rule 26(a) or 26(e)(1) [requiring supplementation of responses], or to amend a prior response to discovery as required by Rule 26(e)(2), is not, unless such failure is harmless, permitted to use as evidence at a trial, at a hearing, or on a motion any witness or information not so disclosed.

Fed. R. Civ. P. 37(c)(1).

Sanctions imposed under Rule 37 "must be just . . . ." Rubin v. Belo Broadcasting Corp. (In re Rubin), 769 F.2d 611, 615 (9th Cir. 1985). The Ninth Circuit has addressed the issue of what may be considered to be an appropriate sanction under Rule 37 for willful failure to comply with Fed. R. Civ. Proc. 26. See, e.g., Valley Eng'rs Inc. v. Elec. Eng'g Co., 158 F.3d 1051, 1057 (9th Cir. 1998); Wendt v. Host Int'l, Inc., 125 F.3d 806, 814 (9th Cir. 1997); Wanderer v. Johnston, 910 F.2d 652, 656 (9th Cir. 1990). In those cases, the court set forth a five-part test for the imposition of sanctions, such as entry of default, dismissal of claims, or exclusion of testimony. The reasons for sanctions, warranted under Rule 37, are:

(1) The public's interest in expeditious resolution of litigation;

(2) The court's need to manage its docket;

(3) The risk of prejudice to the [party seeking sanctions];

(4) The public policy favoring disposition of cases on their merits; and

(5) The availability of less drastic sanctions.

Valley Eng'rs, 158 F.3d at 1057; Wanderer, 910 F.2d at 656.

Here, the bankruptcy court expressly stated that it considered preclusion of Pete's evidence to be a lesser sanction than ordering relief by default. Pete argues that the sanction was a de facto order for relief by default, because he could not thereafter produce any evidence to support his defense. See United States v. Sumitomo Marine & Fire Ins. Co., 617 F.2d 1365, 1369 (9th Cir. 1980) (stating that preclusion of evidence is tantamount to dismissal).

Pete's argument is misplaced. Pete had already sealed his fate by refusing to comply with the discovery orders. See id. (further stating that ultimate sanction may not be imposed when the failure to comply is due to circumstances beyond the disobedient party's control.)

The record contains voluminous discussions between the court and Pete's attorney concerning the court's expectation for production, its fair warnings, and the attorney's concession that he would attempt to get the material from Pete.[17] The

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[17] Pete contends that the court imposed the sanction without notice at the January 17, 2002 hearing. This is incorrect. In its January 4, 2002 order, the court expressly stated that Pete would be precluded from introducing at trial any documents within the scope of the discovery orders that were not produced, and that additional sanctions could also be imposed. Order Overruling Alleged Debtor's Objection (Jan. 4, 2002), at 3.

documents were not burdensome or costly, but were simply bank statements, bills, check stubs, etc., that Pete would have received or prepared in regard to the alleged creditors.

When Pete failed to produce these documents, his attorney then belatedly requested that he be allowed to produce evidence of the other creditors two days before trial. The court properly refocused the issue upon Pete's failure to cooperate in discovery:

> THE COURT: Mr. Glass, how are you going to prove this at trial?
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> MR. GLASS: We would get all of the documents from the creditors.
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> THE COURT: Well, Mr. Glass, if you're going to do that, then you've got to produce them in discovery.
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> MR. GLASS: Right, but —
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> . . . .
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> THE COURT: . . . . Your trial is coming up in less than a week . . . . [I]f you're going to produce things at trial you have to produce them in discovery.

Tr. of Proceedings (Jan. 17, 2002), at 66 (alteration added).

The evidence supports the court's ultimate finding that Pete was intentionally withholding evidence. Such a tactic is improper in discovery. See Charles Alan Wright, et al., Federal Practice and Procedure: Civil 2d § 2001 (1994). The court gave Pete multiple chances but finally had to move on to trial in order to facilitate the Bankruptcy Rules' requirement for a prompt hearing. See Fed. R. Bankr. P. 1013(a). Therefore, the

court did not abuse its discretion in imposing the discovery sanction.

### C. Pete's Evidence

The bankruptcy court considered the evidence produced by Pete on November 30, 2001. His discovery response referred only to an IRS debt, an Oregon Department of Revenue debt, and a Discover Card debt, in addition to the two debts of the Petitioning Creditors.

Pete contends that the court admitted the entire Rule 1003(b) List, which contained the names of twenty-seven creditors, and thus it erred in its ultimate finding that there were only five creditors. The record does not support Pete's argument that the court admitted the Rule 1003(b) List in its entirety.

At trial, Pete's attorney made an offer of proof of the Rule 1003(b) List, and the court took it under advisement. Then, in its Letter Opinion, the court clearly admitted the Rule 1003(b) List, but only in reference to the debts of creditors established in the documents produced on November 30, 2001, and not as to any other creditors. This ruling was consistent with the court's January 4, 2002 order and January 17, 2002 oral ruling.

Therefore, we affirm the court's finding that Pete had only five creditors.

## D. Section 303(h) - Failure to Generally Pay Debts When Due

The court found that the Petitioning Creditors met their burden to prove that Pete was not generally paying his debts as they became due, a required element of proof under § 303(h)[18]; see Rothery, 143 F.3d at 548.

This determination requires a totality of the circumstances analysis. Vortex Fishing Sys., 277 F.3d at 1072; Hayes v. Rewald (In re Bishop, Baldwin, Rewald, Dillingham & Wong, Inc.), 779 F.2d 471, 475 (9th Cir. 1985). A negative finding "requires a more general showing of the debtor's financial condition and debt structure than merely establishing the existence of a few unpaid debts." Vortex Fishing Sys., 277 F.3d at 1072 (citation omitted). Instead, courts should "compare the number of debts unpaid each month to those paid, the amount of the delinquency, the materiality of the non-payment, and the nature of the [d]ebtor's conduct of its financial affairs." Id. (citation

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[18] Section 303(h) provides, in pertinent part:

> (h) If the petition is not timely controverted, the court shall order relief against the debtor in an involuntary case under the chapter under which the petition was filed. Otherwise, after trial, the court shall order relief against the debtor in an involuntary case . . . only if—
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> (1) the debtor is generally not paying such debtor's debts as such debts become due unless such debts are the subject of a bona fide dispute; . . .

11 U.S.C. § 303(h).

omitted).

Again, Pete maintains that the court failed to consider the Rule 1003(b) List in conjunction with his deposition testimony in which he stated that he earned enough to pay his creditors and was current with those creditors.

The court did not admit Pete's Rule 1003(b) List in its entirety, but limited it to the five proven creditors. Pete's testimony that he earned enough money to pay his creditors, and that he was current in payments, was overcome by evidence of: the settlement with the IRS, from which the court inferred that Pete was not current with it; the absence of evidence concerning any payment on the State of Oregon and Discover Card debts; and the Petitioning Creditors' testimony that no payments were made on their debts, other than the $65 collected through a garnishment proceeding.

The court found that, of the five debts, aggregating $408,523.28, ninety-nine percent or $402,967.28 of that amount was not being paid when due. Letter Opinion (Feb. 1, 2002), at 9. Pete failed to rebut the evidence provided by the Petitioning Creditors. Therefore, the bankruptcy court did not err in finding that the Petitioning Creditors met their burden of proof on this issue.

**E. Bad Faith**

There is a presumption that the Petitioning Creditors filed

the involuntary petition in good faith, and Pete had the burden of proving bad faith by a preponderance of the evidence. Collier on Bankruptcy, supra, ¶ 303.06. The Bankruptcy Code does not define what constitutes "bad faith" for the purpose of sanctioning an improper involuntary petition. We have held that the test for bad faith under § 303 is an objective one "that asks 'what a reasonable person would have believed.'" Wavelength, 61 B.R. at 620 (quoting In re Grecian Heights Owners' Ass'n, 27 B.R. 172, 173 (Bankr. D. Or. 1982)).[19]

Pete maintains that the involuntary petition should have been dismissed for bad faith because the Petitioning Creditors failed to exhaust their state law collection remedies due to "laziness." Appellant's Opening Brief, (June 26, 2002), at 12.[20]

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[19] We are bound to use the objective test, although many courts apply a combination of objective and subjective standards or the standard used for Rule 9011/Fed. R. Civ. P. 11 sanctions. See Gen. Trading Inc. v. Yale Materials Handling Corp., 119 F.3d 1485, 1501-02 (11th Cir. 1997) (observing that a number of courts have sought to model the bad faith inquiry on the standards set forth in Bankruptcy Rule 9011). See also Collier on Bankruptcy, supra, ¶ 303.06[1].

[20] It is unclear from the record where Pete made the "bad faith" argument in bankruptcy court. His motion to dismiss is not included in the excerpts of record. His answer contains a prayer for damages under § 303(i), an action which must be brought after a resolution of the petition in his favor. See Miyao v. Kuntz (In re Sweet Transfer & Storage, Inc.), 896 F.2d 1189, 1191 (9th Cir. 1990) ("Any actual claim brought for damages is premature prior to dismissal of the petition."). See also 11 U.S.C. § 303(i)(2)(providing for damages and punitive damages against any petitioner that filed in bad faith, "if the court dismisses a petition under this section"). Nevertheless, the court considered, and we may too, his "bad faith" argument to the extent that it was asserted merely to defeat the

(continued...)

Relying on the testimony of the Petitioning Creditors' attorney, Pete asserts that they improperly used bankruptcy as a substitute for customary collection procedures under state law.

At trial, the Petitioning Creditors' attorney was cross-examined as to why he had not conducted a judgment debtor's examination, and he explained:

> A. Well, I've been doing this for 25 years, and I find that judgment debtor exams are less than fruitful. Frequently the judgment debtor will not bring the documents that are requested; they won't produce the evidence. I think Mr. Pete's conduct in this case is evidence of that. And after you've gone through and spent a lot of money on judgment debtor exams and fruitless garnishments, then — and perhaps start fraudulent transfer actions, then what happens when you finally get to the goal they [sic] file a Chapter 7 proceeding anyway.
>
> So, in this particular case, we determined because of the lack of cooperation on the part of Mr. Pete, to fast forward that track, skip the spending of the money on the state court procedures, and try and economize by getting it done in the bankruptcy court where all of the same relief is available as well.
>
> Q. You presumed that the state court procedures then are ineffective?
>
> A. No, I think state court procedures are equally effective, but . . . As I was saying, we wanted to skip all of those state court procedures because it looked to me like Mr. Pete was going to eventually file bankruptcy anyway.

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[20](...continued)
petition. See Sweet Transfer & Storage, 896 F.2d at 1191 ("Although a debtor may include a 'counterclaim' for damages as described under § 303(i), it is only permissible under [Rule] 1011(d) to the extent that bad faith is considered in defeating the petition."); Rule 1011(d) ("A claim against a petitioning creditor may not be asserted in the answer except for the purpose of defeating the petition.").

Tr. of Proceedings (Jan. 23, 2002), at 102-03.

The Bankruptcy Code does not require a petitioning creditor to exhaust state remedies prior to filing an involuntary petition. There may be circumstances where a judgment debtor's conduct prevents any progress from being made under state law, thereby forcing the judgment creditor to seek alternatives such as an involuntary bankruptcy. The question before us, therefore, is whether good faith required the Petitioning Creditors to fully exhaust their state court remedies before seeking relief in bankruptcy court. The case law is unclear as to whether a creditor's frustration in collection efforts, alone, can constitute an "exhaustion of state remedies."

Pete cites single-creditor cases where bad faith was found for the creditor's seeking of bankruptcy relief in a two-party dispute. While the Code clearly allows for a single-creditor involuntary petition, see 11 U.S.C. § 303(b)(2), such petitions have not been favored.[21] See Collier on Bankruptcy, supra,

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[21] A number of courts have denied relief in single-creditor involuntary cases. See Atlas Mach., 986 F.2d at 715 (stating that "[d]ebt collection is not a proper purpose of bankruptcy"); Bankers Trust Co. v. Nordbrock (In re Nordbrock), 772 F.2d 397, 398 (8th Cir. 1985) (finding single petitioning creditor filed in bad faith by using the bankruptcy court "as a forum for the trial and collection of an isolated disputed claim"); Smith, 243 B.R. at 197 ("[C]ourts have been reluctant to entertain a one creditor case absent a showing that bankruptcy can do something for the creditor that state law can not [sic]"); In re Kass, 114 B.R. 308, 309 (Bankr. S.D. Fla. 1990) (treating the involuntary petition as essentially a two-party dispute and stating that "[d]ismissal should be granted where the Court finds that the petitioning creditors have

(continued...)

¶ 303.04[5] (stating public policy to protect prospective debtors involved in a two-party dispute). Generally, courts which invoke the "single creditor rule"[22] will order relief in a single-creditor involuntary case if: (1) there is a showing of fraud or artifice on the part of the debtor; or (2) the debt is not otherwise recoverable under state law. See, e.g., Concrete Pumping Serv., Inc. v. King Constr. Co. (In re Concrete Pumping Serv., Inc.), 943 F.2d 627, 630 (6th Cir. 1991); H.I.J.R. Props. Denver v. Schideler (In re H.I.J.R. Props. Denver), 115 B.R. 275, 278 (D. Colo. 1990).

The Fifth Circuit has indicated that the policy reasons for the three-creditor requirement under § 303(b)(1) are "(1) 'the fear that involuntary bankruptcy might be used by one or two recalcitrant creditors as a means of harassing an honest debtor'; and (2) 'the possibility that the threat of an involuntary petition would be used to compel the debtor to make preferential payments to one or more litigious creditors.'" Subway Equip. Leasing Corp. v. Sims (In re Sims), 994 F.2d 210, 217 (5th Cir. 1993), (emphasis added) (quoting 2 Collier on Bankruptcy

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[21](...continued)
adequate State law remedies"); In re Dwoskin, 24 B.R. 41, 42 (Bankr. S.D. Fla. 1982) (holding that petition should be denied unless the judgment creditor "would otherwise be without an adequate remedy under non-bankruptcy law").

[22] The "single creditor rule" arises from the notion that failure to pay the debt of a particular creditor will not justify an involuntary petition, or in other words, will not lead to the conclusion that the debtor is not generally paying his debts as they become due. See H.I.J.R. Props. Denver, 115 B.R. at 279.

¶ 303.08[12][a], at 303-42 (1993)). See also Collier on Bankruptcy, supra, ¶ 303.04[2]. Therefore, the fear that a single creditor may use involuntary bankruptcy to harass the debtor may also apply to a two-creditor scenario.

Some courts have opened the possibility that the rule against single-creditor involuntary petitions could also apply to a two-creditor scenario. In Kass, 114 B.R. 308, five creditors filed an involuntary petition against the debtor after being frustrated in their efforts to obtain relief in a pending divorce litigation in state court.[23] The debtor objected to the petition. The bankruptcy court found that all the claims were related to the dissolution proceeding and therefore the involuntary petition was essentially a two-party dispute. See Kass, 114 B.R. at 308. Further, the bankruptcy court noted that all of the creditors' claims were pending in state court litigation and that their frustration in obtaining relief did not constitute a basis for allowing an involuntary petition to proceed. Therefore, the court granted a dismissal because "the petitioning creditors are attempting to use the Bankruptcy Court as an alternative to proceeding with pending State Court litigation to resolve what is essentially a two-party dispute." Id. at 309.[24] The Kass court clearly stated: "Dismissal should

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[23] The petitioning creditors were the debtor's ex-wife, three attorneys and one accountant who provided services to the ex-wife. Kass, 114 B.R. at 308.

[24] Even though there were technically more than one (continued...)

be granted where the Court finds that the petitioning creditors have adequate State law remedies." Id. at 309. Accord In re Petro Fill, Inc., 144 B.R. 26, 30 (Bankr. W.D. Pa. 1992) ("An involuntary petition should be dismissed where petitioning creditors have adequate remedies under state law.").

To the extent that "bad faith" is measured by an objective test in the Ninth Circuit, the pertinent question is whether the Petitioning Creditors acted reasonably in filing the involuntary petition. Wavelength, 61 B.R. at 619; Collier on Bankruptcy, supra, ¶ 303.06[1].

Although the Petitioning Creditors believed that the state court procedures were "equally effective," they decided not to take full advantage of their state law remedies because "it looked . . . like Mr. Pete was going to eventually file bankruptcy anyway." Tr. of Proceedings, (Jan. 23, 2002), at 103. According to the Petitioning Creditors, "because of the lack of cooperation on the part of Mr. Pete," they decided "to fast forward that track, skip the spending of the money on the state court procedures, and try and economize by getting it done in the bankruptcy court where all of the same relief is available as well." Id.

There was evidence that the Petitioning Creditors attempted

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[24](...continued)
creditor, the court treated the proceeding as a "two-party dispute" because the creditors' claims were related. Id. at 308. It is unclear from the excerpts of record whether the state judgments awarded to the Petitioning Creditors were related.

to collect their judgments under state law, but Pete did not cooperate. According to the bankruptcy court:

> the petitioning creditors made sufficient attempts to collect their judgments prior to filing the petition. At least one garnished debtor's bank account but, according to Mr. Gemignani's testimony, only succeeded in collecting approximately $65. The petitioning creditors also sent debtor a demand letter, requesting payment or payment arrangements . . . Charles Markley, an attorney who represented the petitioning creditors, testified that the petitioning creditors' attempts to collect their judgments were met with consistent refusals to pay or make payment arrangements.

Letter Opinion (Feb. 1, 2002), at 10. On appeal, Pete conceded these facts and added that the Petitioning Creditors' attorney made several telephone calls to Debtor's attorney, presumably to collect debts. Therefore, even though the Petitioning Creditors did not exhaust their state law remedies, the bankruptcy court's finding that an involuntary bankruptcy was a reasonable course of action was not clearly erroneous.

On appeal, Pete relies on Atlas Mach., Smith, and In re Broshear, 122 B.R. 705 (Bankr. S.D. Ohio 1991), to support his contention that the Petitioning Creditors' involuntary petition was filed in bad faith because they did not exhaust their state remedies. These cases are distinguishable.

In Atlas Mach., a single creditor filed an involuntary petition against the debtor after it failed to pay a debt pursuant to a settlement agreement. Under the settlement agreement, the creditor was required to satisfy the debt first through foreclosure on the debtor's property. The creditor made several unsuccessful attempts to collect the debt before filing

the involuntary petition. See Atlas Mach., 986 F.2d at 711-12. However, the court dismissed the petition for bad faith, finding that the creditor was aware that the debtor had more than twelve creditors. Further, the court found that the creditor filed the petition solely for the improper purpose of debt collection. Id. at 716. Here, unlike the creditor's awareness in Atlas Mach., there was no evidence that the Petitioning Creditors knew that Pete had twelve or more creditors at the time of their filing.[25]

In Smith, a single corporate creditor filed an involuntary petition against the debtor. The bankruptcy court subsequently dismissed the case because, among other reasons, it found that the creditor filed the involuntary petition in bad faith. Smith, 243 B.R. at 173, 194-97. Specifically, the court found that the creditor was the only creditor complaining about the debtor's financial problems and admitted, in trial, that the case "boil[ed] down to a two-party dispute." Id. at 197. According to the creditor, it filed an involuntary petition because the debtor was fraudulently transferring assets. Id. at 196. However, the bankruptcy court held that such transfers could be set aside under state law. The court dismissed the case because

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[25] At the trial, Pete's attorney attempted to prove that the Petitioning Creditors knew that there were twelve or more creditors through Mr. Gemignani's testimony that he had seen a copy of the creditor list in Pete's related corporate bankruptcy case. The court sustained an objection to this evidence on the grounds of relevance, because such list did not prove Pete's personal debts. The court also declined to take judicial notice of the list, which was unavailable in the courtroom. See Tr. of Proceedings (Jan. 23, 2002), at 94-96. Pete has not challenged the court's evidentiary rulings in this matter.

there was no evidence that the creditor even attempted to recover the transfers under state law and, thus, the creditor had not shown that its state court remedies were inadequate. Id. at 198. Furthermore, the court found that the creditor filed the petition as a means to avoid collecting its debt under state law. Id. Here, unlike Smith, there was evidence that the Petitioning Creditors made numerous unsuccessful attempts to collect their judgments under state law.

In Broshear, an involuntary petition was initially filed against the debtor by a single creditor, and was later joined by two additional creditors. The creditors and the debtor entered into an agreement to pay the creditors and dismiss the petition. A day before the entry of the dismissal order, CBS, another creditor of the debtor, filed a request for additional time to object to dismissal because it did not receive notice of the dismissal. The court overruled the motion on the condition that the creditors return to the debtor any benefits that they received under the settlement. The court found merit in CBS's motion because policy considerations did not favor initiation of an involuntary bankruptcy "in furtherance of debt collection activities by a creditor or creditors against a debtor" to the exclusion of other creditors who did not participate in the case. Broshear, 122 B.R. at 707-08. Here, there was no settlement between the Petitioning Creditors and Pete. Therefore, the Petitioning Creditors did not benefit to the exclusion of other creditors by means of the involuntary

petition.

In summary, the bankruptcy court did not err in concluding that the Petitioning Creditors filed the involuntary petition in good faith. See Wavelength, 61 B.R. at 619; Collier on Bankruptcy, supra, ¶ 303.06[1]. First, there is no per se rule requiring petitioning creditors to exhaust their state remedies before filing an involuntary petition. Rather, the inquiry of bad faith is fact intensive. Here, Pete's only bad-faith argument on appeal was that the Petitioning Creditors failed to exhaust their state remedies before filing the involuntary petition. This fact alone was insufficient to find bad faith.

Second, the Petitioning Creditors' actions did not support a finding of bad faith. The Petitioning Creditors attempted to collect their state judgments utilizing remedies available under state law, and Pete consistently refused to pay.[26] The court also found that the Petitioning Creditors reasonably relied on their attorney's advice that a debtor's examination would not be useful, in light of Pete's unresponsiveness. These findings were not clearly erroneous. Furthermore, there was no evidence that the Petitioning Creditors knew that Pete had twelve or more

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[26] In their demand letter, the Petitioning Creditors indicated that they believed Pete was engaging in fraudulent transfers to dispose of his assets. According to the bankruptcy court, the Petitioning Creditors' belief would suggest that they filed the petition in good faith because they believed that "a court supervised disposition of debtor's assets, such as is available in a chapter 7 case, was necessary." Letter Opinion (Feb. 1, 2002), at 10 n.8.

creditors at the time they filed the involuntary petition.[27] In examining all of the circumstances, the court found that bankruptcy court was the proper forum for the marshaling of Pete's assets to pay the two unsatisfied state court judgments. The involuntary petition also protected Pete from multiple collection activities.

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[27] The "reasonable person" test may also include "a review of the petitioner's pre-filing inquiries into the total number of claim holders . . . ." In re Caucus Distrib., Inc., 106 B.R. 890, 924 (Bankr. E.D. Va. 1989). However, Pete has not preserved this issue on appeal.

The trial transcript shows that the court sustained an objection, on the basis of relevance, to Pete's attorney's line of questioning concerning the Petitioning Creditors' duty to investigate Pete's creditors. See Tr. of Proceedings (Jan. 23, 2002), at 87. The court then noted that the Petitioning Creditors filed as separate creditors, believing that they would also meet any three-creditor requirement. Therefore, the court found that the Petitioning Creditors were reasonable in not making any allegations with regard to the number of Pete's creditors. Letter Opinion (Feb. 1, 2002), at 11.

In a footnote in his opening brief, and then more extensively in his reply brief, Pete argues that the Petitioning Creditors' petition was filed in bad faith because they made no efforts to determine who Pete's creditors were prior to filing. See Appellant's Opening Brief (June 26, 2002), at 11 n.8 and Appellant's Reply Brief (Aug. 15, 2002), at 6. Pete's mere mention of this issue in a footnote and presenting argument for the first time in the reply brief is inadequate to preserve any challenge to the court's findings, and, thus, he has waived this issue. See Branam v. Crowder (In re Branam), 226 B.R. 45, 55 n.10 (9th Cir. BAP 1998), aff'd mem., 205 F.3d 1350 (9th Cir. 1999) (issues discussed in headnote-type statements were deemed abandoned); St. Paul Fire & Marine Ins. Co. v. Fort Vancouver Plywood Co. (In re Brazier Forest Products, Inc.), 921 F.2d 221, 224 n.2 (9th Cir. 1990) (court would not consider matter raised for the first time in appellant's reply brief); Miller v. Fairchild Industries, Inc., 797 F.2d 727, 738 (9th Cir. 1986) (appellate courts will not "consider matters on appeal that are not specifically and distinctly argued in appellant's opening brief").

Therefore, the bankruptcy court did not err in determining that the Petitioning Creditors acted reasonably and that they filed the involuntary petition in good faith.

## CONCLUSION

The prospective involuntary debtor, in the Ninth Circuit, must prove the number of his creditors if he asserts a defense that the petition is deficient in the proper number of petitioning creditors. Pete alleged the existence of twelve or more creditors, and then he obstructed the Petitioning Creditors' discovery efforts concerning such creditors. The court properly sanctioned Pete by precluding his evidence of the alleged other creditors, who were the subject of the disregarded discovery orders.

The court's findings that there were only five creditors, that Pete was generally not paying his debts as they came due, and that the involuntary petition was filed in good faith were not clearly erroneous.

The court's order for relief is therefore AFFIRMED.