

Involuntary bankruptcy: A creditor's friend or foe?

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Involuntary bankruptcy is one of the several legal remedies available to a creditor against a delinquent borrower or customer. A case may be made that when dealing with a debtor who is incompetent or engaged in concealment of its assets, whose business is rapidly declining in value, or who is at risk of losing its critical



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suppliers, an involuntary bankruptcy filing can protect a creditor's interests better than state-law remedies, such as foreclosure, attachment, garnishment or self-help. Yet, a sophisticated creditor should not leap at the chance to put the defaulting debtor in bankruptcy. Rather, creditors must have a good understanding of the advantages and disadvantages associated with the commencement of an involuntary bankruptcy in order to make a well-informed decision about their debt collection or workout strategy.

Who may commence an involuntary bankruptcy?

On their face, the statutory requirements for filing an involuntary bankruptcy petition seem pretty straightforward¹. An involuntary bankruptcy case may be commenced against a debtor under either chapter 11 or chapter 7 of the Bankruptcy Code by at least three creditors if the debtor has twelve or more creditors; and, if the debtor has fewer than twelve creditors, by one creditor. The petitioning creditors must hold claims that are neither contingent nor subject to a "bona fide dispute" by the debtor and which, in the aggregate, include at least \$12,300 of unsecured debt.

The requisite number of creditors often presents a significant hurdle to putting a large national or regional enterprise into an involuntary bankruptcy. Yet, at least in the Third Circuit, a secured creditor may be included among the three petitioning creditors provided that the unsecured portion of the petitioning creditors' aggregate claims is at least equal to the minimum statutory requirement set forth in § 303(b)².

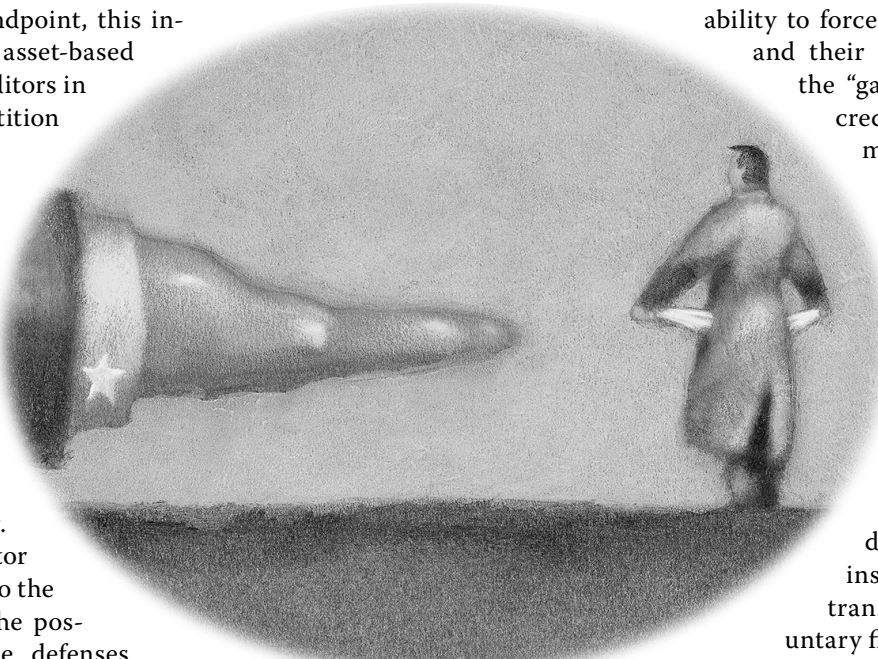
From the practical standpoint, this interpretation enables an asset-based lender to join trade creditors in filing an involuntary petition against its borrower.

What happens next?

If the creditors meet the requirements of § 303, they must file an involuntary petition and serve the petition and the court-issued summons on the debtor. After service, the debtor has 20 days to respond to the involuntary petition. The possible responses include defenses and objections or a motion to dismiss and they typically challenge the presumption that the debtor is not paying its debts as they become due and/or the requisite amount of incontinent claims asserted by the petitioning creditors or allege that the involuntary petition was filed in bad faith³.

If the debtor challenges the involuntary petition, the petitioning creditors will have the burden to show that the debtor is generally not paying its debts as they became due. If the creditors prevail, the court will enter an order for relief and the case will proceed as a chapter 7 liquidation or a chapter 11 reorganization. In the event the court dismisses the involuntary petition, it can order the petitioning creditors to pay the debtor's court costs and legal fees incurred in opposing the involuntary petition and, if it finds that the petition was filed in bad faith, even assess damages against the creditors.

Creditors should be mindful of the period, known as the "gap period," which commences upon the filing of the involuntary petition and lasts until the entry of the order for relief. The involuntary filing triggers the application of the automatic stay as well as the start of the look-back period for the avoidance of pre-petition preferences and fraudulent transfers. On the other hand, during the "gap period," the debtor continues to conduct its business, including the use and disposition of its assets, in the ordinary course. Courts have held that during the "gap period" the debtor does not have the powers and the fiduciary duties of a trustee or debtor-in-possession under §1107(a)⁴. As a practical matter, this means that during the "gap period" the



debtor may not engage in sales of assets outside of the ordinary course pursuant to § 363 and/or enter into post-petition financing secured by super-priority liens pursuant to § 364(c) and (d).

What should a creditor be aware of?

The potential pitfalls of commencing an involuntary bankruptcy are significant. Defeating the debtor's challenges to an involuntary petition often becomes a difficult and expensive undertaking. The involuntary "gap period," which may last indefinitely, gives the debtor the benefit of the automatic stay without the rights and responsibilities of the debtor-in-possession. Hence, where the debtor's vulnerable financial condition may force its creditors into extending credit to it during the "gap period," the creditors will not be able to secure such credit by super-priority liens. Similarly, during the "gap period," the debtor has no authority to agree to a lift of the automatic stay or to make adequate protection payments to protect a secured creditor's interest in its collateral.

In addition, the petitioning creditors will not gain any advantage in the bankruptcy case with respect to their unsecured claims, being limited to a mere, and often distant, pro rata distribution. Finally, in some cases, the petitioning creditors themselves may be vulnerable to an avoidance action by a trustee or the debtor-in-possession.

When does it make sense?

Given the restrictions on creditors'

ability to force a debtor in bankruptcy and their limited leverage during the "gap period," when should creditors consider commencing an involuntary bankruptcy? An involuntary filing makes sense when a creditor wants to reverse a preferential transfer of property made by the debtor to another creditor and, therefore, must commence a bankruptcy case within 90 days (or, with respect to insiders, one year) of such transfer. Similarly, an involuntary filing may prevent a judgment creditor from foreclosing on the debtor's unencumbered assets to the detriment of the other creditors. Also, the commencement of an involuntary bankruptcy will, by triggering the automatic stay, prevent a cash-poor debtor's vendors and utilities from jeopardizing the debtor's chances of rehabilitating its business by terminating their performance under their contracts with the debtor.

Additionally, when a creditor suspects that the debtor may be siphoning or concealing its assets, an involuntary bankruptcy will provide an opportunity for the automatic appointment of a chapter 7 trustee, or, for cause, the appointment of a trustee or examiner in a chapter 11 case, who will investigate the debtor's conduct, provide the necessary reporting to the creditors and possibly even assume the day-to-day management of the debtor's business.

Clearly, involuntary bankruptcy should not be viewed as a panacea. Nevertheless, it is as a powerful remedy that can provide a creditor with additional leverage and a better result in workout negotiations.

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¹See 11 U.S.C. § 303.

²See *In re Paradise Hotel Corp.*, 842 F.2d 47 (3d Cir. 1988).

³See Fed. R. Bankr. P. 1011.

⁴See *In re Roxy Roller Rink Joint Venture*, 73 B. R. 521, 523-27 (Bankr. S.D.N.Y. 1987); *In re E.D. Wilkins Grain Company*, 235 B.R. 647, 650 (Bankr. E.D. Cal. 1999).

