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CREDITOR'S RIGHTS TOOLKIT

What Is an Involuntary Bankruptcy and How Can Creditors Use This Powerful Tool?

In most bankruptcies, the company decides to file for relief. In involuntary bankruptcies, creditors force the company into bankruptcy. Involuntary petitions are an extreme remedy, and therefore the requirements and standards to meet for filing such petitions are strictly construed and applied. If creditors meet the requirements under the Bankruptcy Code for filing an involuntary petition, it can serve as a powerful tool to use against a debtor.

Key Issues

- **WHAT IS REQUIRED TO FILE AN INVOLUNTARY PETITION?**
  Involuntary cases begin with filing a petition with the Bankruptcy Court pursuant to Section 303(a) of the Bankruptcy Code. Creditors can commence an involuntary bankruptcy case against any entity who would be eligible for a voluntary case under Chapter 7 or Chapter 11 of the Bankruptcy Code, except for farmers, family farmers, and nonprofit or charitable corporations. A court will grant involuntary relief against the debtor for any of the following reasons: (i) the debtor fails to timely contest the involuntary petition; (ii) the debtor is generally not paying its undisputed debts as they become due; or (iii) within 120 days before the petition was filed, a custodian was appointed to take possession of substantially all of the debtor's property, other than for the purpose of enforcing a lien against the debtor's property. The Bankruptcy Code sets forth the following minimum number of petitioning creditors. If a debtor has:
    - More than 12 creditors holding qualified claims against the debtor, then three or more of these creditors holding in the aggregate at least $18,600 in eligible unsecured claims may file an involuntary case (§ 303(b)(1), Bankruptcy Code).
    - Less than 12 creditors holding qualified claims against the debtor, then one or more of these creditors holding in the aggregate at least $18,600 in eligible unsecured claims may file an involuntary case (§ 303(b)(2), Bankruptcy Code)

- **SHOULD I COMMENCE THE CASE UNDER CHAPTER 7 OR CHAPTER 11?**
  If the goal is simply to liquidate the assets of the debtor, you should file the petition under Chapter 7. If, however, your goal includes the possible rehabilitation of the debtor, Chapter 11 is

a better choice, especially if there is a business involved. In general, however, Chapter 7 is less costly than Chapter 11. The filing fee for Chapter 7 is less and there is no exposure for payment of U.S. Trustee quarterly fees payable under 28 U.S.C. § 1930, which arguably could be levied against you by virtue of having commenced the case.

- **THE DEBTOR IS NOT PAYING DEBTS AS THEY COME DUE, SHOULD I FILE?**
  Generally, a creditor would consider filing an involuntary bankruptcy petition if (i) it suspects that the debtor is transferring, concealing, or wasting assets; (ii) the statutes of limitations are running on the debtor's causes of action, such as preferences and fraudulent transfers; or (iii) other creditors are seizing the debtor's property, foreclosing on liens, or otherwise dismantling the debtor. The Bankruptcy Code does not define what constitutes a debtor's general failure to pay its debts as they become due. However, the debtor's solvency is *not* a relevant consideration. In other words, a debtor who can pay its debts, but chooses not to, can be subject to an involuntary bankruptcy. Conversely, it is possible for a debtor who is insolvent but pays its debts to avoid involuntary bankruptcy. To determine whether a debtor is generally not paying its debts as they become due, courts consider a variety of factors, including the number of unpaid creditors and the amount of unpaid debts. Therefore, if the debtor regularly defaults on a significant number of payments to creditors or regularly fails to pay debts which constitute a significant portion of its aggregate debt, this might indicate a general failure to pay debts as they become due. Some courts also balance the interests of the debtor with those of its creditors when making this determination.

- **IF I DECIDE TO FILE BECAUSE I MEET THE REQUIREMENTS FOR DOING SO, WHAT HAPPENS NEXT?**
  Once the petition is filed, the debtor has 21 days to file an answer to the involuntary petition. The answer may allege one or more defenses to the involuntary petition. If the debtor defaults by filing no response within the 21 days, the court will, or as soon as practicable, enter an order for relief (Bankruptcy Code § 303(h), and Bankruptcy Rule 1013(b)). Once the court enters the order for relief, the debtor and creditors are subject to all provisions of the Bankruptcy Code. At this time, the debtor no longer has the right to operate its business. The rights of the parties become fixed, and the debtor's general estate passes out of its control.

Takeaway

If a creditor meets the requirements under the Bankruptcy Code for filing an involuntary petition, it can serve as a powerful tool to use against a debtor. Creditors must keep in mind, however, that filing the petition does not mean that the debtor is instantly subject to the Bankruptcy Code. Much like a civil lawsuit, the debtor has a chance to respond and defend itself when charged with an involuntary petition. Therefore, creditors should be prepared to respond to a debtors' answer and assure the bankruptcy process is the best path forward for both the debtor company and the creditor constituents.