

## **INVOLUNTARY BANKRUPTCIES\***

### ***How It Works***

The statutory provisions dealing with involuntary bankruptcies are contained in section 303 of the Bankruptcy Code. There are three basic requirements for filing an involuntary petition, which the Bankruptcy Code divides into two parts—the requirements for filing the petition itself and the standards for the Court to grant the petition. The basic requirements for filing an involuntary petition, contained in section 303(b), are:

- 1) The petition must be filed by three or more entities,<sup>1</sup> each of which is a holder of a claim “that is not contingent as to liability or the subject of a bona fide dispute.”

### **AND**

- 2) The claims of the petitioning creditors aggregate “at least \$11,625 more than the value of any lien on property of the debtor securing such claims.”

Once the petition is filed, the “alleged debtor”<sup>2</sup> is given an opportunity to file an answer or motion to dismiss. The Court will hold a hearing at which it may take evidence. Upon conclusion of the hearing, it may grant the petition if it finds, pursuant to section 303(g), that one of the following conditions have been met:

- 1) The debtor is “generally” not paying its debts as they become due “unless such debts are the subject of a bona fide dispute.”

### **OR**

- 2) Within 120 days before the date of the filing of the petition, a custodian (e.g., trustee or receiver) is appointed to take charge of substantially all of the debtor’s property.<sup>3</sup>

---

\*Written by Joseph S.U. Bodoff. From a presentation made to the National Forest Products Group.

<sup>1</sup> A petition can be filed by one creditor if there are less than 12 creditors of the debtor. It would be a rare situation for a business debtor to have less than 12 creditors.

<sup>2</sup> Until the petition is granted, the debtor is referred to as the alleged debtor”.

<sup>3</sup> In rather contorted language, the statute also seems to allow for the filing of an involuntary petition if a custodian is appointed for less than substantially all of the assets, but only if the custodian has been appointed for reasons other than enforcing a lien against such property. As a practical matter, it would be a rare case where a court would grant an involuntary petition under this alternative test unless substantially all of the debtor’s assets were subject to the control of the custodian.

---

### ***Involuntary Bankruptcy Concepts***

*Contingent Claims*: The obligation to pay arises upon a future event.

*Debts Subject to Bona Fide Dispute*: Generally, debts in bona fide dispute are ones where there are substantial factual or legal questions surrounding the claims.

*Creditors with Unsecured Claims Aggregating at Least \$11,625*: The total amount of the unsecured portion of the claims must at least equal \$11,625. A \$10,000 claim secured by \$7,000 of collateral is deemed to be unsecured to the extent of \$3,000. A fully secured creditor counts towards the requirement of three petitioning creditors if the aggregate of the unsecured claims of the petitioning creditors as a whole equals or exceeds \$11,625.

*Not Paying Debts Generally As They Become Due*: Courts will look both to the proportion of the number of debts not being paid and the dollar amount of debts not being paid. The length of the delinquency is also a factor. Debts in bona fide dispute are excluded from the determination.

### ***The Gap Period, the Automatic Stay and the Order for Relief***

The filing of an involuntary bankruptcy petition puts the debtor in a state somewhere between being in bankruptcy and not. When a debtor files a voluntary petition, two “orders” are automatically entered: an Order for Relief and the automatic stay. The Order for Relief both signifies that the debtor is now under the supervision of the Bankruptcy Court and that the debtor’s rights are now restricted by the provisions of the Bankruptcy Code. Among other things, once an Order for Relief is entered, neither the debtor nor a trustee may take any action to dispose of the debtor’s assets without the approval of the Bankruptcy Court. The automatic stay prevents creditors from taking any action to collect on prepetition debts. One might say that it is the *quid pro quo* for the restrictions placed on the debtor when the Order for Relief is entered.

Unlike a voluntary petition, an Order for Relief is not entered upon the filing of the petition. The Order for Relief and, consequently, the restrictions imposed upon debtors, springs into being only after the alleged debtor is given an opportunity to contest the petition, which may include a lengthy and sometimes drawn-out trial on the matter. The period between the filing of the involuntary petition and the entry of the Order for Relief is known as the “gap period”. While the alleged debtor is not restricted in the way it deals with its assets during the gap period, creditors are nonetheless subject to an automatic stay. In short, the alleged debtor is free to deal with its assets without obtaining court approval, while at the same time, creditors are powerless to collect on their prepetition claims. Blatant abuses by the alleged debtor could lead to the appointment of an interim trustee to preserve the business during the gap period, but it is still a rare case where an interim trustee is appointed.

***Why File an Involuntary Bankruptcy Petition?***

There are a number of reasons why creditors would want to file an involuntary petition against a debtor. They include:

- The secured lender is about to foreclose on the debtor's assets.
- The debtor is about to sell its assets without paying or making suitable arrangements to pay unsecured creditors.
- The debtor has made significant preferential payments to insiders within the previous year.
- The debtor has made significant preferential payments to creditors (other than the petitioning creditors) within the previous 90 days.
- The debtor's business should be shut down in order to avoid continuing losses and deterioration in the business.
- The conduct of the debtor's business is such that it requires court supervision.
- The ability to collect the debt outside of bankruptcy is remote.
- Claims exist against other creditors (e.g., the secured lender) or insiders that can best be dealt with in Bankruptcy Court.
- The debtor is not cooperating in providing information that would allow you to make any of the foregoing determinations.
- Where the debtor itself is likely to file a voluntary petition, creditors may want to consider filing an involuntary petition to control the venue of the court where the case is filed. In this regard, involuntary petitions have been filed by creditors as "preemptive strikes" to prevent the debtor's bankruptcy filing in an inconvenient jurisdiction (e.g., in many cases, Delaware). Note that controlling venue, by itself, likely would not be considered by the courts to constitute a valid reason to file an involuntary petition, but if creditors have information leading them to believe that the debtor itself is about to file, it is likely that other valid reasons to file exist.

---

***When Not to File an Involuntary Bankruptcy Petition.***

You should think carefully about whether or not you want to file an involuntary petition under the following circumstances:

- The chances of collecting are greater in state court than in a bankruptcy proceeding.
- You have received payments within 90 days that may be considered to be avoidable preferences.
- Your actions may be considered to be a bad faith filing (see below).

***Bad Faith Filings***

Creditors found by the Bankruptcy Court to have filed involuntary petitions in bad faith may be held liable for compensatory, consequential and punitive damages, pursuant to section 303(i)(2), which states:

(i) If the court dismisses a petition under this section other than on consent of all petitioners and the debtor, and if the debtor does not waive the right to judgment under this subsection, the court may grant judgment—

\* \* \*

(2) against any petitioner that filed the petition in bad faith, for—

(A) any damages proximately caused by such filing; or

(B) punitive damages.

Despite the language in the statute suggesting that the court has a choice of awarding compensatory damages or punitive damages, courts have awarded both.

There are decisions suggesting that cases can be dismissed and punitive damages awarded solely because the petition was filed in bad faith, even if all of the other requirements for the granting of the petition have been met. See, e.g., the recent decision in *In re WLB-RSK Venture*, 296 B.R. 509 (Bankr. C.D. Cal. 2003).

---

Factors that a court will look at in deciding whether an involuntary petition has been filed in bad faith are:

- Whether the petition's allegations are well grounded in fact.
- Whether the claims of one or more of the petitioning creditors is in bona fide dispute.
- Whether the filing of the petition is viewed as a strategy to collect a debt, or more as the advancement of legitimate objectives of creditors to protect themselves against a failing business, preferential transfers, etc.
- Whether the petition was motivated by an improper purpose, such as ill will, malice, or harassment.

As such, courts generally hold that a creditor cannot file an involuntary petition simply to gain leverage over a debtor as a means of extracting payment. See, e.g., *In re Cannon Express Corporation*, 280 B.R. 450 (Bankr. W.D. Ark. 2002). In a recent case, the Court found that the petition was filed in bad faith where the petitioning creditor's claim was in bona fide dispute, the petitioning creditor knew that the claim was in bona fide dispute (the debtor had filed an answer and counterclaim in state court), and there was evidence that the creditor intended to cause harm to the debtor (among other things, the creditor leaked the filing to the press). *In re John Richards Homes Building Co., L.L.C.*, 291 B.R. 727 (Bankr. E.D. Mich. 2003).

### ***Dismissal of Involuntary Petitions***

Creditors often file involuntary petitions after efforts to negotiate a settlement with a debtor fall through, or at least reach what appears to be a standstill. Sometimes, the negotiations have not actually fallen apart, but there is a general feeling, perhaps, that the debtor is stalling while attempts to accomplish an as yet undefined goal (e.g., completing a sale of assets, or waiting for the preference period to pass on a payment or other transfer). The creditor needs to weigh carefully whether to "pull the trigger" and file the involuntary petition. It is common for creditors to think that there is at least a possibility that the debtor will make it an acceptable offer even after the petition is filed. Such an offer almost always is conditioned upon the case being dismissed. But, once filed, it is not so easy to dismiss an involuntary petition.

Section 303(j) of the Bankruptcy Code provides that the court may dismiss an involuntary petition only after notice to all creditors, even if the dismissal is upon the consent of all of the petitioners and the debtor. The giving of such notice sets the stage for creditors inquiring about the deal that the debtor made with the petitioning creditors. Additionally, the court may not be willing to dismiss the petition without any such deal

---

being disclosed and the court otherwise assuring itself that the debtor will be able to take care of whatever financial difficulties it is experiencing without the protection of the Bankruptcy Court.

### ***Abstention***

Even where the petitioning creditors are able to prove all of the elements for the granting of an involuntary petition, and even where there is no issue as to whether the petitioning creditors have acted in good faith, the Bankruptcy Court may still dismiss an involuntary petition under the doctrine of abstention.

The decision whether to abstain is within the sole discretion of the Bankruptcy Court and, by statute, is not reviewable by an appellate court. There are seven factors that courts generally consider when deciding whether or not to abstain. They are:

- 1) The economy and efficiency of administration.
- 2) The availability of another forum, or the actual pendency of an insolvency proceeding in one.
- 3) Whether federal proceedings are necessary to reach a just and equitable resolution.
- 4) The availability of alternative means for an equitable distribution of assets and value.
- 5) Whether the debtor and creditors are able to work out a less expensive out-of-court arrangement that better serves all interests in the case.
- 6) Whether a non-federal insolvency proceeding has progressed so far that it would be costly and time consuming to start afresh with the federal bankruptcy process.
- 7) The purpose for which bankruptcy jurisdiction was sought by the petitioners.

Examples of recent decisions on this subject are *In re Fortran Printing, Inc.*, 2003 Bankr. LEXIS 976 (Bankr. N.D. Ohio July 11, 2003), and *In re NRG Energy, Inc.*, 294 B.R. 71 (Bankr. D. Minn. 2003).

***Extending Credit During the Gap Period***

Creditors are free to extend credit during the gap period and, indeed, the debtor is free to pay creditors during that period. This is in spite of the fact that creditors are prohibited by the automatic stay from engaging in collection activities against the debtor. A debtor, however, will often want trade credit during the gap period. Absent a guaranty from a non-debtor, the issuance of a letter of credit or the grant of some other suitable security, creditors should be wary of extending credit during the gap period. The gap period can be very short and can end suddenly by the consent of the debtor or court order. Claims that normally might have been paid in accordance with ordinary business terms may not get paid if for no other reason than the gap period did not last a full billing cycle. Claims arising during the gap period will receive priority, but they will come behind administrative claims and secured claims. Even if paid in full, gap claims are usually not paid until the end of the case, which could come years later.