A Primer on Involuntary Bankruptcy Cases

A Useful but Precarious Option for Creditors

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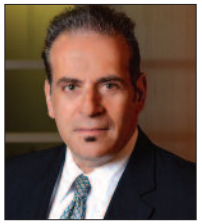

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A bankruptcy case is normally commenced by a debtor that voluntarily files a petition for relief under one of the chapters of the U.S. Bankruptcy Code (*i.e.*, usually Chapter 7 or 11). The filing is usually precipitated by some type of liquidity crisis and/or in response to some action taken against the debtor or its property by one or more of its creditors. For example, many voluntary bankruptcies are filed in response to lawsuits, including foreclosure proceedings, initiated by creditors, or in response to a judgment creditor seeking to levy against a debtor's assets. A voluntary bankruptcy filing by the debtor provides the debtor with various benefits. For example, a bankruptcy filing operates as an automatic stay, applicable to all entities, from, among other things, commencing actions or continuing any actions to enforce their claims or liens against the debtor or its property.[1] Additionally, the filing of a bankruptcy petition is designed to provide the debtor with an opportunity for a fresh start, which potentially may include a discharge of all pre-bankruptcy debts, while at the same time ensuring an "equality of distribution among the creditors of the debtor."[2]

Despite the fact that bankruptcy often provides a debtor with potential benefits, in some circumstances, a debtor may choose not to voluntarily file for bankruptcy despite the fact that it is unable to pay its debts as those debts become due, or despite the fact that creditors are taking actions against the debtor or its property. Under these circumstances, the failure by a debtor to voluntarily file for bankruptcy may potentially create a conundrum for creditors who may want the debtor to be the subject of a bankruptcy case. In these situations, one of the tools potentially available to creditors is to file an involuntary bankruptcy petition against a debtor, wherein creditors seek to place a debtor in a bankruptcy case on an involuntary basis. However, as discussed in further detail herein, the filing of an involuntary bankruptcy petition is a serious matter that requires careful thought and analysis, and may result in serious consequences if pursued incorrectly or improperly.

What is an Involuntary Bankruptcy?

Section 303 of the code governs involuntary bankruptcy cases[3] and permits creditors to commence a bankruptcy case against a debtor under either Chapter 7 or Chapter 11 of the code[4] if certain statutory criteria are satisfied. Involuntary bankruptcy cases are generally filed to prevent a debtor from engaging in actual or potential fraud or mismanagement, to preserve valuable causes of action (such as avoidance-type actions), to allow for the fair distribution of a debtor's assets pursuant to the priority scheme set forth in the code and/or to prevent certain creditors from seizing the debtor's assets and gaining preferential treatment over other creditors. In other words, an involuntary bankruptcy case is an important tool for creditors to preserve value and/or to prevent diminution of value of the debtor's assets.

How to Commence an Involuntary Bankruptcy Case

In order to initiate an involuntary bankruptcy case, a creditor (or creditors, which is generally the case) must file an involuntary bankruptcy petition against the debtor with the bankruptcy court,[5] and must serve that petition, along with a summons, on the debtor.[6] The filing of the involuntary petition begins a civil action before the bankruptcy court, whereby the petitioning creditor or petitioning creditors[7] request the bankruptcy court to enter an 'order for relief'[8] against the debtor.

If the debtor has 12 or more creditors, at least three petitioning creditors are required to participate in filing the involuntary petition.[9] However, if a debtor has less than 12 creditors, a single creditor may itself file the involuntary petition.[10]

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In addition to the foregoing numerosity requirements, the claims of each of the petitioning creditors must satisfy the following:

1. each petitioning creditor must hold a claim that is not contingent as to liability[11] or the subject of a bona fide dispute as to liability or amount;[12] and
2. the petitioning creditors' claims must aggregate at least $15,775[13] more than the value of any lien on property of the debtor securing such claims held by the holders of such claims.[14]

In order for the bankruptcy court to enter an order for relief against the debtor, the petitioning creditors must also demonstrate the following: 1) that the debtor is generally not paying its debts as they become due, or 2) within

120 days before the petition date, a custodian, other than a trustee, receiver or agent appointed or authorized to take charge of less than substantially all of the debtor's property for the purpose of enforcing a lien against such property, was appointed or took possession.[15]

The 'Gap Period'

In a voluntary bankruptcy case, the filing by the debtor of the petition triggers and constitutes an order for relief.[16] In contrast, in an involuntary bankruptcy case the entry of the order for relief is delayed while the debtor is offered an opportunity to contest the involuntary filing and/or the bankruptcy court is able to make a determination as to whether an order for relief should be entered. As a result, the filing of an involuntary bankruptcy case leaves the debtor in a state of limbo for the period between the date of the filing of the involuntary petition and the entry of the order for relief. This period is referred to as the gap period. During the gap period, unless the bankruptcy court orders otherwise, a debtor may continue to operate its business in the ordinary course, including using, acquiring and disposing of property, as if the involuntary petition had not been commenced.[17] Despite the foregoing, the filing of the involuntary petition triggers certain fundamental bankruptcy protections, including the creation of a bankruptcy estate[18] and the protection afforded by the automatic stay.[19]

There are various additional protections afforded to both a debtor and its creditors during the gap period. For example, in order to preserve the *status quo* and allow the debtor to continue to operate in the ordinary course, the claims of creditors arising in the ordinary course of the debtor's business course during the gap period are afforded priority over general pre-bankruptcy unsecured claims,[20] which is designed to encourage ordinary creditors to continue to do business with the debtor during the gap period. Additionally, after notice and a hearing, a debtor, upon a showing of cause, may require the petitioning creditors to post a bond to indemnify the debtor for amounts the bankruptcy court may later allow as due to the debtor if the case is dismissed.[21] Further, during the gap period, parties-in-interest may seek the appointment of an interim trustee to take possession of the debtor's property and operate the debtor's business to the extent necessary to preserve property or prevent loss to the estate.[22]

Responding to an Involuntary Petition

A debtor has 21 days from the service of the summons to respond to the involuntary petition.[23] If there exists no basis to contest the involuntary petition, a debtor can simply not contest the involuntary petition, by either filing an answer affirmatively consenting to entry of the order for relief or choosing not to respond at all to the involuntary petition. In either case, assuming the petitioning creditor(s) properly filed the involuntary petition, the bankruptcy court will presumably enter an order for relief, and the bankruptcy case will thereafter proceed similar to that of a voluntary bankruptcy case.[24] However, even if the debtor consents to entry of an order for relief, the debtor may nonetheless seek to convert the case to a case under another chapter.[25]

Alternatively, the debtor may contest the involuntary bankruptcy petition by timely responding to the involuntary petition by way of answer, motion to dismiss or motion to abstain. In responding to the involuntary petition, the debtor may assert various defenses to entry of the order for relief, including, among other things, that: 1) the debtor is ineligible to be an involuntary debtor; 2) the venue is improper; 3) the petitioning creditors fail to satisfy the requirements of Section 303(b) of the U.S. Bankruptcy Code (*i.e.*, inadequate number of petitioning creditors, petitioning creditor's claims are contingent and/or subject of *bona fide* dispute); or 4) the involuntary petition was filed fraudulently, for an improper purpose or in bad faith. In the event the involuntary petition is contested, the bankruptcy court would be called upon to adjudicate the issue of whether to enter an order for relief.

In determining whether to enter an order for relief, the bankruptcy court must also determine whether: 1) the debtor is generally not paying its debts when they become due, or 2) within 120 days before the date of the filing of the petition, a custodian, other than a debtor, receiver, or agent appointed or authorized to take charge of less than substantially all of the property of the debtor for the purpose of enforcing a lien against such property, was appointed or took possession.[26] The petitioning creditors' failure to meet these requirements is a basis for dismissal of the involuntary case.

If the petitioning creditors are successful, and the bankruptcy court enters an order for relief, the bankruptcy case will thereafter proceed in the ordinary course. If not, and the bankruptcy court ultimately decides to dismiss the involuntary petition, as set forth below, the petitioning creditors may potentially face consequences, which could be severe.

Dismissal and the Consequences of Filing an Involuntary Bankruptcy Case

A bankruptcy court may dismiss an involuntary bankruptcy petition for various reasons. Alternatively, a court may choose to abstain from the involuntary case if, after notice and hearing, the court determines that such action is in "the interest of creditors and the debtor would be better served by such dismissal or suspension."[27] For example, courts have dismissed or abstained from involuntary cases on the following grounds: 1) the petitioning creditors' claims are

pending in a state court proceeding; 2) allowing the case to remain in bankruptcy court would be inefficient and costly; 3) allowing the case to remain in bankruptcy court would cause prejudice to other creditors; and 4) the petitioner sought bankruptcy jurisdiction for an improper purpose.[28]

The bankruptcy court will dismiss an involuntary petition after notice and a hearing under the following circumstances: 1) upon motion of a petitioner, 2) on consent of all petitioners and the debtor, or 3) for lack of prosecution.[29] Additionally, the bankruptcy court may dismiss an involuntary petition other than on consent of all the petitioning creditors and the debtor. If this occurs, the bankruptcy court may grant judgment against the petitioning creditors and in favor of the debtor for costs or for reasonable counsel fees.[30] In fact, upon dismissal there exists a presumption that a debtor is entitled to costs and attorney's fees, and the award may include the fees incurred from preparing and litigating the motion to dismiss itself.[31] This presumption exists because of the extremely serious consequences for the debtor, including loss of credit standing, inability to carry on business affairs and public embarrassment.[32]

In determining whether to award compensatory damages, bankruptcy courts consider factors such as: 1) the merits of the involuntary petition, 2) the role of any improper conduct on the part of the alleged debtor, 3) the reasonableness of the actions taken by the petitioning creditors, and 4) the motivation and objectives behind the filing of the petition.[33]

Importantly, to the extent the bankruptcy court determines the petitioning creditors filed the involuntary petition in bad faith, the bankruptcy court may grant judgment against the petitioning creditors and in favor of the debtor for any damages proximately caused by the filing of the involuntary petition, or for punitive damages.[34] In assessing punitive damages, bankruptcy courts generally consider "the nature, extent, and enormity of the wrong, the intent of the party committing it and all circumstances attending the particular incident, as well as any mitigating circumstances which may operate to reduce without wholly defeating such damages, including financial position of defendant."[35]

Bankruptcy courts consider a number of factors in determining whether an involuntary petition was filed in bad faith, including, but not limited to, whether: 1) the creditors satisfied the statutory criteria for filing the petition; 2) the involuntary petition was meritorious; 3) the creditors made a reasonable inquiry into the relevant facts and pertinent law before filing; 4) there was evidence of preferential payments to certain creditors or of dissipation of the debtor's assets; 5) the filing was motivated by ill will or a desire to harass; 6) the petitioning creditors used the filing to obtain a disproportionate advantage for themselves rather than to protect against other creditors doing the same; 7) the filing was used as a tactical advantage in pending actions; 8) the filing was used as a substitute for customary debt-collection procedures; and 9) the filing had suspicious timing.[36]

This power by the bankruptcy court to award damages serves as an important safeguard by "ensur[ing] that the Bankruptcy Code's careful balancing of interests is not undermined by petitions whose aims are antithetical to the basic purposes of bankruptcy."[37]

Finally, a bankruptcy court may utilize Section 105(a) of the U.S. Bankruptcy Code to impose civil contempt sanctions on the wrongful petitioning creditors,[38] and may also impose sanctions against a petitioning creditor's counsel if the facts are sufficiently egregious.[39]

For these reasons, it is important that careful consideration and thought be given before deciding whether to file an involuntary petition.

Conclusion

If done properly, the filing of an involuntary bankruptcy petition can be an effective tool to preserve value. Certain situations warrant the use of this important tool. For example, if creditors suspect fraud or mismanagement on the part of the debtor, or if the filing is necessary to prevent the further transfer of assets by a debtor or to preserve valuable causes or action, an involuntary petition may be the appropriate course of action. However, if done hastily, incorrectly or without proper consideration or due diligence, filing an involuntary petition can be very costly for petitioning creditors. ⚖

Endnotes

1. 11 U.S.C. § 362(a).
2. Collier on Bankruptcy ¶ 1.01[1] (16th ed. 2018) (*quoting Union Bank v. Wolas*, 502 U.S. 151, 161 (1991)).
3. 11 U.S.C. § 303.
4. 11 U.S.C. § 303(a). Importantly, involuntary cases may only be commenced under Chapter 7 or Chapter 11 of the bankruptcy code, and not under Chapters 9, 12 and 13 of the bankruptcy code.
5. 11 U.S.C. § 303(b)(1). Importantly, an involuntary case may only be commenced against a person that may be a debtor under Chapter 7 or Chapter 11. *See* 11 U.S.C. § 303(a). Pursuant to Section 101(41) of the bankruptcy code, a "person" includes, among other things, an "individual, partnership and corporation." *See* 11 U.S.C. § 101(41). Farmers, family farmers and non-moneyed corporations are expressly excluded from being the subject of involuntary cases. *See* 11 U.S.C. § 303(a).

6. *See* Fed. R. Bankr. P. 1010.
7. The 'petitioning creditors' are the creditors who file the involuntary case.
8. An 'order for relief' refers to the court order that determines the debtor is subject to the control of the bankruptcy court.
9. 11 U.S.C. § 303(b). Note that specials rules can apply when determining who may serve as a petitioning creditor, including with respect to employees, insiders and recipients of transfers. These issues should be carefully analyzed prior to any filing.
10. *See* 11 U.S.C. § 303(b)(2).
11. The term 'contingent claim' is not defined in the bankruptcy code, but has been interpreted to mean a claim that is contingent as to liability, meaning a claim "as to which the debtor's obligation to pay does not come into being until the happening of some future event, and that event was within the contemplation of the parties at the time their relationship originated." 2 Collier on Bankruptcy ¶ 303.10[1] (16th ed. 2018).
12. The standard for the phrase "subject to a bona fide dispute" has been interpreted in several ways, although most courts now adopt an objective standard, as articulated by the Third Circuit: whether there are "'substantial' factual and legal questions raised by [the] debtor" as to the claim. *B.D.W. Assocs., Inc. v. Busy Beaver Bldg. Centers, Inc.*, 865 F.2d 65, 67 (3d Cir. 1989).
13. This amount applies to cases commenced on or after April 1, 2016, and is subject to increase at three-year intervals.
14. These general rules are slightly modified if there are fewer than 12 holders of claims, *see* 11 U.S.C. § 303(b)(2); if the person is a partnership, *see* 11 U.S.C. § 303(b)(3); or if the involuntary case is commenced by a foreign representative of the estate in a foreign proceeding concerning such person. *See* 11 U.S.C. § 303(b)(4).
15. 11 U.S.C. § 303(h).
16. 11 U.S.C. § 301(b).
17. 11 U.S.C. § 303(f).
18. 11 U.S.C. § 541(a).
19. 11 U.S.C. § 362. The automatic stay is one of the primary protections afforded by the bankruptcy code and prevents the debtor's pre-petition creditors from collecting debts from the debtor.
20. *See* 11 U.S.C. §§ 502(f) and 507(a)(3). Importantly, creditors whose claims arise during the gap period but that are *not* incurred by the debtor in its ordinary course of business are simply treated as pre-bankruptcy creditors. *See* 2 Collier on Bankruptcy ¶ 303.25[1] (16th ed. 2018).
21. 11 U.S.C. § 303(e).
22. 11 U.S.C. §§ 303(g) and 1104(a).
23. Fed. R. Bank. P. 1011(b).
24. 11 U.S.C. § 303(h).
25. *See* 11 U.S.C. §§ 706(a) and 1112(a).
26. 11 U.S.C. § 303(h).
27. 11 U.S.C. § 305(a)(1).
28. *See, e.g., Profutures Special Equity Fund, L.P. v. Spade (In re Spade)*, 269 B.R. 225, 228-29 (D. Colo. 2001); *In re Mountain Dairies, Inc*, 372 B.R. 623, 634-36 (Bankr. S.D.N.Y. 2007); *In re Reid*, 107 B.R. 79, 82-83 (Bankr. E.D. Va. 1989).
29. 11 U.S.C. § 303(j).
30. 11 U.S.C. § 303(i).
31. *In re TPG Troy, LLC*, 793 F.3d 228, 235 (2d Cir. 2015); *In re Landmark Distribs., Inc.*, 195 B.R. 837, 845 (Bankr. D.N.J. 1996).
32. *See In re Forever Green Athletic Fields, Inc.*, 804 F.3d 328, 335 (3d Cir. 2015).
33. *In re Taub*, 438 B.R. 761, 763 (Bankr. E.D.N.Y. 2010).
34. *See In re Silverman*, 230 B.R. 46, 52-54 (Bankr. D.N.J. 1998); *Landmark*, 189 B.R. at 316-17.
35. *Silverman*, 230 B.R. at 52-54.
36. *See Forever Green Athletic Fields, Inc.*, 804 F.3d at 335.
37. *Id.* at 334.
38. *See, e.g., Marrama v. Citizens Bank of Mass.*, 549 U.S. 365, 375 (2007); *Knupfer v. Lindblade (In re Dyer)*, 322 F.3d 1178, 1189-90 (9th Cir. 2003); *Walls v. Wells Fargo Bank,* 276 F.3d 502, 507 (9th Cir. 2002).
39. *See, e.g., Landon Liberty Tool v. Hunt*, 977 F.2d 829, 833 (3d Cir. 1992); *In re Century Tile & Marble, Inc.*, 152 B.R. 688, 689 (Bankr. S.D. Fla. 1993).