# Involuntary Bankruptcy Filings: A PRIMER FOR CREDIT PROFESSIONALS

THE BANKRUPTCY CODE PROVIDES MANY POWERFUL TOOLS TO MAXIMIZE THE VALUE OF A DISTRESSED CUSTOMER'S ASSETS AND GENERATE RECOVERIES TO CREDITORS. HOWEVER, FINANCIALLY DISTRESSED CUSTOMERS MAY DECIDE NOT TO FILE A BANKRUPTCY PETITION FOR ANY NUMBER OF REASONS.

Customers may be deterred by the potential stigma caused by the public filing and other potential risks. An individual's or company's bankruptcy filing also exposes the debtor and "insiders" (such as a debtor's owners, directors, officers, and other management) to scrutiny and potential liability for certain causes of action that a chapter 7 trustee, creditors' committee, liquidating trustee or other bankruptcy estate fiduciary can assert if the bankruptcy filing were preceded (or perhaps caused) by any misconduct.

Financially distressed customers may instead choose to simply "shut off the lights" or otherwise languish away without commencing any bankruptcy or other insolvency proceedings, leaving their creditors in search of potential options to collect their outstanding claims and otherwise obtain closure. To make matters worse, these customers might have made distributions to their owners on account of their equity or debts owed to them, where they instead should have paid creditors on their outstanding claims. What can creditors do about this kind of debtor misconduct?

One potential option: Creditors may consider filing an involuntary bankruptcy petition against a customer that is failing to timely pay its debts. If successful, a trustee will be appointed to liquidate the debtor's assets, reconcile claims, and investigate potential causes of action that may be brought on behalf of the debtor, potentially resulting in recoveries that can fund distributions to creditors that would not have otherwise been possible without a bankruptcy filing. This makes an involuntary bankruptcy filing a powerful tool for creditors, particularly where the debtor may be transferring, concealing, or otherwise wasting assets, or there is "a run" on the debtor by other creditors that are commencing foreclosure actions or are otherwise attempting to collect their claims against and seize assets from the debtor.

However, the decision to join an involuntary bankruptcy petition should not be taken lightly. An involuntary bankruptcy filing may yield little benefit to creditors where the debtor's secured lender has a large outstanding claim that exceeds the value of its

collateral or the debtor otherwise lacks sufficient assets to provide a recovery to unsecured creditors. Moreover, an improper involuntary bankruptcy filing exposes the petitioning creditors to potentially huge damage claims that the debtor may assert against them.

This primer provides a high-level summary of the requirements petitioning creditors must satisfy to prevail on an involuntary bankruptcy filing and certain key issues creditors should consider when asked to join an involuntary bankruptcy petition. But always remember: a creditor considering joining an involuntary bankruptcy petition should consult with counsel and heavily scrutinize the circumstances, timing, and risks of a potential involuntary bankruptcy petition!

## THE REQUIREMENTS FOR FILING AN INVOLUNTARY BANKRUPTCY PETITION

Section 303 of the Bankruptcy Code sets forth the following requirements for prevailing on an involuntary bankruptcy petition:

1. If a debtor has twelve or more creditors, at least three creditors must join in the involuntary petition and collectively hold claims in an aggregate amount of at least $21,050[1] that are not contingent or the subject of a ***bona fide* dispute as to liability or amount**. This numerosity requirement is intended to discourage creditors from using an involuntary petition to coerce a debtor to pay debts to which the debtor has legitimate defenses.
2. If a debtor contests an involuntary petition, the petitioning creditors must prove that:
   a. **the debtor is generally not paying its debts as they become due** (not considering debts subject to a *bona fide* dispute as to liability or amount), or
   b. 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.

If the petitioning creditors satisfy all of Section 303's requirements, the bankruptcy court will usually enter an order for relief on their involuntary bankruptcy petition. The petitioning creditors can then assert an administrative expense priority claim for the fees they incurred successfully prosecuting the petition.

However, if the petitioning creditors fail to satisfy Section 303's requirements and the involuntary petition is dismissed, the petitioners face significant risks. The bankruptcy court may require the petitioning creditors to pay the debtor's fees and costs incurred in defending the petition, including the debtor's attorneys' fees. Under certain circumstances (such as a bad faith filing, as discussed below), the court may also award the debtor compensatory damages for the actual losses

IF THE PETITIONING CREDITORS FAIL TO SATISFY SECTION 303'S REQUIREMENTS AND THE INVOLUNTARY PETITION IS DISMISSED, **THE PETITIONERS FACE SIGNIFICANT RISKS**.

the debtor incurred as a result of the filing and, in the most egregious cases, punitive damages. These claims are intended to compensate the debtor for the harm caused by an improperly filed involuntary petition and discourage petitioning creditors from joining a frivolous involuntary petition.

## THE DEBTOR'S POTENTIAL RESPONSE TO AN INVOLUNTARY PETITION

The filing of an involuntary bankruptcy petition is just the beginning. The debtor will then have 21 days to respond to the involuntary petition. If the debtor fails to timely respond, the bankruptcy court will enter an order for relief and the bankruptcy case will continue.

Interestingly, sometimes a debtor will file a *voluntary* bankruptcy petition after an involuntary petition has been filed. This is treated as the functional equivalent of the debtor admitting that a bankruptcy case should proceed, with the court typically consolidating the two cases under the docket of the first-filed case.

If the debtor files an answer or other response opposing an involuntary petition, a variety of issues may be litigated. The debtor may argue that it is ineligible to be a debtor, the venue is improper, or the petitioning creditors otherwise cannot satisfy all of the requirements for joining an involuntary petition. For example, the debtor may contest the eligibility of one or more of the petitioning creditors, often arguing that some or all of the creditors' claims are subject to *bona fide* dispute. If the debtor is successful and disqualifies one or more of the petitioning creditors, the involuntary petition will be dismissed if there no longer is the requisite number of creditors or aggregate amount of claims needed to obtain relief on the involuntary petition. The debtor may also argue it is paying all debts not subject to *bona fide* dispute as they come due, or that the case was not filed in good faith which also warrant dismissal of the involuntary petition. Certain of these key issues are discussed below.

## THE *BONA FIDE* DISPUTE REQUIREMENT

A claim is subject to a "*bona fide* dispute" when there is an objective factual or legal basis to dispute the validity of the debt or its amount. A debtor may dispute liability to a petitioning creditor, such as where the petitioning creditor's claim is based on unresolved litigation, or the debtor disputes the creditor's delivery of ordered goods or provision of requested services. A debtor may also dispute all or a portion of a petitioning creditor's claim.

Historically, the prevailing view was that a creditor's partially disputed claim is not subject to *bona fide* dispute and, therefore, did not disqualify the creditor from joining in an involuntary petition. However, in 2005, Congress amended Bankruptcy Code Section 303(b)(1) to require that a petitioning creditor's claim cannot be subject to a *bona fide* dispute "**as to liability or amount**." This change has prompted courts to question the eligibility of petitioning creditors whose claims are partially disputed and has led to conflicting court rulings. Several courts have held that Section 303(b)(1) treats any partially disputed claim as subject to a *bona fide* dispute because the claim is disputed "as to amount." These courts disqualified creditors with partially disputed claims from joining an involuntary petition, regardless of how small the dispute may be. Other courts have interpreted Section 303(b)(1) as merely clarifying prior legislative intent to focus primarily on liability issues regarding petitioning creditors' claims and not precluding creditors with partially disputed claims from seeking involuntary bankruptcy relief based on the undisputed amount of their claims as long as the creditor satisfies the numerosity and other requirements of Section 303(b).

That said, the legal landscape is trending toward a strict interpretation of Section 303(b)(1)'s "*bona fide* dispute" limitation. The U.S. Courts of Appeals for the First, Fifth, and Ninth Circuits, as well as other federal courts, such as the U.S. Bankruptcy Court for the Southern District of New York, have held that a dispute as to any portion of a claim gives rise to a *bona fide* dispute that strips a creditor's standing to join an involuntary bankruptcy petition.

## FAILURE TO PAY DEBTS AS THEY COME DUE

There is no definitive standard for determining whether a debtor is paying debts as they come due. Courts will consider the number and amount of debts, the extent of the debtor's default on its debts, and other circumstances surrounding the debtor's business. Of note, the debtor's "solvency" on a balance sheet basis is irrelevant. A balance sheet insolvent debtor may be generally paying debts as they come due, and a balance sheet solvent debtor may choose not to pay debts as they come due! Whether this requirement for an involuntary filing is satisfied involves a highly fact-sensitive inquiry that courts will decide on a case-by-case basis.

## THE "GOOD FAITH" REQUIREMENT

A bankruptcy court may dismiss an involuntary petition if the court finds the petition was not filed in good faith. A bankruptcy court will consider the following indicators of "good faith":

- whether the creditors satisfied the statutory criteria for filing the petition;
- whether the involuntary petition was meritorious;
- whether the creditors made a reasonable inquiry into the relevant facts and pertinent law before filing; and

- whether there was evidence of preferential payments to certain creditors or a dissipation of the debtor's assets.

Again, there is no definitive standard for determining whether a petition was filed in "bad faith." Bankruptcy courts across the country have utilized a variety of tests in determining bad faith. They include the following:

- **The improper purpose test,** under which the court analyzes whether the filing was motivated by a desire to harass the debtor or other ill-will;
- **The objective test,** which is hardly objective at all—under this test, the court assesses whether a "reasonable person" would have commenced the involuntary bankruptcy proceeding; and
- **The totality of the circumstances test.** This is a highly fact-based standard through which the bankruptcy court considers many potential factors. For example, in the Third Circuit (where prominent bankruptcy courts such as those in Delaware and New Jersey are located), bankruptcy courts consider whether:
  - The petitioning creditors satisfied the statutory criteria for filing the petition;
  - The involuntary petition was meritorious;
  - The creditors made a reasonable inquiry into the relevant facts and pertinent law before filing;
  - There was evidence of preferential payments to certain creditors or a dissipation of the debtor's assets;
  - The filing was motivated by ill will or a desire to harass a debtor;
  - The petitioning creditors used the filing to obtain a disproportionate advantage for themselves rather than to protect against other creditors doing the same;
  - The filing was used as a tactical advantage in a pending litigation;
  - The filing was used as a substitute for customary debt-collection efforts; and
  - The filing was marked by suspicious timing.

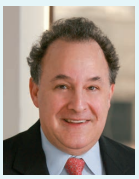
The fact-sensitive and case-by-case nature of the above tests makes it difficult for a petitioning creditor to know in advance whether its conduct rises to the level of bad faith. As such, a creditor should carefully consider the above factors before joining an involuntary petition. Courts have not looked kindly at petitioning creditors that have used an involuntary petition purely as a debt collection tool. Note, an involuntary petition may be dismissed as a bad faith filing even where the petitioning creditors satisfied all of Bankruptcy Code Section 303's requirements!

## CONCLUSION

An involuntary bankruptcy filing may be a powerful tool for creditors, particularly where the creditors have a legitimate reason to believe the debtor has transferred assets to its owners or other third parties that may be recoverable by a bankruptcy trustee. But creditors considering pushing a company into bankruptcy should do their diligence to ensure they satisfy Bankruptcy Code Section 303's requirements and that the filing is unlikely to be considered a bad faith filing. Otherwise, the involuntary case may be dismissed, and the petitioning creditors may be on the hook for the debtor's costs, including attorneys' fees, to defend the petition—and for potentially significant actual and punitive damage claims.

Creditors contemplating joining an involuntary petition may also consider raising the threat of filing with the debtor-customer before actually filing the petition. The threat alone, if raised properly, may be sufficient to drive a settlement with the debtor, particularly if the debtor or its principal(s) have something to hide. The debtor (or its principal(s)) may prefer to settle rather than face the time, expense, and risk associated with a contested involuntary bankruptcy petition. BC

*1 For cases filed on or after Apr. 1, 2025.*



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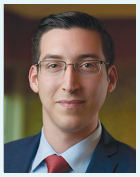

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