Lack of Business Trust

Not all types of entities are eligible to be debtors under the federal bankruptcy statute. A business trust is included within the definition of eligible debtors, but the statute does not provide guidance to determine whether a particular trust is a "business trust". A federal judge in Maryland recently provided guidance on this issue.

A creditor filed involuntary petitions against two trusts against which the creditor had obtained judgments. The trusts held assets which included equity and/or debt interests in multiple corporate entities, but did not own any physical property and did not have any employees. The trusts each filed a motion in the bankruptcy court to dismiss the involuntary petitions, arguing that they were not "business trusts" and were ineligible to be debtors in bankruptcy. The bankruptcy judge agreed and dismissed the petitions. The judgment creditor appealed.

In affirming the decision of the bankruptcy judge, the district judge explained that the determination as to whether these were business trusts was fact specific and focused on the purpose and operations of the trusts. Did the trusts exist for the purpose of conveying assets to family members or for the purpose of furthering business activities? Only the second purpose would sustain the involuntary petitions against the trust.

The court explained that the following factors indicated testamentary trusts rather than a business trusts: (1) the trusts were irrevocable; (2) the trust documents stated that each trust's primary purpose was to act as a resource for the family; (3) the beneficiaries of the trusts were family members; (4) the trusts had no employees, bank accounts or creditors (other than the judgment creditor); and (5) the trusts were structured as estate planning and strategic tax planning devices.

Creditor Cannot Use Involuntary Bankruptcy as Collection Tool

In the same case, the court also dismissed the involuntary petitions against the trusts on entirely independent grounds.

By way of background, it generally requires three creditors to file an involuntary bankruptcy petition against a debtor. If the debtor has less than 12 total creditors (excluding insiders), only one creditor is required to file an involuntary petition.

The court added its own gloss to the statute and determined that where there are no other creditors with an interest in pursuing claims against the debtor, an involuntary petition "cannot be used as a single creditor collection device." The court reasoned that appointing a Chapter 7 trustee and invoking the substantial powers of the bankruptcy court would add nothing to the collective benefit of creditors, as only one creditor was known, and would impose costs on the bankruptcy system. The creditor would have to use other methods to collect its judgment.

Rae v. 2002 John C. Erickson GST Trust, 2021 U.S. Dist. LEXIS 77673 (D. Md. 2021)

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