Involuntary Bankruptcy: A Powerful Tool in the Creditor's Arsenal, but Proceed with Caution

Panel Members:

- Judge John W. Kolwe, U.S. Bankruptcy Judge for the Western District of Louisiana
- Louis M. Phillips, Kelly Hart
- Benjamin W. Kadden, Lugenbuhl, Wheaton, Peck, Rankin & Hubbard
- Brooke W. Altazan, Stewart Robbins Brown & Altazan, LLC

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Topics for Today

I. Common reasons for petition and overview of the statutory grant.
II. Eligible debtors and chapters.
III. Requirements for petitioners.
IV. Requirements for order for relief.
V. The "Gap Period."
VI. Dismissal and debtor's remedies against petitioners.
VII. Venue.
VIII. Conclusion and questions.

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I. Common reasons for petition and overview of the statutory grant.

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Why file an involuntary petition?

- Common catalysts:
  - Incompetent debtor management
  - Friction among partners in a partnership debtor
  - Debtor transferring assets or paying favored creditors
    - *See* 2 COLLIER ON BANKRUPTCY ¶ 303.01 (Richard Levin & Henry J. Sommer eds., 16th ed.) (hereinafter, COLLIER).
- Bankruptcy court as an emergency room, not the morgue.

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The Statutory Grant

- 11 U.S.C. § 303
  - **(a) Eligible debtors, chapters.**
  - **(b) Petitioner requirements.**
  - (c) Creditors who may join petition.
  - (d) Who may answer the petition.
  - (e) Necessity of bond.
  - **(f) Ability of debtor to operate, do business.**

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The Statutory Grant (cont.)

- 11 U.S.C. § 303
  - **(g)Appointment of interim trustee.**
  - **(h) Necessity of trial, requirements for order for relief.**
  - **(i) Costs, attorney's fees, damages, and punitive damages.**
  - **(j) Dismissal, necessity of notice and hearing.**
  - (k) False or fraudulent petitions, sealing and other remedies.

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II. Eligible debtors and chapters.

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The Involuntary Debtor | § 303(a)

- May be commenced "only against a person."
  - Person "includes individual, partnership, and corporation." 11 U.S.C. § 101(41).
- But § 303 excludes:
  - A farmer,
  - Family farmer, or
  - A corporation that is not a moneyed, business, or commercial corporation.
    - E.g., schools, churches, charitable organizations and foundations.
    - Some courts have excluded limited liability partnerships because the limited liability partners aren't responsible for partnership debts.
      - *See, e.g., In re Rambo Imaging, L.L.P.*, No. 07-11190, 2008 Bankr. LEXIS 2311, at *16 (Bankr. W.D. Tex. July 15, 2008).

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Available Chapters | 303(a)

- Only authorized in chapter 7 and 11.
- Why?
  - Chapter 9 - could enable disgruntled city contractors to put a municipality in bankruptcy.
  - Chapter 12 – the farming season is cyclical.
  - Chapter 13 – raises concerns regarding involuntary servitude and Thirteenth Amendment.
  - See COLLIER, at ¶ ¶ 303.03, 303.05.



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Involuntary Requirements Generally

- Availability of involuntary relief generally hinges on two sets of requirements:
  - Thresholds by head and amount for petitioning creditors, set forth in 303(b).
  - Court determination that debtor is not paying debts as they become due, set forth in 303(h)
- These requirements are ***not*** jurisdictional and may be waived.
  - *See Adams v. Zarnel (In re Zarnel)*, 619 F.3d 156, 169 (2d Cir. 2010)
- Debtor can also consent to an order for relief following an involuntary petition.
  - *See In re Whistler Energy II, LLC,* No. 16-10661 (Bankr. E.D. La.), Doc. No. 59.

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III. Requirements for qualifying petitioners.

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Petitioner Requirements | 303(b)

- Thresholds:
  i. Sufficent number of petitioning creditors by head (1 or 3).
  ii. Sufficient amount of qualifying debt ($18,600.00[1]) held in aggregate by petitioners.

[1] Adjusted as of April 1, 2022. *See* 11 U.S.C. § 104.

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Petitioner Requirements | 303(b)

- Petitioners needed by head:
  - **3** qualified petitioning creditors, at least, if the debtor has 12 or more eligible creditors.
  - **1** qualified petitioning creditor, at least, if the debtor has less than 12 eligible creditors.

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Eligible Creditors | 303(b)

- Holders who never count toward the 12-creditor cutoff:
  1. Employees;
  2. Insiders; or
  3. Transferees whose transfers are voidable.
     - Generally, this is determined on the petition date, not the hearing date; however, courts have made an exception if a creditor receives a post-petition transfer under § 549.
       - *See In re Intelligent Surveillance Corp.*, No. 21-31096, 2021 Bankr. LEXIS 3376, at *12 (Bankr. N.D. Tex. Dec. 10, 2021).
     - Ordinary course defenses must be considered to determine whether a creditor is excluded.
       - *See Hanh Thai Williams v. Armand L. Roos.* No. 19-01674, (Bankr. W.D. La.), Doc. No. 18.

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Eligible Creditors | 303(b)

- Holders who ***may*** not count toward the 12-person cutoff:
  4. Claimants with very small recurring claims (*Denham* claims).
     - Circuits split over whether small reoccurring expenses (e.g., utility bills and insurance premiums) are counted in number of total creditors.
       - *See Denham v. Shellman Grain Elevator, Inc.*, 444 F.2d 1376 (5th Cir.1971) (excluding creditors with very small, recurring claims)
       - *See In re Moss*, 249 B.R. 411, 419 (Bankr. N.D. Tex. 2000) (collecting cases, noting criticism of Fifth Circuit's *Denham* decision).

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Petitioner Requirements | 303(b)

- Effect of creditors' repayment?
  - Petitioner requirements are determined to be met (or not) as of petition date, not the hearing date.
    - *See In re Revolution Aluminum Propco, LLC* (Case No. 16-81024, Bankr. W.D. La.). Involuntary petition filed against Propco, after a motion to dismiss by Propco and motion for summary judgment by petitioning creditors, parties agreed an order of relief shall be entered unless by a certain date the creditors claims were satisfied. *See Id.*, Doc. No. 65.

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Qualifying Petitioner Debt | 303(b)

- Qualifying petitioner debt contributing to $18,600[1] threshold must be:
  1. Not contingent as to liability;
  2. Not the subject of a bona fide dispute as to liability or amount; and
  3. Not secured.
     - A fully secured creditor may qualify as a petitioner by head without his debt contributing to the aggregate qualified debt minimum.
     - Some courts have found a secured creditor can waive the security for a portion of its claim to meet the minimum. *See, e.g., In re Green*, Nos. 06-11761, 06-11762, 2007 Bankr. LEXIS 1296, at *16 (Bankr. W.D. Tex. Apr. 9, 2007).

[1] Adjusted as of April 1, 2022. *See* 11 U.S.C. § 104.

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1. Not Contingent as to Liability | 303(b)

- "[C]laims are contingent as to liability if the debt is one which the debtor will be called upon to pay only upon the occurrence or happening of an extrinsic event which will trigger the liability of the debtor to the alleged creditor and if such triggering event or occurrence was one reasonably contemplated by the debtor and creditor at the time the event giving rise to the claim occurred." *In re All Media Props., Inc.*, 5 B.R. 126, 133 (Bankr. S.D. Tex. 1980).
- Contingent debt examples:
  - Unearned sales agent commissions
  - Guarantor payments, prior to principal default
- Non-contingent debt example:
  - A debt for merchandise purchased that the purchaser contests is defective
- *See* COLLIER at ¶ 303.10



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2. Not Subject to Bona Fide Dispute to Liability or Amount | 303(b)

- Petitioning creditors bear initial burden to prove their claims are *not* subject to bona fide dispute to liability or amount (then burden shifts to the debtor)
  - Rationale – prevents creditors with disputed claims from extorting payment through the involuntary process. *See* COLLIER, at ¶ 303.11.
- A "bona fide dispute" is a dispute as to "whether there is an objective basis for a factual or legal dispute as to the validity of the debt." *Subway Equip. Leasing Corp. v. Sims (In re Sims)*, 994 F.2d 210, 221 (5th Cir. 1993) (collecting cases).
  - Debtor's mere refusal to pay alone isn't necessarily a bona fide dispute. COLLIER at ¶ 303.11.
  - Common Issues of contention:
    - Affirmative defenses
    - Counterclaims (same versus different transactions)
    - Pending but unresolved litigation

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2. Not Subject to Bona Fide Dispute to Liability or Amount | 303(b) (cont.)



Phrase, "as to liability or amount," was added in 2005 amendments.



Language spawned some debate whether a bona fide dispute over a *portion* of its claim disqualifies the creditor.

See *In re Seven Three Distilling Co., LLC*, No. 21-10219, 2021 Bankr. LEXIS 1790, at *19 (Bankr. E.D. La. July 6, 2021) (finding that as long as the disputed portion doesn't drop the claim amount below the threshold, this will not exclude the petitioning creditor).

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3. Not secured | 303(b)

- Per § 101(50), a security interest is a "lien created by agreement," while a "statutory lien" (see § 101(53)) expressly carves out "security interest"
- A petitioning creditor can waive its security interest.
  - *See In re All Media Props., Inc.*, 5 B.R. 126, 141 (Bankr. S.D. Tex. 1980).

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IV. Requirements for order for relief.

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Relief Requirements | 303(h)

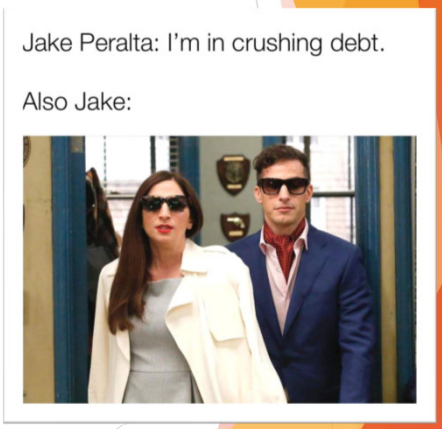
- Debtor generally not paying debts as they become due.
- Unless the debts are the subject of a bona fide dispute as to liability or amount.

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Debtor Generally Not Paying Debts as They Become Due | 303(h)

- Not an insolvency test; key issue is whether the debtor ***is*** paying their debts (not ***can*** pay their debts). *See Seven Three Distilling*, 2021 Bankr. LEXIS 1790, at *30.
- Factors (relevance is dependent upon the facts of the case):
  - Number of unpaid claims
  - Amount of such claims
  - Materiality of non-payments
  - Putative debtor's overall conduct in their financial affairs



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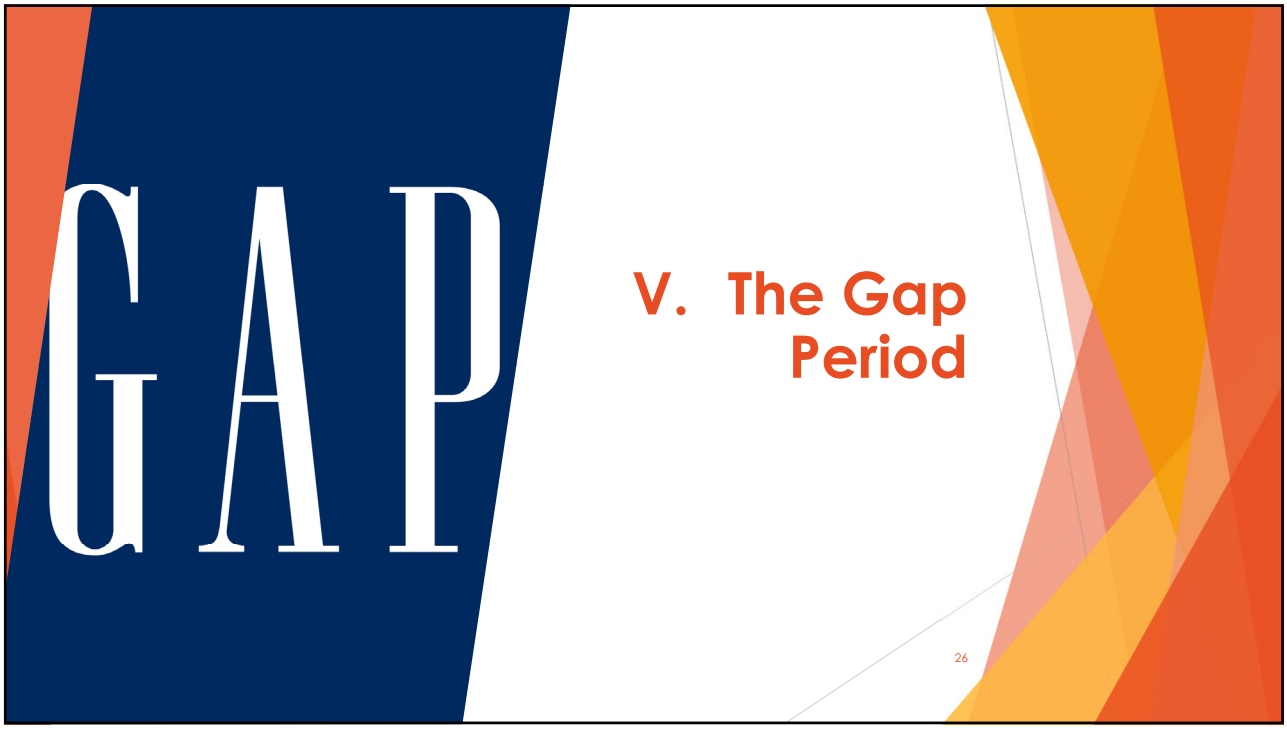
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Debtor Generally Not Paying Debts as They Become Due | 303(h)

- In considering whether Debtor is paying debts as they become due, court should ***not*** consider:
  1. Debts subject to bona fide dispute as to liability or amount; or
  2. Postpetition payment of prepetition debts.

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V. The Gap Period

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The Gap Period | 303(f)



- The "Gap Period" is the time between the involuntary filing and order for relief.
- During this time, the debtor can (unless the Court orders otherwise):
  - Continue operating as a business;
  - Use, acquire, or dispose of property as if no case was commenced (and notwithstanding § 363).
    - But this is tempered by § 549.

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Minding the Gap | 303(g), (h)

- During this time:
  - An estate under § 541 is created.
  - Automatic stay under § 362 applies once the petition is filed.
    - But not all creditors may know an involuntary petition was filed since notice isn't required. *See* COLLIER, at ¶ 303.25.
- Additional Protections:
  - Some have issued injunctions under § 105(a) until the Court considers whether to enter an order for relief. *See Villarreal v. N.Y. Marine & Gen. Ins. Co. (In re OGA Charters, LLC)*, 554 B.R. 415, 433 (Bankr. S.D. Tex. 2016).
  - Party in interest may request court order the UST to appoint interim trustee under § 701. *See* § 303(g).

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Minding the Gap

- Creditors whose claims arise in the ordinary course of business after the petition date but before the order for relief are afforded priority status under § 507(a)(3).
  - But attorneys' fees incurred after the petition date and before order for relief to contest an involuntary petition have been held to not be debt incurred in the ordinary course of business. *Seven Three Distilling*, 2021 Bankr. LEXIS 2072, at 5-7.
- Postpetition payments to debtor's attorneys for services rendered before the petition date could be subject to avoidance under § 549.
  - *See* COLLIER at ¶ 303.25

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VI. Dismissal and debtor's remedies against petitioners

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Dismissal and Debtor Remedies | 303(j)



- If the petition is not dismissed with "consent of all petitioners and the debtor," courts may grant judgment:
  - Against petitioners for costs and reasonable attorney's fees; or
  - Against any petitioner filing the petition in bad faith for damages proximately caused by filing and punitive damages.

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Dismissal and Debtor Remedies | 303(j)

- Bad Faith:
  - Collier has identified 7 tests to analyze bad faith. COLLIER, at § 303.16.
    - *See Seven Three Distilling*, 2021 Bankr. LEXIS 2072, at *18 (analyzing bad faith under § 303(i) by examining the totality of circumstances).
  - Generally requires wrongful motives, objectives, or both. *In re Kennedy*, 504 B.R. 815, 824 (Bankr. S.D. Miss. 2014)

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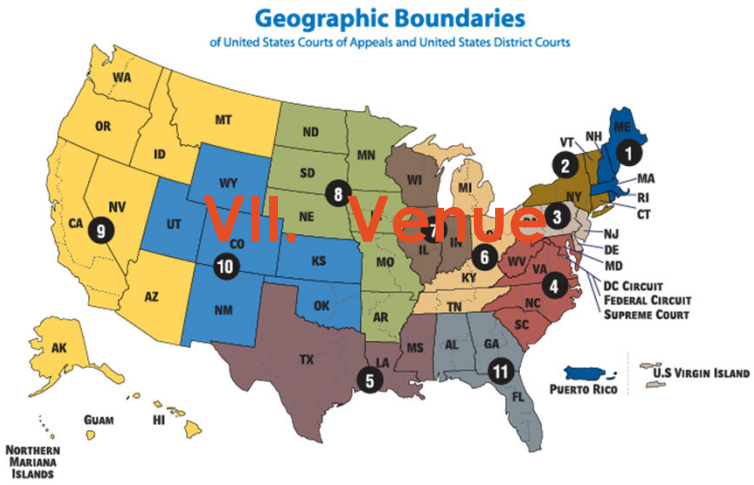
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Dismissal and Debtor Remedies | 303(j)

- Illustrations (see COLLIER, at ¶ 303.16):
  - Petition used to intimidate debtor into settlement
  - Creditor knowing its claim is subject to bona fide dispute to liability/amount
  - Single creditor knowing debtor has more than 11 creditors
  - Creditor disregarding information
- Courts split over whether bad faith can exist even if the petition satisfies the requirements of § 303.
  - Courts in the Fifth Circuit conclude a finding of bad faith is inappropriate if petitioners carry their burden under §§ 303(b) and (h). *See Seven Three Distilling*, 2021 Bankr. LEXIS 2072, at *16 (collecting cases).

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VII. Venue

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Venue

- 28 U.S.C. § 1408 is disjunctive and provides 4 separate grounds for venue.
- If there are two separate cases, court in the first filed case can determine where the cases should proceed. FED. R. BANKR. P. 1014(b).
  - Tracking the language of 28 U.S.C. § 1412 (regarding change of venue), the court considers two separate avenues: (1) interest of justice; and (2) convenience of parties. *In re Cox Operating, LLC*, 652 B.R. 49, 55 (Bankr. E.D. La. 2023).
  - Moving party usually has burden under 28 U.S.C. § 1412, but this becomes less clear with competing motions in two cases.
    - The "first-filed" rule from civil litigation doesn't translate into bankruptcy.
    - Typically becomes a question of deference as opposed to burden of proof.

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Venue

- Convenience Factors (*see In re Commonwealth Oil Refining Co.*, 596 F.2d 1239, 1247 (5th Cir. 1979)):
  - Proximity of creditors and debtor to court (technological innovation can downplay this factor);
  - Proximity of witnesses necessary for administering the estate;
  - Location of assets; and
  - Economic administration of estate.
- Interests of Justice:
  - Considers what is fair for ALL parties. *In re Patriot Coal Corp.*, 482 B.R. 718, 753 (Bankr. S.D.N.Y. 2012).
    - Chapter 11 isn't an us vs. them process; everyone is in it together and the goal is to maximize value. *Id*. at 722.

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Bankruptcy Remotes

- Party putting funds in "special purpose vehicle" (SPV) retains veto power over a voluntary bankruptcy filing.
  - This has led SPV to solicit creditors to file an involuntary petition. *In re Kingston Square Assocs.*, 214 B.R. 713, 739 (Bankr. S.D.N.Y. 1997) (bankruptcy court did not dismiss involuntary when SPV solicited creditors, but did request UST appoint chapter 11 trustee)
  - Can SPV be required to contest an otherwise proper involuntary petition or obtain dismissal within certain time?

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VIII. Conclusion

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Questions?

- **Your panelists:**
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  - Louis M. Phillips, Kelly Hart
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