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04/01/2005

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TEXAS
SHERMAN DIVISION

In re:	§	
	§	
TEXAS BARCODE SYSTEMS, INC.,	§	Case No. 05-40123
	§	
Alleged Debtor.	§	

ORDER REGARDING EXPEDITED DISCOVERY REQUEST AND REQUESTS FOR PROTECTIVE ORDER

This matter is before the Court on the *Motion for Protective Order and/or to Quash Subpoena Duces Tecum* filed by Edward A. Pietzsh, Ron McDearmon, John H. Thomas and Ralph Patterson; the *Motion for Leave to Take Expedited Discovery* (the "Expedited Discovery Request") filed by Texas Barcode Systems, Inc. ("TBS"); and the *Petitioners' Motion for Protective Order and Objection to Debtor's Motion for Leave to Take Expedited Discovery* filed by John H. Thomas, PSC, Inc. and Zebra Technologies, Inc. The Court heard arguments regarding the motions on January 25, 2005. At the conclusion of the hearing, the Court invited the parties to submit additional briefing on the requirements for the initiation of an involuntary bankruptcy petition.

Procedural History

On January 5, 2005, an involuntary bankruptcy petition was filed against TBS by Edward A. Pietzsh, Ron McDearmon, Ralph Patterson, John H. Thomas, PSC, Inc., and Zebra Technologies, Inc. (collectively, the "Petitioning Creditors").

On January 7, 2005, TBS served Notices of Deposition and Subpoena Duces Tecum upon Messrs. McDearmon, Pietzsh, and Patterson. The Notices scheduled the depositions and production of documents for January 12, 2005.

On January 11, 2005, Messrs. McDearmon, Pietzsh, and Patterson filed a *Motion for Protective Order and/or to Quash Subpoena Duces Tecum*.

On January 13, 2005, Messrs. McDearmon, Pietzsh, and Patterson filed a *Notice of Withdrawal and/or Dismissal Without Prejudice* wherein they stated that "Movants no longer wish to pursue their claims at this time."

On January 17, 2005, TBS filed a *Motion to Dismiss, Motion for Judgment, and, Alternatively, Motion for Abstention* (the "Motion to Dismiss") pursuant to Rule 7012(b)(1) of the Federal Rules of Bankruptcy Procedure and 11 U.S.C. §§ 303(i) and 305.

TBS filed the Expedited Discovery Request on January 19, 2005.

The next day, January 20, 2005, the remaining Petitioning Creditors filed the *Petitioners' Motion for Protective Order and Objection to Debtor's Motion for Leave to Take Expedited Discovery*.

On March 7, 2005, TBS filed an answer to the involuntary petition subject to and without waiving the relief requested in its Motion to Dismiss.

The issue at the hearing on January 25, 2005, was whether TBS should be permitted to take discovery from the Petitioning Creditors relating to whether the involuntary petition was filed in bad faith. The Petitioning Creditors argued that good faith is not a statutory requirement for filing an involuntary petition and that

bad faith would only become relevant if the Court determines that the involuntary petition should be dismissed. Further, the Petitioning Creditors argued that the requested discovery relates to matters that have no bearing on whether the Petitioning Creditors filed the involuntary petition in good faith. The Petitioning Creditors also objected to the discovery propounded upon the three individuals who have since withdrawn from this case.

Following the hearing, John H. Thomas, PSC, Inc., and Zebra Technologies, Inc. responded to TBS' discovery requests. The respondents interposed broad objections to many of TBS' discovery requests based on their request for a protective order from this Court, among other things.

On March 22, 2005, TBS filed a *Motion to Compel Discovery*. John H. Thomas, PSC, Inc. and Zebra Technologies, Inc. objected to TBS' motion on the same day.

Discussion

In general, Bankruptcy Rule 1013 requires the Court to dispose of involuntary petitions as quickly as is practicable within the time limits imposed by Bankruptcy Rule 1011(b). Bankruptcy Rule 1011(b) states that normally a debtor has 20 days after service of the summons to serve and file an answer or a motion. This mandate to speedily resolve an involuntary petition recognizes that an involuntary petition often represents a substantial interference with the debtor's operations and will likely adversely affect the debtor's reputation.

In this case, the alleged debtor has contested the involuntary petition. The procedure for resolving a contested involuntary petition has many of the attributes of an adversary proceeding governed by Part VII of the Bankruptcy Rules, which are derived largely from the Federal Rules of Civil Procedure. In particular, Bankruptcy Rule 1018 provides in pertinent part:

> The following rules in Part VII apply to all proceedings related to a contested involuntary petition …: Rules 7005, 7008-7010, 7015, 7016, 7024-7026, 7028-7037, 7052, 7054, 7056 and 7062.

FED.R.BANK.P. 1018.[1] Additionally, Bankruptcy Rule 1018 permits the Court to direct that some of these rules will be inapplicable in a particular case, or to direct that other rules in Part VII will be applied. *See, e.g.*, *In re Blackwell*, 270 B.R. 814, 817-18 (Bankr. W.D. Tex. 2001) (service under Fed.R.Bankr.P. 7004 not required under Bankruptcy Rule 1018).

The issue currently before the Court is whether TBS may seek discovery from the Petitioning Creditors in order to determine whether the petition was filed in good faith pursuant to §303(b). In contrast to §303(i)(2) -- which generally provides that if a court dismisses an involuntary petition, the debtor may seek judgment against any petitioner that filed the petition in bad faith -- §303(b) does

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[1] The 1983 Advisory Committee Note to Rule 1018 states:
Because of the special need for dispatch and expedition in the determination of the issues in an involuntary petition, see *Acme Harvestor Co. v. Beekman Lumber Co.*, 222 U.S. 300, 309 (1911), the objective of some of the Federal Rules of Civil Procedure and their adaptation in Part VII to facilitate the settlement of multiple controversies involving many persons in a single law suit is not compatible with the exegesis of bankruptcy administration. *See United States F.&G. Co. v. Bray*, 225 U.S. 205, 218 (1912) For that reason Rules 7013, 7014 and 7018-7023 will rarely be appropriate in a proceeding on a contested petition.

not address the bad faith of petitioning creditors. Thus, the Petitioners argue that the issue of "bad faith" is not before the Court.

There is no express requirement that petitioning creditors must commence an involuntary petition in good faith. Section 303(b) dictates who can properly file an involuntary case against an eligible debtor, as follows:

> (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--
> (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 $10,000 more than the value of any lien on property of the debtor securing such claims held by the holder of such claims;
> (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 under section 544, 545, 547, 548, 549, or 724(a) of this title, by one or more of such holders that hold in the aggregate at least $10,000 of such claims;

11 U.S.C. §303(b). However, "since section 303(i) specifically refers to bad faith filings, it is generally agreed that involuntary filings must be in good faith and that consequences flow if they are not." COLLIER ON BANKRUPTCY ¶ 303.06 (15th ed. rev.); *see, e.g., Atlas Mach. & Iron Works, Inc. v. Bethlehem Steel Corp*., 986 F.2d 709 (4th Cir. 1993) (petitioner not permitted to correct defect in petition where petitioner admitted it filed petition in order to collect debt); *In re WLB-RSK Venture*, 296 B.R. 509 (Bankr. C.D. Cal. 2003) (holding that although petitioner had standing to file petition, petition was filed as a litigation tactic and would be dismissed pursuant to §105(a)). Moreover, "[w]hen an original petition is filed in bad faith, intervention of a good faith creditor does not normally purge the taint of

the original creditor's bad faith in filing." *In re Norriss Brothers Lumber Co.*, 133 B.R. 599, 608 (Bankr. N.D. Tex. 1991) (collecting cases).

It has long been recognized that using the bankruptcy process to promote individual interests not consistent with the purposes of the Bankruptcy Code is an abuse of the bankruptcy courts. As the Fifth Circuit stated in *In re Walden*, 781 F.2d 1121 (5th Cir. 1986), "[a]n allegation of bankruptcy invokes remedies not available to any ordinary debt collection procedures. It should not be invoked unadvisedly and contrary to statutory right." *Id.* at 1123. 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 §§303(b), as the Petitioning Creditors argue here. *See Paradise Hotel Corp. v. Bank of Nova Scotia*, 842 F.2d 47, 52 (3rd Cir. 1988) ("We believe it would be inconsistent with the overall scheme of the Code to find that §303(i)(2) is an exclusive remedy for [claims arising from improper filings of bankruptcy petitions].").

In re Knoth, 168 B.R. 311 (Bankr. D.S.C. 1994), which is cited by the Petitioning Creditors, is readily distinguishable. The bankruptcy court in *In re Knoth* briefly addressed the question of bad faith sanctions after a trial on the merits of the petition. *In re Immudyne*, 218 B.R. 860 (Bankr. S.D. Tex. 1998), which is also cited by the Petitioning Creditors, reflects that a bankruptcy court must balance the need for discovery against the need for the alleged debtor to transact its business in the ordinary course. To the extent the bankruptcy court in

In re Immundyne held that the issue of bad faith was not properly before it on a motion to dismiss an involuntary petition, that portion of the decision does not cite any cases or other authority and is contrary to the weight of authority reviewed by this Court.

The Court has found no guidance from the Fifth Circuit regarding the proper test for determining whether an involuntary petition was filed in bad faith. Other courts have used several standards for determining bad faith, including an improper purpose test, an improper use test, an objective test, a subjective test, and the Bankruptcy Rule 9011 standard. *See Lubow Machine Co., et al. v. Bayshore Wire Products Corp. (In re Bayshore Wire Products Corp.)*, 209 F.3d 100, 105 (2nd Cir. 2000) (surveying the different tests for determining "bad faith"); COLLIER ON BANKRUPTCY ¶303.06 (15th ed. rev.). The Bankruptcy Rule 9011 standard combines the subjective and objective tests. In particular,

> "[a]n analysis under Rule 9011 inquires into 'a significant objective requirement bearing on the legal justification of a claim or defense: a reasonable inquiry into the facts and the law.' In addition to requiring an objective inquiry, Rule 9011 requires a subjective inquiry as well: the bankruptcy proceeding cannot have been interposed for an improper purpose, 'such as to harass, to cause delay, or to increase the cost of litigation.'"

General Trading Inc. v. Yale Materials Handling Corp., 119 F.3d 1485 (11th Cir. 1997) (citing *In re Turner*, 80 B.R. 618, 623 (Bankr. D. Mass. 1987)).

In the absence of any authority from the Fifth Circuit on the issue of how to determine whether an involuntary petition was filed in bad faith, the Court believes that bad faith should be measured by the broad standards of Bankruptcy

Rule 9011. Bankruptcy Rule 9011 tracks Rule 11 of the Federal Rules of Civil Procedure, applies to lawyers as well as parties, and covers all pleadings and motions. Further, Bankruptcy Rule 9011 appears to encompass all of the various indicia of bad faith. It is therefore logical to adopt its standards in a challenge under §303(b) in order to avoid conflicting standards. *See In re Crown Sportswear, Inc*., 575 F.2d 991, 993 (1st Cir. 1978) (applying the Rule 11 standard to a motion to dismiss involuntary petition); *In re Turner*, 80 B.R. 618, 623 (Bankr. D. Mass. 1987); (applying the Rule 11 standard to a §303(i)(2) case); *see also Keiter v. Stracka*,192 B.R. 150 (S.D.Tex. 1996) (affirming Rule 9011 sanctions award against attorney for the bad faith filing of an involuntary petition).

It is TBS' burden to establish that the involuntary petition was filed in bad faith by the Petitioning Creditors. *See, e.g., Atlas Mach.*, 986 F.2d at 716 n.8 (collecting authority); *In re Val W. Poterek & Sons, Inc.*,169 B.R. 896 (Bankr. N.D. Ill. 1994). Messrs. Pietzsh, McDearmon and Patterson did not purge their bad faith, if any, by withdrawing from this case, and each of the original Petitioning Creditors should be required to respond to discovery propounded by TBS on an expedited basis to the extent it relates to (1) whether the Petitioning Creditors had standing to file the involuntary petition against TBS under §303(b)(1); (2) whether the Petitioning Creditors made a reasonable inquiry into relevant facts and pertinent law prior to filing the involuntary petition; (3) whether the involuntary petition was well grounded in fact; (4) whether the involuntary filing was warranted by existing law or by a good faith argument for change in the

current law; and (5) whether the filing was undertaken for an improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation.

It is therefore ORDERED that the *Motion for Protective Order and/or to Quash Subpoena Duces Tecum* filed by Edward A. Pietzsh, Ron McDearmon, John H. Thomas and Ralph Patterson and the *Petitioners' Motion for Protective Order and Objection to Debtor's Motion for Leave to Take Expedited Discovery* filed by John H. Thomas, PSC, Inc. and Zebra Technologies, Inc. shall be, and are hereby, DENIED; except any confidential trade secret information of the Petitioning Creditors shall be submitted only to counsel for TBS and counsel for TBS shall be prohibited from disseminating such information without first obtaining a further order from this Court; and it is further

ORDERED that the Expedited Discovery Request shall be, and hereby is, GRANTED as follows:

1. The Court expects counsel to confer regarding a mutually agreeable discovery schedule and scope and to cooperate regarding discovery;
2. Each of the original Petitioning Creditors shall respond to the discovery propounded by TBS within ten (10) days of the date of this Order unless the parties agree otherwise; and
3. Each of the Petitioning Creditors shall respond to the discovery propounded by TBS to the extent the discovery relates to (1) whether the Petitioning Creditors had standing to file the involuntary petition

against TBS under §303(b)(1); (2) whether the Petitioning Creditors made a reasonable inquiry into relevant facts and pertinent law prior to filing the involuntary petition; (3) whether the involuntary petition was well grounded in fact; (4) whether the involuntary filing was warranted by existing law or by a good faith argument for change in the current law; and (5) whether the filing was undertaken for an improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation.

Signed on 4/1/2005

Brenda T. Rhoades MD

HONORABLE BRENDA T. RHOADES,
UNITED STATES BANKRUPTCY JUDGE