Requirements and Risks in Petitioning for an Involuntary Bankruptcy Case

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Abstract

This article provides an overview of the requirements petitioning creditors must satisfy to commence an involuntary process and discusses certain circumstances under which an involuntary filing may be contested by a putative debtor.

Aside from the traditional path of pursuing a judgment against the putative debtor in state court, one or more creditors—if certain criteria are met—can force a delinquent debtor into a bankruptcy proceeding through the filing of an *involuntary* bankruptcy petition. Commencing an involuntary bankruptcy is a powerful remedy to secure payment. However, involuntary bankruptcy cases account for less than one percent of bankruptcy proceedings in the United States each year.[1]

An involuntary bankruptcy "exists as an avenue of relief for the benefit of the overall creditor body . . .[I]t was not intended to redress the special grievances, no matter how legitimate, of particular creditors . . . ." *Wilk Auslander LLP v. Murray (In re Murray)*, 900 F.3d 53, 59–60 (2d. Cir. 2018) (citation omitted). For example, an involuntary bankruptcy is an appropriate tool to prevent funds and assets from being dissipated to the detriment of creditors or to ensure certain creditors are not receiving preferential treatment or payments. Commencement of an involuntary proceeding is also an effective way to provide a supervised forum to review the debtor's prepetition transactions and implement an orderly liquidation. On the other hand, the case law and Bankruptcy Code are clear that an involuntary bankruptcy filed for the purpose of settling a two-party dispute will be dismissed. While a creditor may be in technical compliance with the Bankruptcy Code, the risk of dismissal remains where the bankruptcy court determines the petition was filed in bad faith—for example to harass or exercise leverage over the putative debtor.

This article provides an overview of the requirements petitioning creditors must satisfy to commence an involuntary process and discusses certain circumstances under which an involuntary filing may be contested by a putative debtor.

I. The Bankruptcy Code Requirements for Involuntary Petitions

The Bankruptcy Code's requirements for commencing an involuntary proceeding are straight forward. The eligibility requirements, set forth in Section 303(b)(1) of the Bankruptcy Code, direct that the requisite number of petitioning creditors holding non-contingent, undisputed, unsecured claims must hold an aggregate debt across all petitioning creditors totaling at least $16,750.[2] The petitioning creditors bear the initial burden of establishing a prima facie case that they meet the eligibility requirements set forth in Section 303(b) of the Bankruptcy Code. *See, e.g.*, *In re Persico Contracting and Trucking, Inc.*, No. 10-22736 (RDD), 2010 WL 3766555, at *3 (Bankr. S.D.N.Y. Aug. 10, 2010).

A. Eligible Debtor:

With certain exceptions, any "person"[3] who is eligible to file a voluntary bankruptcy petition may be the putative debtor in an involuntary bankruptcy petition. Notably, courts have also held

[1] *See* Table 7.2–U.S. Bankruptcy Courts Judicial Facts and Figures (September 30, 2022), (available at https://www.uscourts.gov/statistics/table/72/judicial-facts-and-figures/2022/09/30).

[2] This dollar amount is adjusted every three years. 11 U.S.C. § 104(b).

[3] The term "person" is defined in the Bankruptcy Code to include both individuals and business entities. *See* 11 U.S.C. § 101(41).

that involuntary petitions cannot be filed against nonprofit organizations or municipalities. *See, e.g.*, *Official Comm. of Unsecured Creditors v. Archdiocese of Saint Paul & Minneapolis (In re Archdiocese of Saint Paul & Minneapolis)*, 888 F.3d 944 (8th Cir. 2018). Similarly, an involuntary petition cannot proceed against a farmer, unless the farmer consents to entry of an order for relief.

B. Number of Petitioning Creditors:

If the putative debtor has twelve or more creditors, at least three qualifying creditors must join as petitioning creditors to collectively file the involuntary petition. However, the Bankruptcy Code requires only one petitioning qualifying creditor in instances where the putative debtor has less than twelve creditors.

C. Qualification of Creditors:

Each petitioning creditor must hold non-contingent, undisputed, unsecured claims and be otherwise qualified to join the petition. Examples of creditors which potentially can serve as petitioning creditors (if the other requirements above are met) include (i) a judgment holder against the putative debtor, (ii) a transferee or transferor of a claim so long as the transfer was not for purposes of initiating the involuntary bankruptcy case, (iii) a fully or partially secured creditor, or (iv) an indenture trustee. Notably, certain ordinary course creditors with *de minimis* recurring claims (i.e., utility bills or insurance premiums), although holding legitimate claims against the putative debtor, are typically not eligible to qualify as a petitioning creditor. In addition, certain creditors such as employees, insiders, and transferees of avoidable transfers are statutorily excluded from being counted towards the requisite number of petitioning creditors. 11 U.S.C. § 303(b)(2).

Attempts by creative, scorned creditors to skirt these stringent requirements are often rejected by courts. For example, a creditor may not sell or assign a portion of its claim against the putative debtor to another party purely for the purpose of artificially creating the requisite number of qualifying creditors to file an involuntary petition. An entity that has transferred or acquired a claim for the purpose of commencing an involuntary petition will not be considered a qualifying creditor eligible to become a petitioning creditor. Fed. R. Bankr. P. 1003(a).

Similarly, if two or more creditors are both eligible to potentially collect on a debt—such as affiliates or parties who sold the right, in full or in part, to collect on a claim or otherwise share the right to payment over the same debt—those creditors do not count as multiple qualifying creditors. Thus, if a putative debtor has twelve or more creditors, at least three creditors with a *separate right to payment under applicable state law* are required as petitioning creditors.

D. Qualifying Debt:

A qualifying creditor must also hold a "qualifying" debt, meaning the creditor must hold a distinct claim (as set forth above) that is not contingent[4] or the subject of a *bona fide* dispute as

[4] A claim is contingent if the debt is not due and owing unless and until a specific future event occurs.

to liability or amount. Although the Bankruptcy Code does not define the term "bona fide dispute", courts utilize an objective standard, analyzing "whether there is an objective basis for either a factual or a legal dispute as to the validity of the debt." *In re Biogenetic Techs., Inc.*, 248 B.R. 852, 856–57 (Bankr. M.D. Fla. 1999) (citations omitted). For example in *In re Biogenetic Technologies, Inc.*, the bankruptcy court found a bona fide dispute existed as to the enforceability of the contract the debt was based upon, and therefore the creditor was not eligible to be a petitioning creditor in the involuntary bankruptcy proceeding. *Id.* at 859.

E. Demonstrate Grounds for the Relief:

Section 303(h) of the Bankruptcy Code also requires the petitioning creditors to prove one of two alternative grounds for the involuntary relief. Either (i) the putative debtor is generally not paying its debts as they become due (unless the debt is the subject of a bona fide dispute as to liability or amount); or (ii) within 120 days before the filing of the involuntary petition, a custodian, other than a trustee, receiver, or an 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. 11 U.S.C. § 303(h). Satisfaction of either prong requires the putative debtor to be in significant financial distress—thus, providing a limit on a creditor's ability to inappropriately commence an involuntary proceeding.

Whether a debtor is generally not paying its debts as they become due is a highly factual inquiry. Bankruptcy courts have rejected a purely mechanical test and have held that "generally" does not necessarily mean usually or most of the time, because the standard is flexible and depends on the totality of circumstances. Common factors include the number of debts, the amount of the delinquency, the materiality of the nonpayment, and the nature and conduct of the debtor's business.

The second ground for relief, where a custodian has been appointed, was included in the Bankruptcy Code to provide creditors in these circumstances a simpler test for entering an involuntary bankruptcy, allowing creditors to easily obtain protections that the Bankruptcy Code provides. After the initial 120-day period, however, a creditor in these circumstances will need to prove the more challenging test described above.

II. Putative Debtor's Attempts to Dismiss the Involuntary Bankruptcy

Once a prima facie case has been established by the petitioning creditors, the burden then shifts to the entity against whom the involuntary petition has been filed (referred to herein as the putative debtor) to demonstrate that the eligibility requirements have not been met. *See Persico*, 2010 WL 3766555, at *3. Even where the factors set forth above have been met, petitioning creditors should not expect a putative debtor to give in quietly to the involuntary petition. In addition to seeking dismissal of the petition, the putative debtor might seek damages against the petitioning creditors if it believes the involuntary petition was filed in bad faith. As such, creditors considering filing an involuntary petition must carefully consider the putative debtor's potential defenses to the petition and the related consequences if the involuntary petition is dismissed.

After the involuntary petition is filed, there is a 21-day gap period that provides the debtor with a deadline to respond to the involuntary petition. The putative debtor may allege a number of defenses in its response to the involuntary petition, such as: [5]

- The involuntary petition has procedural deficiencies, for example that: (i) the putative debtor is not eligible to be a bankruptcy debtor; (ii) the petitioning creditors do not satisfy the requirement for three or more qualifying creditors (in cases where the putative debtor has twelve or more creditors); or (iii) the venue of the case is improper.

- The petitioning creditors are not qualifying creditors and/or their claims are subject to bona fide dispute.

- The petitioning creditors do not have the requisite aggregate amount of qualifying debt.

- The putative debtor is generally paying its debts as they become due.

Additionally, a putative debtor can seek dismissal of an involuntary petition alleging that the petition was not filed in good faith (a requirement under the Bankruptcy Code). Even where the petitioning creditors have met all the requirements for filing an involuntary bankruptcy case, the case may be dismissed if it was filed in bad faith—for example, with the goal of harassing the putative debtor. *In re Forever Green Athletic Fields, Inc.*, 804 F.3d 328, 335–36 (3d Cir. 2015). The Bankruptcy Code's requirement for good faith filings has "strong roots in equity," *id.* at 334, and seeks to prevent improper involuntary petition filings by ensuring that the "balancing of interests is not undermined by petitioners whose aims are antithetical to the basic purposes of bankruptcy." *NMSBPCSLDHB, L.P. v. Integrated Telecom Express, Inc. (In re Integrated Telecom Express, Inc.)*, 384 F.3d 108, 119 (3d Cir. 2004).

Courts utilize different tests and factors in determining whether an involuntary petition was filed in bad faith. *Forever Green*, 804 F.3d at 336. For example, the following are examples of tests courts use in making this determination:

- The "improper use" test questions whether the filing was intended to obtain a disproportionate advantage for the petitioning creditor rather than to protect the creditor collectively.

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[5] However, a debtor can also (i) consent to the entry of an order for relief, (ii) file its own voluntary petition in the same or a difference venue, (iii) fail to timely contest the involuntary petition, after which the bankruptcy court can enter an order for relief (essentially holding that the involuntary bankruptcy is proper) and require the debtor to file documents such as a list of creditors and schedule of assets. In addition, after the involuntary petition is filed, other creditors may seek to join the involuntary petition or seek to dismiss it. If the involuntary petition is permitted to move forward, all creditors, including those that took the laboring oar to initiate the involuntary bankruptcy proceeding, must still share in the debtor's assets within the Bankruptcy Code's priority scheme. This means that a general unsecured creditor, even if it is a petitioning creditor, will have to share *pro rata* with other general unsecured creditors, and may not be paid in full. The priority and potential payment of its claim should also be considered by a creditor considering filing an involuntary bankruptcy.

- The "improper purpose" test analyzes whether the filing was motivated by ill will or a desire to harass.

- The "objective test" assesses the filing through the lens of "a reasonable person" to see if a reasonable person in the creditor's position would have filed the involuntary petition.

- The "totality of the circumstances" test is a highly fact-based standard through which the bankruptcy court considers a myriad of factors including, *inter alia*, the improper use test, the improper purpose test, and whether (i) the statutory requirements were met, (ii) the creditors made "a reasonable inquiry into the relevant facts and pertinent law before filing", (iii) the filing was used to create a tactical advantage and/or was used as a substitute to debt-collection procedures, (iv) the timing of the filing was suspicious, and (v) the creditors had evidence of dissipation of the debtor's assets.

Id. at 335–36.

In *In re Forever Green Athletic Fields, Inc.*, the court dismissed the involuntary petition as being filed in bad faith applying the totality of circumstances test. The court based its decision on a multitude of facts, including that the petitioning creditor, (i) made clear he had a litigation strategy of using "any means necessary to force payment" of his lien, (ii) acted in a way that "ran counter to the spirit of collective creditor action", (iii) used the bankruptcy proceeding to exert pressure on the debtor and gain a personal advantage, (iv) did not conduct any diligence regarding payments to other creditors, and (v) filed the petition days before he was required to file a brief in the related state court proceeding between the parties. *Id.* at 336–37.

Conversely, indicia of good faith finding include: (i) the creditors satisfied the statutory criteria for filing the petition; (ii) the involuntary petition was meritorious; (iii) the creditors made a reasonable inquiry into the relevant facts and pertinent law before filing; and (iv) there was evidence of preferential payments to certain creditors or of dissipation of the debtor's assets. *Id.* at 335–36. For example, in *General Trading v. Yale Materials Handling Corporation*, the Eleventh Circuit found that where the petitioning creditor's primary concern in filing the involuntary bankruptcy petition "was to protect itself against other creditors' obtaining a disproportionate share" of the putative debtor's assets, the petition was filed for a "proper purpose" and could not be dismissed for bad faith. 119 F.3d 1485, 1502 (11th Cir. 1997).

If the bankruptcy court determines that an involuntary petition was in fact filed in bad faith, as it did in *Forever Green*, or for the reasons set forth above pursuant to any test, the putative debtor may seek an award of costs, reasonable attorneys' fees, and damages, to be paid by the petitioning creditors. 11 U.S.C. § 303(i). The threat of sanctions on the petitioning creditors is intended, in part, to discourage petitioners from filing involuntary petitions to force debtors to pay on a disputed debt. *Crest One SpA v. TPG Troy, LLC (In re TPG Troy, LLC)*, 793 F.3d 228, 235 (2d Cir. 2015).[6]

[6] A putative debtor may also request, and a bankruptcy court might require, that the petitioning creditors post an indemnity bond to protect the debtor in the event the court finds, for example, the involuntary petition was filed in bad faith.

As such, a potential petitioning creditor must evaluate and weigh both the potential benefits and risks when deciding whether an involuntary bankruptcy petition is the best strategy to use against a counterparty that is not paying its debts as they come due. Because an improper involuntary filing can impact the creditor's own wallet through a court issuing sanctions against petitioning creditors or requiring them to post indemnity bonds, a petitioning creditor needs to carefully consider, with the assistance of counsel, (i) if they meet the eligibility requirements, and (ii) whether filing an involuntary bankruptcy is an appropriate strategy.

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