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## Last in Line

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### With Lenders Asleep at the Wheel, Unsecured Creditors Should Consider Involuntary Bankruptcy



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The dearth of corporate bankruptcies in 2021 is easily attributed to federal stimulus funds, but there are other less-publicized causes, including a less active secured creditor body.<sup>1</sup> For example, behind the scenes, regulators pressured lenders to take a more forgiving approach, especially where defaults were linked to the pandemic.<sup>2</sup> Likewise, the Federal Reserve amended reserve ratio requirements, which granted banks the runway needed to take a more lenient approach.<sup>3</sup> In addition, the negative public image that would result from overzealous lenders exercising draconian default remedies during the height of the COVID-19 pandemic was likely a deterrent to that type of behavior.<sup>4</sup>

This borrower-friendly approach was not without unintended consequences. Unsecured creditors who historically relied on secured lenders to act as the primary gatekeepers of fiscally sound decision-making and liquidity were left without that oversight and are now forced to more actively monitor their trade counterparties. Of course, there are other factors putting pressure on unsecured creditors to more actively pursue their claims: supply chain and labor issues, inflation, and prohibitively slow collection actions through state

courts due to historic case backlogs.<sup>5</sup> Unsecured creditors must protect themselves, and involuntary bankruptcies can provide a powerful, albeit risky, remedy.<sup>6</sup>

#### Why Commence an Involuntary Proceeding?

Some situations that could justify commencing an involuntary proceeding against a debtor. These could include a suspicion that a debtor is concealing or fraudulently transferring assets, there is a race among competing creditors to seize a debtor's assets, and there is a looming statute of limitations with respect to avoidance actions.

#### What Are the Basic Requirements?

Section 303 of the Bankruptcy Code provides the mechanics for initiating an involuntary bankruptcy.<sup>7</sup> Section 303(b) provides, in relevant part:

An involuntary case against a person is commenced by the filing with the bankruptcy court of a petition under chapter 7 or 11 of this title —

(1) by three or more entities, each of which is either a holder of a claim against such person that is *not contingent as to liability* or the *subject of a bona fide dispute* as to liability or amount, or an indenture trustee

1 Maria Chutchian, "Bankruptcy Filings Lowest Since 1985 Amid Pandemic Relief," Reuters (Aug. 4, 2021), available at [reuters.com/legal/transactional/bankruptcy-filings-lowest-since-1985-amid-pandemic-relief-2021-08-04](https://www.reuters.com/legal/transactional/bankruptcy-filings-lowest-since-1985-amid-pandemic-relief-2021-08-04) (unless otherwise specified, all links in this article were last visited on Nov. 22, 2021).

2 Kevin Buehler, et al., "Leadership in the Time of Coronavirus: COVID-19 Response and Implications for Banks," McKinsey & Co. (March 17, 2020), available at [mckinsey.com/industries/financial-services/our-insights/leadership-in-the-time-of-coronavirus-covid-19-response-and-implications-for-banks](https://www.mckinsey.com/industries/financial-services/our-insights/leadership-in-the-time-of-coronavirus-covid-19-response-and-implications-for-banks).

3 Jeffrey Cheng, et al., "What's the Fed Doing in Response to the COVID-19 Crisis? What More Could It Do?," Brookings (March 30, 2021), available at [brookings.edu/research/fed-response-to-covid19](https://www.brookings.edu/research/fed-response-to-covid19).

4 Moreover, banks have been reluctant to deploy field examiners during the pandemic due to concerns for the health of their employees. See Donald F. Clarke, "Changed for Good? Completing Field Exams in a New Normal," *ABF Journal* (June 17, 2021), available at [abfjournal.com/articles/changed-for-good-completing-field-exams-in-a-new-normal](https://www.abfjournal.com/articles/changed-for-good-completing-field-exams-in-a-new-normal) (detailing complications and changes in lender site visits).

5 Lyle Moran, "Court Backlogs Have Increased by an Average of One-Third During the Pandemic, New Report Finds," *ABA Journal* (Aug. 31, 2021), available at [abajournal.com/news/article/many-state-and-local-courts-have-seen-case-backlogs-rise-during-the-pandemic-new-report-finds](https://www.abajournal.com/news/article/many-state-and-local-courts-have-seen-case-backlogs-rise-during-the-pandemic-new-report-finds).

6 The Bankruptcy Code provisions governing involuntary bankruptcies are specific and numerous, and the ramifications for commencing an involuntary bankruptcy without fulfilling those numerous requirements are serious and can be expensive for creditors.

7 11 U.S.C. § 303.

representing such a holder, if such noncontingent, undisputed claims aggregate at least \$15,775 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims;<sup>8</sup>

(2) if there are fewer than 12 such holders, excluding any employee or insider of such person and any transferee of a transfer that is voidable under section 544, 545, 547, 548, 549, or 724(a) of this title, by one or more of such holders that hold in the aggregate at least \$15,775 of such claims.<sup>9</sup>

There are a few points to consider. First, you can bring in other petitioning creditors after the petition is filed but before the case is dismissed.<sup>10</sup> Second, priority creditors can serve as petitioning creditors.<sup>11</sup> Third, an unliquidated claim is not necessarily noncontingent for purposes of an involuntary filing.<sup>12</sup> Finally, courts have construed “bona fide dispute” to require “an objective basis for either a factual or a legal dispute as to the validity of the debt.”<sup>13</sup> However, “courts have been evenly split on whether ‘a dispute as to any portion of a claim, even if some dollar amount would be left undisputed, means there is a bona fide dispute as to the amount of the claim.’”<sup>14</sup> Depending on the jurisdiction, a creditor’s eligibility to commence an involuntary proceeding under § 303 might be in jeopardy.<sup>15</sup>

## How Does It Work?

Even if the eligibility requirements are met, filing the involuntary petition against the debtor is really just the start of the process. Upon filing the involuntary petition, the case moves into the “gap period.” Under § 303(f) of the Bankruptcy Code, “except to the extent that the court orders otherwise, and until an order for relief [is issued] in the case, any business of the debtor may continue to operate, and the debtor may continue to use, acquire, or dispose of property as if an involuntary case concerning the debtor had not been commenced.”<sup>16</sup> However, a debtor’s authority during the gap period is generally less extensive than that of a trustee or debtor in possession in a voluntary filing.<sup>17</sup>

Creditors can move for the emergency appointment of an interim trustee if, for example, they are concerned about a dissipation of assets.<sup>18</sup> However, the existing case law under

§ 303(g) “counsels that a request for an interim trustee should be denied in ‘the absence of an exceptionally strong need for doing so’ or ‘where no facts are alleged showing a necessity for the appointment.’ In order to appoint a trustee, a movant must show ‘a substantial risk of loss to the estate.’”<sup>19</sup>

Also, moving creditors may be stayed from further collection activity.<sup>20</sup> Debtors who oppose an involuntary petition may file a response within 21 days of service of the summons.<sup>21</sup> Rule 1011 of the Federal Rules of Bankruptcy Procedure sets forth the guidelines for any responsive pleading, and Bankruptcy Rule 1013 provides that “[t]he court shall determine the issues of a contested petition at the earliest practicable time and forthwith enter an order for relief, dismiss the petition, or enter any other appropriate order.”<sup>22</sup> If the petition has not been dismissed, the bankruptcy court will enter an order for relief and the case proceeds under the relevant chapter of the Bankruptcy Code.

## Makes Sense, but What Are the Benefits?

A primary benefit of an involuntary bankruptcy is that a fiduciary is appointed to take control of the process, and the outcome is not dictated by a secured creditor.<sup>23</sup> There are, of course, other benefits.

First, the Bankruptcy Code and Rules provide guidelines for an established process as opposed to amorphous state law alternatives. Second, the costs of an involuntary filing can be lower than pursuing protracted state court litigation. If an order for relief is entered, the estate bears the burden of the trustee’s costs of investigation and collection, rather than a single creditor. In fact, petitioning creditors are entitled to a priority claim for “the actual, necessary expenses ... incurred by a creditor that files a petition” under § 303.<sup>24</sup>

Third, once an order for relief has been entered, the automatic stay becomes a powerful tool to prevent the further dissipation of assets.<sup>25</sup> Fourth, certain avoidance actions are only available under the Code, including the ability to unwind a secured creditor’s lien. In *In re Concrete Pumping Service Inc.*, the Sixth Circuit allowed an involuntary bankruptcy to proceed

19 *In re Diamondhead Casino Corp.*, 540 B.R. 499, 505 (Bankr. D. Del. 2015) (quoting *In re Levin*, 2011 WL 1469004, at \*2 (Bankr. S.D. Fla. April 15, 2011) (citing *In re R.S. Crist Co.*, 16 B.R. 872, 873 (Bankr. S.D. Fla. 1982)); *In re Barkats*, 2014 WL 6461884, at \*2 (Bankr. D.D.C. Nov. 17, 2014).

20 *In re Signature Apparel Grp. LLC*, 577 B.R. 54, 87 (Bankr. S.D.N.Y. 2017) (“Section 303(f) ... cannot be used to absolve a creditor from liability for violating the automatic stay where it takes action against property of the estate after an involuntary petition is filed. *In re Omni Graphics Inc.*, 119 B.R. 641 (Bankr. E.D. Wis. 1990). *In re Omni Graphics Inc.*, the debtor corporation, the bank and the guarantors entered into an agreement to surrender all of the debtor’s assets, which had been pledged by the debtor, to the bank. Other creditors filed an involuntary petition against the debtor, and the public sale of the debtor’s assets took place during the gap period without court approval. The Court held that the bank violated the stay and explained why § 303(f) gave the bank no cover for its actions.”) *But see In re Acelor*, 169 B.R. 764, 765 (Bankr. S.D. Fla. 1994) (recognizing split in authority over whether automatic stay is effective in involuntary proceeding before order for relief is entered, and holding automatic stay is not effective merely because involuntary petition is filed).

21 11 U.S.C. § 303(d).

22 Fed. R. Bankr. P. 1011 and 1013(a).

23 Richard M. Hynes & Steven D. Walt, “Revitalizing Involuntary Bankruptcy,” 105 *Iowa L. Rev.* 1127 (2020) (“[S]hareholders of a firm teetering on the brink of bankruptcy are gambling with someone else’s money. They have an incentive to delay bankruptcy past the socially optimal point where bankruptcy could increase the aggregate value of a firm and its assets.”).

24 11 U.S.C. §§ 503(b)(3)(A) and (b)(4). However, “the goal of § 503(b)(3)(A) is to make creditors whole for bringing a debtor into bankruptcy; it is not to reimburse creditors for fees they would have otherwise incurred in pursuit of their own interests. Accordingly, the Court concludes that the petitioning creditors are not entitled to recover fees for work they would have done had this involuntary case not been filed.” *In re Engler*, 500 B.R. 163, 171 (Bankr. M.D. Fla. 2013).

25 *In re Betterroads Asphalt LLC*, No. 17-04156 (Bankr. D.P.R. 2018) (“Once the involuntary bankruptcy petition is filed, a bankruptcy estate is created under 11 U.S.C. § 541(a) and the provisions of the automatic stay come into effect.”); *see also In re Murray*, 900 F.3d 53, 59 (2d Cir. 2018) (although court ultimately upheld lower court’s decision to dismiss involuntary filing, Second Circuit noted that “[i]nvoluntary bankruptcy petitions help ensure the orderly and fair distribution of an estate by giving creditors an alternative to watching nervously as assets are depleted, either by the debtor or by rival creditors who beat them to the courthouse”).

8 *In re Green Hills Dev. Co. LLC*, 741 F.3d 651, 656 (5th Cir. 2014) (“Prior to [the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)], the provision did not include the phrase ‘as to liability or amount,’ and some courts, including this one, interpreted the pre-BAPCPA § 303(b) to deny standing to a creditor only when there was a bona fide dispute as to liability.”).

9 11 U.S.C. § 303(b) (emphasis added).

10 11 U.S.C. § 303(c).

11 11 U.S.C. § 507(a).

12 *In re Braten*, 741 B.R. 1021, 1023 (Bankr. S.D.N.Y. 1987) (“A dispute as to the amount of a claim does not negate its existence if the legal obligation to pay is present.”) (citations omitted).

13 *In re Marciano*, 459 B.R. 27, 54 (B.A.P. 9th Cir. 2011), *aff’d*, 708 F.3d 1123 (9th Cir. 2013).

14 *Dep’t of Revenue v. Blixseth*, 942 F.3d 1179, 1185 (9th Cir. 2019) (quoting *Fustolo v. 50 Thomas Patton Drive LLC*, 816 F.3d 1, 9 (1st Cir. 2016)).

15 The U.S. Courts of Appeals for the Second and Sixth Circuits adopted an objective standard, and will examine whether there is a genuine, material factual or legal dispute as to the validity or amount of the debt or a legitimate factual or legal basis for nonpayment. *See In re TPG Troy*, 793 F.3d 228, 234 (2d Cir. 2015); *In re DSC Ltd.*, 486 F.3d 940, 945 (6th Cir. 2007).

16 11 U.S.C. § 303(f).

17 *In re Sweports Ltd.*, 476 B.R. 540, 545 (Bankr. N.D. Ill. 2012) (“[T]he filing of an involuntary case also creates a bankruptcy estate, just as the filing of a voluntary case does, *see id.* § 541(a), and an alleged debtor does not have the powers of a trustee under section 1107(a), *In re E.D. Wilkins Grain Co.*, 235 B.R. 647, 650 (Bankr. E.D. Cal. 1999) (holding that § 303(f) “does not invest the debtor with the powers of a trustee”); *see also In re Roxy Roller Rink Joint Venture*, 73 B.R. 521, 527 (Bankr. S.D.N.Y. 1987) (alleged debtor therefore has no authority “to bind the bankruptcy estate during the gap period” and no ability “to waive the protection afforded to property of the estate by the automatic stay.” *Wilkins*, 235 B.R. at 650).

18 11 U.S.C. § 303(g).

where the petitioning creditor sought to avoid a lien against the debtor held by the debtor's principal, and the subsequent transfer of assets to her.<sup>26</sup> In that case, the transactions at issue had occurred around the same time that the petitioning creditor had received a judgment against the debtor in state court.<sup>27</sup> The lien and transfer were blatant attempts to protect the assets from collection and were ripe for avoidance in bankruptcy.<sup>28</sup>

## Are There Any Drawbacks?

Involuntary filings are not without risk. For example, in those cases where the petitions are dismissed, moving creditors might be liable for the debtor's costs of opposing the involuntary petition, other consequential damages and, in some cases, punitive damages.<sup>29</sup> In *In re Anmuth Holdings LLC*, the petitioning creditors were liable to the debtor for damages incurred.<sup>30</sup> The court found that the filing was made in bad faith, solely as a litigation tactic.<sup>31</sup> Ultimately, the debtor was entitled to punitive damages of \$600,000.<sup>32</sup> The Ninth Circuit eloquently explained the danger of improper involuntary filings in *In re Macke Intern. Trade Inc.*:

[B]eing targeted by an involuntary bankruptcy petition is a disruptive and, in many cases, financially traumatic event for the alleged debtor. Resources, including time and money, must be diverted from other commitments to defend against the petition. Moreover, pending a resolution of the issues by the bankruptcy court, the alleged debtor exists in a financial interstice, necessarily uncertain of its future, restricted in its ability to make normal business decisions and plans. The pendency of the bankruptcy petition may cause suppliers, customers and investors to be reluctant to deal with the debtor. And even if adjudication of bankruptcy relief proves unwarranted, and the petition is eventually dismissed, the debtor may suffer considerable loss or damages from the process.<sup>33</sup>

## Conclusion

When secured lenders fail to safeguard against standard borrower-related issues, and the courts are too clogged to efficiently pursue a collection action and/or judgment enforcement, unsecured creditors should consider the possibility of pursuing an involuntary bankruptcy filing. Involuntary bankruptcy provides a meaningful, albeit underused and potentially risky, tool that warrants greater consideration in this environment. **abi**

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<sup>26</sup> 943 F.2d 627, 628 (6th Cir. 1991).

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> See 11 U.S.C. § 303(i).

<sup>30</sup> 600 B.R. 168, 176 (Bankr. E.D.N.Y. 2019).

<sup>31</sup> *Id.*

<sup>32</sup> *Id.* at 204.

<sup>33</sup> 370 B.R. 236, 246 (B.A.P. 9th Cir. 2007) (awarding sanctions to debtor in amount of \$20,000).