

# Involuntary Bankruptcy: Creditor's Tool to Be Used with Caution

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Lisa P. Sumner  
919.573.7423  
lsumner@nexsenpruet.com

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If you have ever been a creditor concerned about a debtor not paying debts as they become due or paying other creditors while ignoring your demands, then forcing the debtor into an involuntary bankruptcy may be an option. An involuntary petition can be filed only under Chapter 7 (liquidation) or Chapter 11 (reorganization) of the U.S. Bankruptcy Code. Most involuntary bankruptcy petitions are filed as Chapter 7 cases because the filing fee (paid by the petitioning creditor upon filing the involuntary) is lower than in Chapter 11, and because the petitioning creditor typically wants a bankruptcy trustee appointed immediately (which is rare in Chapter 11 cases). If the petition is granted, the debtor can seek to convert the case from Chapter 7 to Chapter 11 later.

This creditors' remedy has limitations. A creditor who files an involuntary petition against an alleged debtor must hold a claim "that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount." An involuntary petition usually must be filed by three such creditors whose non-contingent, undisputed claims aggregate to 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." If, however, the alleged debtor has fewer than 12 such creditors (excluding employees, insiders and the recipients of voidable transfers), then only one such creditor with a claim of at least \$15,775 is sufficient.

## The Bankruptcy Code sets several eligibility requirements for petitioning creditors:

1. The claim must be for a readily determined amount, not a claim that may or may not exist depending upon future events, and not a claim for which the amount cannot yet be determined.
2. The claim must not be subject to a bona fide dispute. If the debtor has a good faith basis for objecting to the existence or amount of the claim, that claim cannot be relied upon by the petitioning creditor. A creditor who is a plaintiff in a lawsuit would not usually be eligible as a

petitioning creditor unless and until the alleged debtor stipulates to the validity and amount of the claim, or the plaintiff obtains a judgment that is not subject to appeal.

3. If the petitioning creditor's claim is secured by a perfected lien on collateral, then the secured claim can be used as one of the qualifying petitioning claims only if the value of collateral is less than the amount of the claim, leaving the petitioning creditor with an unsecured deficiency claim. The unsecured deficiency claim can be used to meet the involuntary petition requirements so long as the deficiency claim is non-contingent and undisputed, and the aggregate amount of the three claims meets the minimum threshold for filing an involuntary petition.

## Risks of Being a Petitioning Creditor

If the motive of a petitioning creditor is other than simple debt collection, there is a risk that the alleged debtor will seek and recover from the petitioning creditor the legal fees incurred to defend against the involuntary bankruptcy. The classic example of such a bad faith involuntary filing is a business competitor of the debtor initiating the bankruptcy with the primary goal of disrupting the competitor's business, even though the debtor isn't really struggling financially. If the court finds that a petitioning creditor filed the petition in bad faith, then the Bankruptcy Code permits the court to require that petitioning creditor to pay "any damages proximately caused by such filing," plus punitive damages. There are numerous cases from the Bankruptcy Courts in North Carolina and South Carolina allowing fees and costs associated with the dismissal of an involuntary proceeding based upon a finding of a bona fide dispute and other requirements. Most courts hold that there is a rebuttable presumption that the petitioning creditors acted in good faith in filing an involuntary petition, and that the alleged debtor then has a burden of proving bad faith by a preponderance of the evidence.

Potential petitioning creditors also need to evaluate the risk of triggering a preference lawsuit against themselves by initiating an involuntary case. An unsecured or partially secured creditor who received payments or other transfers of value from the debtor during the last 90 days before the involuntary petition filing may find that the debtor or trustee later sues the petitioning creditor because payments on unsecured claims made within that time frame might be clawed back by the bankruptcy trustee as a preferential transfer under the Bankruptcy Code. Petitioning creditors usually opt out of an involuntary filing effort when they have substantial preference risk exposure.

## Other Considerations

If all the requirements of the Bankruptcy Code are met, the alleged involuntary debtor is given about a month to respond to the involuntary petition and either concede it belongs in a bankruptcy case, or fight against being forced into bankruptcy. If the debtor wants to oppose bankruptcy, the bankruptcy court is to determine if (1) the debtor is generally not paying such debtor's debts as such debts become due (unless such debts are the subject of a bona fide dispute as to liability or amount) or (2) "within 120 days before the date of the filing of the petition, a custodian, other than a trustee, receiver, or 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."

The dispute in contested involuntary petitions usually turns on whether the alleged debtor is generally paying its debts as they become due. Courts have been reluctant to adopt a mechanical test. The court looks to the date that the involuntary petition was filed to make this determination. Payments of a debtor's obligations by a third party, or through cash infusions from third parties, are not treated as payment by the debtor itself, and a company who pays its debts by borrowing funds and creating another liability is generally not paying its debts as they come due.

Bankruptcy courts may be disinclined to keep an objecting debtor in bankruptcy if there are pending proceedings outside bankruptcy court such as assignments for the benefit of creditors, court receiverships or bulk sale agreements. Courts also consider whether the debtor has any valuable nonexempt assets that can be liquidated to produce enough cash to pay both the administrative expenses of bankruptcy and a worthwhile dividend to the debtor's creditors.

Once an involuntary petition is filed, the creditors cannot withdraw it, even with the consent of the alleged debtor, until obtaining bankruptcy court approval to withdraw the petition. The court will require notice to all creditors of the proposed withdrawal and will conduct a hearing.

In sum, while filing an involuntary petition is not without risks, it can be an excellent alternative for creditors who lack the motivation and financial resources to chase a recalcitrant debtor alone. Invoking the power of the Bankruptcy Code enables creditors and trustees to find and recover assets using means that are often unavailable or not cost-efficient outside of bankruptcy. Experienced bankruptcy counsel can help creditors decide when to employ involuntary petitions to their advantage.

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*Ron Jones is a Member based in Nexsen Pruet's Charleston office, where he focuses his practice on bankruptcy and creditors' rights. He has extensive experience in debtor and creditor representation and is a Certified Specialist in Bankruptcy and Debtor-Creditor Law, earning specialist distinction from the South Carolina Supreme Court. Lisa Sumner, a Member based in Nexsen Pruet's Raleigh office, is a commercial litigator focusing her practice in the areas of bankruptcy & creditors' rights. She is experienced in representing creditors in a variety of cases, including claims of lender liability, fraudulent transfers and breach of fiduciary duty, as well as in the filing of involuntary bankruptcy petitions.*