

The Nuts & Bolts of Involuntary Bankruptcy

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Amid weakened economic conditions, many businesses are experiencing increased claims against distressed companies. Creditors holding such claims may consider initiating an involuntary bankruptcy petition, rather than pursuing various state law collection remedies. This primer provides a general overview of the procedures for filing an involuntary petition and addresses issues unique to the involuntary bankruptcy process.¹

Filing an Involuntary Petition



J. Kate Stickles

Section 303 governs the commencement of an involuntary case under the Bankruptcy Code and limits such filing to a case under chapter 7 or 11.² An involuntary case is commenced by the filing of a petition, which must be served upon the involuntary debtor.³ Section 303(b) defines the entities that can commence an involuntary case. If the involuntary debtor has more than 12 creditors, then at least three entities, each of which holds a separate claim against the involuntary debtor, are required to file an involuntary petition.⁴ If the involuntary debtor has fewer than 12 creditors, excluding interested parties, a single qualifying creditor may file an involuntary petition.⁵

Section 303(b)(1) mandates that petitioning creditors hold claims that are “not contingent as to liability or the subject of a bona fide dispute as to liability or amount.”⁶ Additionally, the aggregate of the claims must be at least \$13,475.⁷ Involuntary debtors often challenge whether a petitioning creditor’s

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claims satisfy these requirements as a basis for dismissal of a petition.

Each petitioning creditor bears the burden to prove that it is qualified under §303(b)(1).⁸ After the petitioning creditor satisfies its burden, the burden shifts to the involuntary debtor to demonstrate that the claim is contingent as to liability or that a bona fide dispute exists.⁹ If the involuntary debtor establishes a legitimate defense, the claim may be disqualified as a basis for an involuntary bankruptcy.

Practice & Procedure



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In *In re Taylor & Assocs. LP*, the Bankruptcy Court for the Eastern District of Tennessee addressed the phrase “contingent as to liability” and adopted the following standard for determining whether a claim is contingent as to liability under §303(b):

When all the events have occurred which allow a court to adjudicate a claim and determine whether or not payment should be made, there is no contingency concerning the claim itself, unless “it is apparent, to a legal certainty,” that the petitioning creditor would be unable to obtain a judgment against

the debtor upon adjudication of its claim.¹¹

A petitioning creditor’s claim must also not be the subject of a bona fide dispute.¹² The majority of courts has adopted an objective standard to decide whether a claim is subject to a bona fide dispute.¹³ For example, the Third Circuit has articulated this standard as follows: “If there is either a genuine issue of material fact that bears upon the debtor’s liability, or a meritorious contention as to the application of law to undisputed facts, then the petition must be dismissed.”¹⁴ A court need not resolve any issue of fact or law; it must only decide that such issues exist.¹⁵

Joining an Involuntary Petition

After the filing of an involuntary petition, but before the case is dismissed or an order for relief is entered (often referred to as the “gap period”), creditors other than the original petitioning creditors may join in the petition with the same effect as if the joining creditor had been one of the original petitioning

creditors.¹⁶ Consequently, if one of the original petitioning creditors is deemed unqualified, a subsequent petitioning creditor may cure the defect, and the case will not be dismissed due to an insufficient number of qualifying petitioning creditors or a deficiency in the amount of petitioning claims, assuming the joining creditor meets the statutory requirements. Accordingly, the joinder of additional qualified creditors provides security to the original petitioning creditors.

The bankruptcy court has the power to set a deadline for the joinder of additional petitions based on its “case management authority, in order to ensure orderly, fair and efficient proceedings.”¹⁷ In defending an involuntary petition, an involuntary debtor may request that the court impose a deadline for joinder of additional petitioning creditors to reduce

¹ This article does not address involuntary bankruptcy petitions filed against partnerships or foreign representatives.

² 11 U.S.C. §303(a).

³ Fed. R. Bankr. P. 1010 governs service of the involuntary petition and summons in accordance with Fed. R. Bankr. P. 7004.

⁴ 11 U.S.C. §303(b)(1).

⁵ 11 U.S.C. §303(b)(2).

⁶ 11 U.S.C. §303(b)(1) (italics in original).

⁷ *Id.*

⁸ See *In re DSC Ltd.*, 486 F.3d 940, 944 (6th Cir. 2007).

⁹ King, Lawrence P., 1 *Collier on Bankruptcy*, ¶303.03[2][b] (15th ed. rev. 2007) (citations omitted).

¹⁰ *In re Sims*, 994 F.2d 210, 220 (5th Cir. 1993).

¹¹ *In re Taylor & Assocs. L.P.*, 193 B.R. 465, 475 (Bankr. E.D. Tenn. 1996), (citing *Longhorn 1979-II Drilling Program*, 32 B.R. 923, 927 (Bankr. W.D. Okla. 1983)).

¹² 11 U.S.C. §303(b).

¹³ See, e.g., *Key Mech Inc. v. BDC*, 330 F.3d 111 (2d Cir. 2003); *B.D.W. Assocs. Inc. v. Busy Beaver Bldg. Ctrs. Inc.*, 865 F.2d 65 (3d Cir. 1989).

¹⁴ *B.D.W. Assocs.*, 865 F.2d at 66-67.

¹⁵ *DSC*, 486 F.3d at 945.

¹⁶ 11 U.S.C. §303(c).

¹⁷ *DSC*, 486 F.3d at 948.

the potential for cure that additional qualified creditors may provide.

Application of Automatic Stay

Upon the filing of an involuntary petition, the automatic stay provision of §362 of the Code is triggered to protect the alleged involuntary debtor, but the order for relief will not be entered until a bankruptcy court determines that an order for relief should be entered against the involuntary debtor or the involuntary debtor consents to the relief.¹⁸ During the gap period, the involuntary debtor does not have the responsibilities of a debtor-in-possession (DIP). Until an order for relief is entered, the involuntary debtor may continue to operate its business and continue to use, acquire or dispose of property as if the involuntary case had not been commenced.¹⁹

Responding to an Involuntary Petition

After an involuntary petition is filed, the involuntary debtor has 20 days to file a responsive pleading. Significantly, §303(h) provides that if the involuntary petition “is not timely controverted, the court shall order relief against the debtor.”²⁰ Similarly,

Bankruptcy Rule 1013(b) states that “[i]f no pleading or other defense to the petition is filed within the time provided...the court, on the next day, or as soon thereafter as practicable, shall enter an order for the relief requested in the petition.”²¹

In accordance with Bankruptcy Rule 1011, an involuntary debtor may contest the petition or file a motion under Rule 12 of the Federal Rules of Civil Procedure.²² The filing of a Rule 12(b) motion extends the time for filing a responsive pleading.²³ The court may dispose of the involuntary petition, prior to the filing of a formal response, based on the Rule 12(b) motion.

The response to an involuntary petition cannot include a claim against the petitioning creditors, except for the purpose of defeating the involuntary petition.²⁴ The response may include a request for relief under subsection (i) or (l) of §303 (*i.e.*, costs, attorneys fees, damages, sealed record). Possible defenses to an involuntary petition include, but are not limited to, (1) lack of jurisdiction, (2) improper venue, (3) noncontingent undisputed indebtedness of the petitioning creditors does not aggregate \$13,475, (4) insufficient number of petitioning creditors, (5) nonqualifying petitioning creditors and/or (6) petitioning

creditor’s claim raises issues of duress, estoppel, fraud or falsity.²⁵

If the involuntary debtor contests the petition, the court “shall determine the issues of a contested petition at the earliest practicable time and forthwith enter an order for relief, dismiss the petition or enter any other appropriate order.”²⁶ The court will hold a hearing to determine (1) whether the involuntary debtor is generally not paying debts as they become due unless such debts are the subject of a *bona fide* dispute as to liability or amount, or (2) whether, within 120 days of the filing, a custodian other than a trustee, receiver or agent was appointed or authorized to take charge of debtor’s property for purposes of enforcing a lien against such property.²⁷

The phrase “generally not paying debts” as they become due is not defined in the Code. The question of whether the debtor is generally not paying debts as they become due is a question of fact, and courts look to “the totality of the circumstances existing when the petition is filed.”²⁸ Courts have examined various factors, including:

¹⁸ 11 U.S.C. §§362(a) and 303(h).

¹⁹ 11 U.S.C. §303(f).

²⁰ 11 U.S.C. §303(h) (emphasis added).

²¹ Fed. R. Bankr. P. 1013(b).

²² Fed. R. Bankr. P. 1011(b).

²³ Fed. R. Bankr. P. 1011(c).

²⁴ Fed. R. Bankr. P. 1011(d).

²⁵ *Collier on Bankruptcy*, ¶303.10[4].

²⁶ Fed. R. Bankr. P. 1013.

²⁷ 11 U.S.C. §303(h)(1).

²⁸ *In re Concrete Pumping Serv. Inc.*, 943 F.2d 627, 630 (6th Cir. 1991), (quoting *In re Matter of Bishop, Baldwin, Rewald, Dillingham & Wong*, 779 F.2d 471, 475 (9th Cir. 1985)).

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(1) the number of debts, (2) the amount of the delinquency, (3) the materiality of the nonpayment, (4) the nature and conduct of the debtor's business, (5) the rapid decline in the value of the debtor's assets resulting from asset sales rather than profit-generating activity, (6) the amount of the debtor's debts compared to the debtor's yearly income and (7) the debtor's voluntary shutdown of operations.²⁹

Assuming the petitioning creditors are successful, the court will enter an order for relief and the bankruptcy case will proceed in chapter 7 or 11. If the case proceeds as a chapter 7 case, an interim trustee will be promptly appointed after the order for relief is entered.³⁰

Recovering Expenses Incurred Filing an Involuntary Case

A petitioning creditor may be entitled to reimbursement of its actual and necessary expenses for filing an involuntary case.³¹ Courts have recognized that petitioning creditors are entitled to be compensated for the fees and costs incurred in connection with the preparation, filing and adjudication of an involuntary petition.³² Courts have also recognized that services rendered by a petitioning creditor in connection with the appointment of a trustee are also compensable. In order to qualify as an "actual" and "necessary" expense, however, the expenditures must benefit the estate as a whole rather than just the creditor claimant.³³

Dismissal of an Involuntary Petition

An involuntary petition may be dismissed on motion of a petitioner, by consent of the petitioning creditors and the debtor, or for want of prosecution.³⁴ In order for an involuntary petition to be dismissed, there must be written notice to all creditors and a hearing.³⁵ A hearing on the dismissal is mandatory. If the dismissal is based on a settlement between the involuntary debtor and the petitioning creditors under §303(j)(2), the court must determine if the settlement is in the best interest of the estate.³⁶ Moreover, "if the settlement

involves something other than a cash payment, the court must determine the effect of the settlement on similarly situated creditors and, if creditors are not treated fairly and equitably, the settlement should not be approved."³⁷

If a creditor believes dismissal is in the best interests of all creditors and the involuntary debtor, the creditor can move to dismiss under §305(a)(1). A dismissal under §305, unlike §303(j), is not reviewable by a court of appeals on appeal pursuant to §305(c).

If an involuntary case is dismissed, other than on consent of the involuntary debtor and the petitioning creditors, the petitioning creditors may be responsible for costs and attorneys' fees.³⁸ In fact, an involuntary debtor need not establish the existence of bad faith to obtain fees and costs, and some courts have adopted the approach that petitioners should anticipate an award of costs and fees upon the dismissal of an involuntary petition.³⁹

If the involuntary petition is found to have been filed in bad faith, the petitioning creditors may be liable for any damages proximately caused by the filing, or punitive damages.⁴⁰ Bad faith, as it is applied to an involuntary petition, is not defined in the Code, however courts have developed different tests to determine whether an involuntary petition was filed in bad faith.⁴¹ Such tests include (1) the improper-use test (focuses on whether the creditor's conduct takes disproportionate advantage of other creditors), (2) the improper-purpose test (focuses on the creditor's motive for filing the petition), (3) the objective test (focuses on whether a reasonable person in the creditor's position would have filed the petition under the same circumstances), (4) the subjective test (focuses on the petitioning creditor's motivation for filing the petition) and (5) the combined objective and subjective test.⁴² The burden to prove damages under §303(i) is on the involuntary debtor.⁴³ An involuntary debtor seeking relief under §303(i) must seek such relief in connection with the underlying proceeding in bankruptcy court.⁴⁴

In addition, §303(l), which was enacted in 2005, addresses involuntary filings that are improperly filed against public officials and private individuals. This subsection provides that records of a fraudulent involuntary filing, and all references thereto, can be sealed if certain requirements are met. In addition, subsection (l) provides an additional remedy for individuals harmed by an involuntary filing and permits the court to enter an order prohibiting consumer credit reporting agencies from making a consumer report that contains information relating to the involuntary petition or the bankruptcy case.⁴⁵

Whether to File an Involuntary Petition

Clearly, there are significant risks associated with the filing of an involuntary petition. There are, however, situations that may merit filing an involuntary petition rather than pursuit of state law remedies. For example, if a creditor suspects corporate mismanagement, fraudulent transfers or depletion of assets, it may be beneficial to file an involuntary petition in order to trigger the automatic stay and seek the appointment of a trustee. An involuntary petition may also be used to prevent a judgment creditor from foreclosing on assets at the expense of the debtor's other creditors. The legal strategy adopted depends on a careful review and analysis of the specific facts and the goals to be accomplished.

Conclusion

The filing of an involuntary petition can be a powerful tool for a creditor, but it is not without risk. A creditor contemplating an involuntary petition should carefully consider all of its legal options before filing a petition. Moreover, a creditor must be mindful of the importance of due diligence before filing an involuntary petition and ensure that its claim and, if applicable, the claims of other original petitioning creditors satisfy the statutory requirements of §303(b) so as to withstand the challenge of an involuntary debtor. The filing of an involuntary petition and defense of any opposition by the involuntary debtor can be costly and time-consuming. Further, as noted above, in the event the court dismisses the petition, the petitioning creditor risks payment of legal fees and costs. ■

²⁹ *Collier on Bankruptcy*, ¶303.14[1][b].

³⁰ See 11 U.S.C. §701(a)(1).

³¹ See 11 U.S.C. §503(b)(3)(A).

³² See *In re On Tour LLC*, 276 B.R. 407, 415 (Bankr. D. Md. 2002); *In re Crazy Eddie Inc.*, 120 B.R. 273, 278 (Bankr. S.D.N.Y. 1990); *In re Hanson Indus.*, 90 B.R. 405, 410 (Bankr. D. Minn. 1988).

³³ See *In re Stoecker*, 128 B.R. 205, 208 (Bankr. N.D. Ill. 1991).

³⁴ 11 U.S.C. §303(j).

³⁵ *Id.*

³⁶ *Collier on Bankruptcy*, ¶303.16.

³⁷ *Id.*, citing *In re Warren*, 181 B.R. 136, 138 (Bankr. N.D. Ala. 1995).

³⁸ 11 U.S.C. §303(i)(1).

³⁹ See, e.g., *In re Landmark Distribs. Inc.*, 189 B.R. 290, 307 (Bankr. D. N.J. 1995).

⁴⁰ 11 U.S.C. §303(i)(2).

⁴¹ See *In re Cannon Express Corp.*, 280 B.R. 450, 453 (Bankr. W.D. Ark. 2002).

⁴² *Id.*, citing *Landmark Distribs.*, 189 B.R. 290, 309-310.

⁴³ *In re Mundo Custom Homes Inc.*, 179 B.R. 566, 569 (Bankr. N.D. Ill. 1995).

⁴⁴ *Collier on Bankruptcy*, ¶303.15[1] (citations omitted).

⁴⁵ 11 U.S.C. §303(l).