INVOLUNTARY BANKRUPTCY PETITIONS

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I. COMMENCING AN INVOLUNTARY BANKRUPTCY CASE

A. JURISDICTION

Bankruptcy jurisdiction rests with the district court under 28 U.S.C. §1334. The district court, however, may assign cases through reference to the bankruptcy court, which, in fact, all district courts have done.[1] The bankruptcy court may hear all core and non-core matters, unless specifically limited by statute. However, the bankruptcy court may only render final judgments in core matters as opposed to non-core matters.

A case under the Bankruptcy Code may be begun by either a voluntary petition filed by the debtor, or, for a chapter 7 or 11 case, by an involuntary petition filed against the debtor by the requisite number of creditors.[2] The petition is filed with the bankruptcy court clerk.

The petition should state the chapter under which it is filed. Along with the petition, the debtor must pay the appropriate filing fee. Although the fee may be paid in installments, it cannot be waived entirely. Section 302 of the Bankruptcy Code permits a husband and wife to file a joint petition, thus saving the cost of one filing fee.

The date of filing of the bankruptcy petition is a critical date in the bankruptcy case. The filing of the petition establishes a line of demarcation. Any payment or satisfaction by the debtor of any claims arising prior to this date is at least temporarily suspended. Generally, these prepetition claims are either satisfied or discharged through a liquidation under chapter 7 or a plan under chapters 11 or 13.[3]

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[1] *See* 28 U.S.C. § 157.
[2] *See* 11 U.S.C. §§ 301-303.
[3] 11 U.S.C. § 101(5) (defining "claim").

To establish debtor eligibility, one must determine the status of the potential debtor, that is, whether the debtor is an individual, partnership, corporation, etc. This is necessary because a specific entity may be eligible for relief under Title 11, but not eligible for relief under a specific chapter. Second, the debtor must meet the residency or contact requirements with the United States, a sort of minimum contacts test that betrays the historical *in rem* foundation to bankruptcy jurisdiction. Third, the bankruptcy court must determine if a categorical exclusion applies. For example, banks, credit unions, and insurance companies may not file for relief under the Bankruptcy Code. Watch out here, however. A bank or insurance holding company is a corporation and may seek relief under the Bankruptcy Code. Finally, an individual debtor must have taken an approved counseling session within 180 days before the commencement of the case to be eligible for relief.

B. VOLUNTARY CASES

A voluntary case is commenced by the debtor filing a petition under the appropriate chapter of the Bankruptcy Code.[4] The petition is simple and basically states that the debtor has sought the particular relief in question, for example, chapter 7 relief. The petition need not show the debtor has any assets or is insolvent.[5] Many debtors have no assets; and theoretically, a solvent debtor may voluntarily file for bankruptcy protection.[6]

[4] *See* 11 U.S.C. §§ 301-302.
[5] The sole exception is for municipalities that seek relief under chapter 9. *See* 11 U.S.C. § 109(c).
[6] *But see* 11 U.S.C. § 109(c).

C. INVOLUNTARY CASES

An involuntary case is commenced pursuant to 11 U.S.C. § 303 under either chapter 7 or chapter 11: chapters 9, 12, or 13 not being a permitted alternative.[7] An involuntary case cannot be commenced against a railroad, farmer, family farmer, or charitable institution.[8] Additionally, an involuntary petition must be signed by the requisite number of creditors. Generally, three petitioning creditors must possess unsecured, bona fide, non-contingent claims totaling at least $13,475[9] in order to validly file an involuntary petition. If the debtor has less than twelve holders of bona fide, non-contingent claims against it, a single creditor with a single unsecured, bona fide, non-contingent claim of $3,475 is sufficient.[10] A single fully-secured creditor can waive its secured status as to a limited amount of its debt to satisfy this requirement or may join two others without waiving its claim. Moreover, a general partner may, in his capacity as a partner, file a petition on behalf of the partnership. Such filing is characterized as an involuntary case unless and until all general partners join in the filing.

Upon the filing of an involuntary petition, the debtor is permitted twenty days in which to answer the petition. Only the debtor may respond.[11] The alleged debtor may respond to the involuntary petition by consenting to the entry of an order for relief, converting the pending case to a case under a different chapter, or contesting the involuntary petition. Grounds for a denial of an involuntary petition include:

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[7] A petitioning creditor may be entitled to reimbursement of its actual and necessary expenses for filing an involuntary case. *See In re On Tour LLC*, 276 B.R. 407, 415 (Bankr. D. Md. 2002).
[8] *See* 11 U.S.C. § 303(a).
[9] Most dollar amounts under the Bankruptcy Code are adjusted automatically for inflation.
[10] *See* 11 U.S.C. § 303(b); *see also* Jack F. Williams, *Counting Creditors Under Code § 303(b): The Tale of the Ubiquitous "Such,"* Norton Bankr. L. Advisor 7 (June 1992).
[11] *See* 11 U.S.C. § 303(d).

1. Lack of jurisdiction;
2. Improper venue;
3. Insufficient aggregate debt amounts;
4. Insufficient number of petitioning creditors;
5. Non-qualifying petitioning creditors; or
6. Insufficient facts to prove the substantive grounds under subsection (h).

If the debtor contests the involuntary petition, the court generally proceeds to trial on the merits. Parties are entitled to conduct discovery pursuant to the Rules of Bankruptcy Procedure (generally incorporating select rules from the Federal Rules of Civil Procedure with important variations). Parties may also move for summary judgment on the issues raised in the pleadings, if appropriate.[12]

If the debtor does not timely answer the petition, the court will enter an order for relief against the debtor. If the debtor does timely answer the petition, the court can grant relief against the debtor only if the creditors can establish one of two grounds. The petitioning creditors must establish that either (i) the debtor is not generally paying its present debts as they become due unless such debts are subject to a bona fide dispute as to liability or amount or (ii) within 120 days of the date of petition, a receiver, assignee, or custodian had taken possession of substantially all the debtor's property.[13]

[12] *See* Fed. R. Bankr. P. 7026, 7056.
[13] *See* 11 U.S.C. § 303(h).

II. RECURRING ELIGIBILITY AND RELIEF ISSUES

A. PETITIONING CREDITOR POSSESSES NON-CONTINGENT CLAIM NOT SUBJECT TO BONA FIDE DISPUTE

Sections 303(b)(1) and (b)(2) require that a petitioning creditor possess a claim that is not contingent as to amount or subject to bona fide dispute as to liability or amount. The non-contingent and undisputed claims requirements of the Bankruptcy Code are not jurisdictional. Rather, these requirements go to the merits - an element that must be established to sustain an involuntary case.[14] Petitioning creditors cannot prevail unless they show that their claims are non-contingent and not subject to bona fide disputes.

A claim that is contingent as to liability is a claim where an involuntary debtor's obligation to pay does not arise until the occurrence of some future event, which the parties contemplated at the time their relationship started.[15] In *In re Taylor & Assocs. LP*,[16] the bankruptcy court 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.[17]

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[14] *In re Rubin*, 769 F.2d 611, 615 (9th Cir. 1985).
[15] *In re Sims*, 994 F.2d 210, 220 (5th Cir. 1993).
[16] 193 BR. 465 (Bankr. E.D. Tenn. 1996).
[17] 193 BR. 465, 475 (Bankr. E.D. Tenn. 1996), citing *Longhorn 1979-11 Drilling Program*, 32 B.R. 923, 927 (Bankr. W.D. Okla. 1983))

A petitioning creditor's claim must also not be the subject of a bona fide dispute.[18] The majority of courts have adopted an objective standard to decide whether a claim is subject to a bona fide dispute.[19] "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."[20] A court need not resolve any issue of fact or law; it must only decide that such issues exist. In determining the existence of a bona fide dispute, courts determine whether "there is either a genuine issue of a material fact that bears upon the debtor's liability, or a meritorious contention as to the application of law to undisputed facts...."[21] The court is not called upon to determine the likely outcome of any controversy: instead, the court simply determines whether there are facts giving rise to a legitimate legal dispute as to liability or amount.

B. GENERALLY NOT PAYING DEBTS UNLESS SUBJECT TO BONA FIDE DISPUTE

The phrase "generally not paying debts" as they become due is not defined in the Code and not subject to ease in interpretation. Courts consistently hold that the question of whether a debtor is generally not paying debts as they become due is a question of fact. In assessing this requirement, courts characteristically consider the "the totality of the circumstances existing when the petition is filed."[22] This area of the law is short on doctrine and may more appropriately be characterized as illuminated by clusters of cases. These cases tend to gravitate toward several factors, including:

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[18] 11 U.S.C. §303(1)).
[19] *See, e.g.,* Key Mech Inc. v. BDC, 330 F.3d 111 (2d Cir. 2003).
[20] B.D.W. Assocs. Inc. v. Busy Beaver Bldg. Ctrs. Inc., 865 F.2d 65 (3d Cir. 1989).
[21] *In re Lough*, 57 B.R. 933, 996-97 (Bankr. E.D. Mich. 1986)); s*ee also In re Busick*, 831 F.2d 745 (7th Cir. 1987).
[22] *In re Bishop, Baldwin, Rewald, Dillingham t Wong*, 779 F.2d 471, 475 (9th Cir. 1985)).

- the number of debts,
- the amount of the delinquency,
- the character of the debt,
- the nature and relationship of the creditors being paid and those not being paid,
- the materiality of the nonpayment,
- the nature and conduct of the debtor's business,
- the rapid decline in the value of the debtor's assets resulting from asset sales rather than profit-generating activity,
- the amount of the debtor's debts compared to the debtor's yearly income, and
- the debtor's voluntary shutdown of operations.

III. OPERATING A DEBTOR IN AN INVOLUNTARY CASE

A. GAP PERIOD BUSINESS OPERATIONS

Between the filing of the petition and the hearing on the involuntary petition (the so-called "gap period"), the debtor is permitted to continue to operate its business much like a debtor-in-possession in a voluntary chapter 11 case.[23] However, the bankruptcy court may require a bond from the debtor upon a showing of cause by a party in interest.[24] Furthermore, upon motion of any creditor or party in interest, the bankruptcy court can restrict the debtor's use of property or appoint an interim trustee to take

[23] 11 U.S.C. § 303(f).
[24] *See* 11 U.S.C. § 303(e).

possession of the debtor's property and operate the debtor's business if it is established that such action is necessary to prevent loss or destruction of property of the estate.[25]

B. Priority Claim Status

During the operation of the business during the gap period, the debtor may incur debt in the ordinary course of business, for example, trade credit. Those that deal with the involuntary debtor in the ordinary course are generally entitled to a level 3 priority claim under section 507(a)(3).

IV. Sanctions for Improper Commencement

If the debtor is successful in establishing that the grounds for involuntary relief have not been satisfied, the court may grant a judgment in favor of the debtor for its costs and attorney fees.[26] Moreover, any petitioning creditor that files an involuntary petition in bad faith may be held liable for compensatory and punitive damages.

V. BAPCPA Changes Affecting Involuntary Cases

A. Curbing Abusive Involuntary Cases

As part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act"), section 303(l)[27] was amended to curb abusive involuntary cases that are improperly filed against, among others, public officials and private individuals. This subsection provides that records of a fraudulent involuntary case may be sealed if

[25] 11 U.S.C. § 303(g).
[26] *See* 11 U.S.C. § 303(i).
[27] Although styled as subsection (l), it appears that this subsection should be labeled subsection (k).

certain requirements are met. Thus, if (1) the petition is false or contains fraudulent statements, (2) the debtor is an individual, and (3) the court dismisses the petition, then the court, shall upon motion of the debtor, seal the record of the case and all references to the case. In addition, under subsection (l)(2), if the debtor is an individual and the court dismisses under subsection (l), then a court may enter an order prohibiting consumer credit reporting agencies from making a consumer report that contains information relating to such involuntary petition or the bankruptcy case.

B. Criminalizing Commencement of Fraudulent Involuntary Petition

As part of the 2005 Amendments, Congress amended 18 U.S.C. section 157 now making it a crime to file a fraudulent involuntary case. In an orchestrated press release, Congressman James Sensenbrenner summed up the purpose of the criminalization of fraudulent involuntary petitions:

> Unfortunately, tax protestors and other extremists are now resorting to filing fraudulent involuntary bankruptcy petitions against public officials and other innocent parties. In the case of the Ozaukee County officials, some of the county employees didn't even realize they were the subject of a pending involuntary bankruptcy case until after their lines of credit were terminated, or were charged higher interest rates. In addition, some officials even had their mortgage statuses negatively affected. These filings were subsequently dismissed, but not until after causing financial problems for these folks.[28]

VI. Conclusion

Involuntary bankruptcy cases are not routine. In light of the litany of sanctions that a court may impose on unsuccessful petitioning creditor, coupled with the difficulty

[28] F. James Sensenbrenner, Jr., June 10, 2003 (Press Statement).

in making out the prima facie case, there appears to be little chance of that number increasing. However, the involuntary case is still an important tool in a creditor's toolbox. For example, a creditor should consider commencing an involuntary case where:

1. You learn of a large payment to a creditor that diminishes the potential recovery of other creditors;

2. You learn that a creditor has converted an unsecured position into a secured one;

3. You learn that a secured creditor has grabbed additional collateral;

4. You learn that your debtor may be selling assets below fair market value to gin up cash in a distressed situation or to benefit insiders.

Although not regularly utilized, a creditor must be aware of the application, benefits, and costs of commencing an involuntary case.