Navigating the Troubled Waters of Involuntary Bankruptcies

David Neal Stern, Moderator
Frank, Weinberg & Black P.L.; Boca Raton, Fla.

Jonathan T. Edwards
Alston & Bird LLP; Atlanta

Michael A. Friedman
Genovese Joblove & Battista, P.A.; Miami

Garret A. Nail
Thompson Hine; Atlanta

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* Presented by:

Jonathan Edwards
Michael Friedman
Garrett Nail
David Neal Stern

An involuntary bankruptcy can simultaneously be a particularly risky venture and an extraordinarily game-changing arrow in a creditor's quiver. Bankruptcy courts across the country carefully scrutinize involuntary bankruptcies because they are often extreme remedies with serious consequences to the alleged debtor, including loss of credit standing, inability to transfer assets and carry on business affairs as usual, and public embarrassment.[1] And with this high level of scrutiny comes teeth: Courts can levy compensatory and punitive damages against petitioning creditors when they file involuntary petitions in bad faith.[2]

Although filing an involuntary petition is an extreme remedy, it is sometimes a necessary one. Involuntary bankruptcies serve as a useful creditor collection tool to ensure equality of distribution of a debtor's assets. They can preserve assets from further dissipation and provide for their orderly liquidation by a bankruptcy trustee, especially in situations where management is conflicted, has fraudulently transferred assets, or is otherwise wasting value for the creditor body. Given the high-stakes litigation involved in involuntary bankruptcies and the balance that the Bankruptcy Code attempts to strike with these competing policies, it is unsurprising that less than one percent of bankruptcy cases are commenced involuntarily.[3] One study reported that involuntary bankruptcies "have represented less than one-tenth of one per cent of all U.S. liquidation bankruptcy cases for over a decade."[4]

In this article, we have two goals to help you navigate the often troubled waters of involuntary bankruptcy: (1) to refresh your recollection on the statutory elements and the oft-forgotten procedural rules on involuntary petitions; and (2) to bring you up-to-speed on the hot button issues—the areas where courts have given practitioners navigational assistance—in involuntary bankruptcy practice over the last several years. In achieving these two goals, we will also embed certain "practice pointers" in this article, which the authors have found helpful in litigating these issues. Involuntary petitions are best thought of as weapons of last resort, and the unwary creditor who hauls off and files a petition may take a bad situation and make it worse for itself.

A. Ensuring You Have a Seaworthy Case with Proper Rigging

Before setting sail into the troubled waters of involuntary bankruptcy, you must always ensure that your boat—your case—is seaworthy and has proper rigging. This, of course, means that you have done the research and pre-case planning to ensure you can satisfy the statutory requirements in section 303 of the Bankruptcy Code. And although this legal and factual

[1] *In re Smith*, 243 B.R. 169, 174 (Bankr. N.D. Ga. 1999) (quoting *In re Reid*, 773 F.2d 945, 946 (7th Cir. 1985)). *See also In re Landmark Distribs., Inc.,* 189 B.R. 290, 306 (Bankr. D.N.J. 1995) (quoting *In re McDonald Trucking Co*., 76 B.R. 513, 516 (Bankr. W.D. Pa. 1987)).

[2] 11 U.S.C. § 303(i).

[3] 2 COLLIER ON BANKRUPTCY ¶ 303.01 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2002).

[4] Final Report of the ABI Commission to Study the Reform of Chapter 11, American Bankruptcy Institute (2014) available at http://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1096&context=books. The Administrative Office of the U.S. Courts stopped collecting data on involuntary bankruptcies apparently because of their rarity. *See* Robert M. Lawless & Elizabeth Warren, The Myth of Disappearing Business Bankruptcy, 93 Cal. L. Rev. 743, 750 n. 11 (2005).

investigation may seem both obvious and elementary, many cases have been lost due to inadequate planning.

Practice Pointer: We recommend that you prepare an opposition to a motion to dismiss or a motion for summary judgment on the involuntary petition before clicking "submit" on the involuntary petition, including any affidavits, declarations, and client testimony. Doing so will force you to anticipate and ensure you can address the weaknesses in your case and, at a minimum, ensure you can satisfy the fundamentals; it will also help with your counter-arguments in any bad faith dismissal fight (*see* Third Circuit's *Forever Green* discussion below).

1. Basic Statutory Requirements to Commence an Involuntary

Section 303 of the Bankruptcy Code, which governs involuntary cases under Chapter 7 or 11, contains three requirements for commencing an action against a debtor who has twelve or more creditors: (1) there must be three or more petitioning creditors; (2) each petitioning creditor must hold a claim against the debtor that is not contingent as to liability or the subject of a bona fide dispute; and (3) the claims must aggregate[5] at least $15,775 more than the value of liens on the debtor's property.[6] When the debtor has fewer than twelve otherwise eligible unsecured creditors, excluding any employee or insider and any transferee of a voidable transfer,[7] such as a preference or fraudulent transfer claim, then one such unsecured creditor with a claim of at least $15,775 that is not subject to a bona fide dispute as to liability or amount can file an involuntary petition.[8]

If the debtor disputes the involuntary petition, the Bankruptcy Code further provides that the court "shall order relief against the debtor in an involuntary case . . . only if . . . the debtor is generally not paying such debtor's debts as such debts become due" or "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."[9] The burden is on the petitioning creditors to first establish a prima facie case that no bona fide dispute

[5] The use of the word "aggregate" in section 303(b) means that it is the total of the claims of the petitioning creditors that matters, not whether one particular petitioning creditor is owed a prescribed amount. An oversecured or nonrecourse secured creditor may serve as one of the three petitioning creditors as long as the other creditors hold unsecured claims that aggregate at least the amount specified in section 303(b) and are not contingent as to liability or subject to a bona fide dispute as to liability or amount.

[6] 11 U.S.C. § 303(b)(1).

[7] Employees, insiders, or transferees do not count in the determination of whether there are fewer than twelve creditors.

[8] *Id. See In re FMB Bancshares, Inc.*, 517 B.R. 361 (Bankr. M.D. Ga. 2014) (denying a motion to dismiss an involuntary petition filed by a single holder of trust-preferred securities issued by bank holding company).

[9] 11 U.S.C. § 303(h)(1).

exists.[10] Once a prima facie case has been established, the burden shifts to the alleged debtor to demonstrate the existence of a bona fide dispute.[11]

2. Breaking Down the Basic Statutory Requirements

a) Numerosity

Though counting the number of creditors may seem like simple math—thus not meriting any discussion—nuances in case law exist that petitioning creditors should pay careful attention to if they face any argument that they hold a joint obligation. Section 303 of the Bankruptcy Code mandates that each petitioning creditor must hold a separate claim against the alleged debtor.[12] Courts have held that joint holders of an obligation are counted as one creditor and uniformly have applied that reasoning when addressing the numerosity requirement for petitioning creditors.[13] And other courts have held that four creditors holding a single default judgment based on an apparent oral contract constituted four separate creditors for purposes of Section 303(b)(1).[14] In addressing section 303(b)(1)'s numerosity requirement, courts apply a plain language analysis—petitioning creditors must be "entities" and each petitioning creditor must be the "holder of a claim." The definition of a claim under section 101(5) is applied broadly and depends on (1) whether the claimant possessed a right to a payment, and (2) whether that right arose before the filing of the petition.

One other area involving disputes about numerosity concerns cases in which debentures are issued under an indenture; the Ninth Circuit has held that the joinder of an indenture trustee

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[10] *Id.* § 303(b). *In re Charon*, 94 B.R. 403, 405-06 (Bankr. E.D. Va.1988) (petitioner has "burden of proving that it satisfied the jurisdictional requirements of § 303(b)"); *In re James Plaza Joint Venture*, 67 B.R. 445, 448 (Bankr. S.D. Tex. 1986) ("It is plaintiffs' burden to demonstrate the number of creditors of [the] debtor's estate."); 2 COLLIER ON BANKRUPTCY ¶ 303.15, at 76 (15th ed. 1988) ("The burden of proof is on the petitioning creditors to establish that the statutory requirements of section 303 have been satisfied.").

[11] *In re AMC Investors, LLC*, 406 B.R. 478, 484 (Bankr. D. Del. 2009).

[12] *See e.g. In re Mid-America Industrial Inc*., 236 B.R. 640, 644 (Bankr. N.D. Ill. 1999).

[13] *See In re Atwood*, 124 B.R. 402, 409 (S.D. Ga. 1991) (affirming unpublished bankruptcy court decision holding joint holders of a judgment constitute a single creditor for purposes of section 303(b) of the Bankruptcy Code); *In re T.P. Herndon & Co.*, 87 B.R. 204, 206 (Bankr. M.D. Fla. 1988) (finding that because a promissory note was made payable to single entity, petitioning creditors held single right to payment constituting only one claim for purposes of section 303(b) even though note had been assigned to heirs); *In re McMeekin*, 16 B.R. 805, 809 (Bankr. D. Mass. 1982) (dismissing an involuntary petition and holding that a promissory note made payable to two or more individuals is enforceable only by all of them under Massachusetts law); *In re Moss*, 249 B.R. 411 (Bankr. N.D. Tex. 2000) (finding that obligation to investors under same agreement constituted a joint obligation and, thus, investors only held a single claim for purposes of section 303(b)); *In re Iowa Coal Min. Co. Inc.*, 242 B.R. 661 (Bankr. S.D. Iowa 1999) (finding that three bonding companies that filed an involuntary petition on the basis of their claims arising under a single reclamation agreement constituted only one creditor); *In re Averil, Inc*., 33 B.R. 562 (Bankr. S.D. Fla. 1983) (holding that joint obligation constituted a single claim and that the joint holders of the obligation constituted a single creditor for purposes of the numerosity requirement in section 303(b)(1)).

[14] *In re Zapas*, 530 B.R. 560, 568 (Bankr. E.D.N.Y. 2015)

to the involuntary petition under section 303(c) of the Bankruptcy Code does not destroy numerosity based on the plain language of section 303(b).[15]

> ***Practice Pointer:*** The key to numerosity is non-bankruptcy law—the underlying law or contract—and whether the law or particular contract gives rise to an independent obligation that can be enforced by each entity signing the involuntary petition.

b) Contingent as to Liability

Although the Bankruptcy Code does not define the term "contingent," a claim is contingent within the meaning of section 303(b) when the debtor's obligation to pay does not come into being until the happening of some future event and that event was within the contemplation of the parties at the time their relationship originated.[16] Put another way, a claim is contingent if "an alleged debtor's legal duty to pay does not come into existence until triggered by the occurrence of an extrinsic event and such extrinsic event or occurrence was one that was reasonably contemplated by the parties at the time the event giving rise to the claim occurred."[17]

A classic example of a claim that is contingent as to liability is that of a guarantor of payment where the obligation of the guarantor remains contingent until it is clear that the principal obligator is unable to pay.[18] Another example of a contingent debt is where a debtor owes a sales agent commission only if potential purchasers actually buy the goods. In such a scenario, the debtor would only be liable for the commissions once the sales were made. Therefore, its obligation is "contingent" upon the sale. On the other hand, a claim is not "contingent as to liability" when "all events have occurred which allow a court to adjudicate a claim and determine whether or not payment should be made."[19] At that point, the contingency is applicable only to payment and is only a condition of payment. Thus, a claim is not contingent merely because the debtor lacks the ability to pay.

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[15] *Grey v. Federated Group, Inc. (In re Federated Group, Inc.)*, 107 F.3d 730, 732–33 (9th Cir. 1997). Section 303(b)(1) specifically provides that indenture trustees may commence involuntary petitions even though they are not actually creditors themselves. The indenture trustee may join two debenture holders as petitioning creditors, and such joinder would not extinguish the claims of the other holders. Thus, the three petitioning creditors' requirement under section 303(b), unless prohibited by some express language in the debenture itself, is satisfied by a combination of debenture holders and indenture trustees. *See id.*

[16] 2 COLLIER ON BANKRUPTCY ¶ 303.10 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.).

[17] *In re Rosenberg*, 414 B.R. 826, 844 (Bankr. S.D. Fla. 2009).

[18] 2 COLLIER ON BANKRUPTCY ¶ 303.10.

[19] *In re Taylor & Associates, LP,* 193 B.R. 465, 473 (Bankr. E.D. Tenn. 1996) (citing *In re Longhorn 1979-II Drilling Program, L.P.,* 32 B.R. 923, 927 (Bankr. W.D. Okla. 1983)), remanded on other grounds, *In re Taylor & Associates, L.P.,* 249 B.R. 431 (E.D. Tenn. 1997).

c) Bona Fide Dispute as to Liability or Amount

The Bankruptcy Abuse Prevention and Consumer Protection Act amended section 303(b) of the Bankruptcy Code to clarify the definition of bona fide dispute to include disputes as to liability *or* amount. So the existence of a dispute concerning either liability or the amount of a petitioning creditor's claim may give rise to a bona fide dispute that would disqualify the petitioning creditor and risk dismissal of the involuntary petition.[20] As discussed in the "hot-button" issues section below, Congress's change to the statute has caused questions regarding a petitioning creditor's eligibility to commence a case if any portion of its claim is subject to a bona fide dispute. One line of cases applies an "all-or-nothing" approach, finding that if any portion of a claim is subject to a bona fide dispute, the petitioning creditor is automatically disqualified. But the current emerging trend reasons that a claim can be partially disputed without impacting eligibility, as long as the aggregate undisputed portion of the petitioning creditors' unsecured claims totals at least $15,775.

The phrase "bona fide dispute" is not defined in the Bankruptcy Code. In a majority of circuits, however, courts apply an objective standard to determine whether a bona fide dispute exists.[21] That is, a bona fide dispute only exists when the putative debtor raises "substantial factual and legal questions" to dispute the liability or amount of the creditor's claims, which demonstrate "a genuine issue of material fact that bears upon the debtor's liability, or a meritorious contention as to the application of law to undisputed facts."[22] The bankruptcy court's objective is to ascertain whether a dispute that is bona fide exists; it need not actually resolve the dispute. This does not mean, however, that the court is prohibited from addressing the legal merits of the alleged dispute; indeed, the court may be required to conduct a limited analysis of the legal issues in order to ascertain whether an objective legal basis for the dispute exists.[23]

Although the existence of affirmative defenses to a creditor's claim or the existence of counterclaims will cause greater scrutiny regarding whether a petitioning creditor's claims are subject to a bona fide dispute,[24] a bankruptcy court will engage in a limited analysis of those defenses and counterclaims to ensure the alleged dispute is, in fact, bona fide. Courts that have

[20] Before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), a dispute as to the amount of any portion of a claim did not necessarily imply that the entire claim was subject to a bona fide dispute.

[21] *In re Huggins*, 380 B.R. 75, 82 & n.30 (Bankr. M.D. Fla. 2007) (collecting cases).

[22] *See B.D.W. Associates, Inc. v. Busy Beaver Building Centers, Inc.*, 865 F.2d 65, 66-67 (3d Cir. 1989) (citing *In re Busick*, 831 F.2d 745, 750 (7th Cir. 1987)); *see also In re Rimell*, 946 F.2d 1363, 1365 (8th Cir. 1991) (citing favorably to *Busick* and *Busy Beaver* and the Tenth Circuit's decision in *Bartmann* for the adherence to an objective standard in deciding whether a bona fide dispute exists).

[23] *Busy Beaver*, 865 F.2d at 66-67 (the Third Circuit affirmed a determination by the bankruptcy court that a veil piercing claim was not subject to bona fide dispute using a summary judgment type analysis); *In re Rimell*, 946 F.2d 1363, 1365 (8th Cir. 1991) (internal and external citations omitted).

[24] To be more precise, a defense to a claim in the form of recoupment goes to the heart of the claim and may result in a bona fide dispute of the claim. *See* COLLIER ON BANKRUPTCY ¶ 303.11 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.). But a defense to a claim in the form of an independent counterclaim does not in any manner challenge the original claim and so does not place the original claim in bona fide dispute. *Id.*; s*ee also In re Mylotte, David & Fitzpatrick*, No. 07-11861, 2007 Bankr. LEXIS 2375 (Bankr. E.D. Pa. July 12, 2007).

engaged in a bona fide dispute analysis have recognized that the existence of litigation about the petitioning creditor's claims does not establish the existence of a bona fide dispute.[25]

d) The Dollar Requirements

Section 303(b) provides that the noncontingent, undisputed claims of petitioning creditors (whether there are three or fewer) must aggregate at least $15,775.[26] Counterclaims, setoff rights, rights of recoupment and bona fide disputes as to liability or amount may reduce the aggregate claims below $15,775. If a petitioning creditor's claim is eliminated by a counterclaim, setoff or recoupment, that creditor may become ineligible to serve as a petitioning creditor because it no longer holds a claim.[27] Based on the language of section 303(b), the dollar amount must be calculated based on unsecured—not secured—debt. Thus, the undersecured portion of the debt owed a petitioning secured creditor or a totally unsecured claim of a petitioning unsecured creditor can satisfy the dollar requirement.

e) Generally Not Paying Debts

The Code does not define the term "generally not paying," and courts have had to fashion their own definition. A finding that a debtor is generally not paying its debts requires a more general showing of the debtor's financial condition and debt structure than merely establishing the existence of a few unpaid debts.[28] Despite a wide range of definitions, most courts apply a multifactor test to determine whether a debtor is generally not paying its debts. Courts compare the number of debts unpaid each month to those paid, the amount of the delinquency, the materiality of the non-payment, and the nature of the debtor's conduct of its financial affairs.[29]

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[25] *In re Corrline Int'l*, *LLC*, 516 B.R. 106, 150 (Bankr. S.D. Tex. 2014) (Bohm, J.) ("[W]hile the existence of counterclaims establishes that a dispute exists, it *does not* establish that a '*bona fide*' dispute exists."); *In re Vitaminspice*, 472 B.R. 282, 293 (Bankr. E.D. Pa. 2012); *IBM Credit Corp. v. Compuhouse Systems, Inc.*, 179 B.R. 474, 478-480 (W.D. Penn. 1995) (District Court rejected argument that a bona fide dispute existed as to the creditor's claims in an involuntary petition based on a counterclaim in pending state court litigation about the debt); *In re Data Synco, Inc.*, 142 B.R. 181 (Bankr. N.D. Ohio 1992) (holding no bona fide dispute existed despite the fact that debtor had asserted counterclaim in lender's state court action.); *In re Onyx Telecommunications, Ltd.*, 60 B.R. 492, 498 (Bankr. S.D.N.Y. 1985) ("This court is of the opinion that the mere existence of a proceeding in another court in which the Debtor has filed an answer generally denying the allegations of the complaint and asserting assorted affirmative defenses and counterclaims, while concededly establishing the existence of a dispute, does not as a matter of law, without more, establish the existence of a 'bona fide' dispute."); *In re Vortex Fishing Sys., Inc.,* 277 F.3d 1057, 1066 (9th Cir. 2002) (citing *In re Ross,* 63 B.R. 951, 960-61 (Bankr.S.D.N.Y.1986)); *In re Onyx Telecomm., Ltd.,* 60 B.R. 492, 497-98 (Bankr.S.D.N.Y.1985); *In re Gills Creek Parkway Assocs.,* 194 B.R. 59, 62-63 (Bankr.D.S.C.1995)); *see also In re Seko Inv., Inc.,* 156 F.3d 1005, 1008 (9th Cir. 1998) (holding "that the existence of a counterclaim against a creditor does not automatically render the creditor's claim the subject of a 'bona fide dispute.' So long as the petitioning creditor has established that there is no dispute regarding the debtor's liability on the creditor's claim, the creditor has standing under section 303(b) to bring a petition").

[26] Per 11 U.S.C. § 104, the amount is adjusted every three years to account for changes in the cost of living.

[27] 2 COLLIER ON BANKRUPTCY ¶ 303.15 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.).

[28] *See In re Mylotte, David & Fitzpatrick,* 2007 Bankr. LEXIS 2375 at *15 (citations omitted); *In re Huggins*, 380 B.R. 75, 83 (Bankr. M.D. Fla. 2007).

[29] *See also In re Euro-American Lodging Corp*., 357 B.R. 700, 713 (Bankr. S.D.N.Y. 2007).

The failure to pay just one significant creditor can support a finding that the debtor is generally not paying its debts.[30]

The date of the filing of the petition is the appropriate date for determining whether the "generally not paying" standard has been satisfied. The "generally not paying standard" in section 303(h) is not synonymous with the Bankruptcy Code's definition of insolvency contained in section 101(32). It is not a balance-sheet insolvency test based on a comparison of assets and liabilities nor is it the equity insolvency test, though it uses similar verbiage. The "equity insolvency" standard considers whether the debtor can pay its debts as they come due, not whether it *is* paying its debts as they come due. And the "generally not paying" standard has an exception: debts that are subject to bona fide disputes as to liability or amount are excluded from the consideration of "generally not paying."

B. Choppy Seas—Recent, Hot Button Involuntary Bankruptcy Disputes

1. The "All-or-Nothing" Approach

One recent "hot button" issue involves the so-called "all-or-nothing" approach to determining whether a claim is subject to a bona fide dispute. Under BAPCPA's 2005 amendments to the Bankruptcy Code, Congress added the phrase "as to liability or amount" following "bona fide dispute."[4] Before the 2005 amendments, a partially disputed claim did not disqualify a petitioning creditor if the aggregate undisputed portion of the petitioning creditors' unsecured claims satisfied the minimum statutory amount. But following the amendments, many questions—and litigation—arose regarding a petitioning creditor's eligibility to commence a case if any portion of its claim is subject to a bona fide dispute.

These disputes have created a split, with one line of cases applying the "all-or-nothing" approach, holding that if any portion of a claim is subject to a bona fide dispute, the petitioning creditor is automatically disqualified. The other line follows the pre-amendment view.

> ***Practice Pointer:*** The key to the "all-or-nothing" approach is simply pre-filing research—that is, are you before a court or in a circuit where the court or courts are trending toward applying the "all-or-nothing" approach or adhering to the pre-BAPCPA reasoning. *See* Case Matrix below. If so, this may affect the manner in which you proceed.

Colliers on Bankruptcy rejects the "all-or-nothing" approach, citing various cases and reasoning that "the better view is that the 2005 amendments do not change the analysis."[31]

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[30] *Id.*

[31] 2-303 Collier on Bankruptcy P 303.11 (15th 2015). Colliers posed the following questions: "Why would Congress want to disqualify a creditor whose claim is noncontingent and at least partially undisputed? Section 303's requirements regarding type and number of claims are an attempt to balance a debtor's interest in staying out of bankruptcy with the interest of creditors in putting a debtor into bankruptcy. Why shouldn't the undisputed, noncontingent portion of a petitioning creditor's claim count? Why disqualify the creditor *in toto*? Why effectively bar that creditor's access to the bankruptcy forum? Of course, as a practical matter, the prudent creditor will take the suggestion loudly whispered by some courts and simply assert the undisputed non-contingent portion of its claim." *Id.*

Others have argued that courts are also trending in the direction of rejecting the "all-or-nothing" approach.[32] Rather than contending which view is correct, we thought it more helpful to provide practitioners a matrix of current cases and jurisdictions that have ruled on this particular issue:

Jurisdiction	All or Nothing Approach	No Disqualification for Partial Dispute
First Circuit		*In re Fustolo*, 503 B.R. 206 (Bankr. D. Mass. 2013) *Metz v. Dilley (In re Dilley),* 339 B.R. 1 (B.A.P. 1st Cir. 2006)
Second Circuit	*In re Euro-American Lodging Corp.,* 357 B.R. 700 (Bankr. S.D.N.Y. 2007) *In re Mountain Dairies Inc.*, 372 B.R. 623, 634 (Bankr. S.D.N.Y. 2007)	*In re EM Equipment LLC*, 504 B.R. 8 (Bankr. D. Conn. 2013)
Third Circuit	*In re Reg'l Anesthesia Assocs. PC*, 360 B.R. 466, 469-70 (Bankr. W.D. Pa. 2007) *In re Metro Cremo & Son Inc.*, 2008 WL 5158288, at *4 n.8 (Bankr. M.D. Pa. Sept. 29, 2008) *In re Skyworks Ventures Inc.*, 431 B.R. 573, 578 n.1 (Bankr. D.N.J. 2010) *In re Elverson*, 492 B.R. 831, 835 (Bankr. E.D. Pa. 2013) *In re Tobacco Road Assocs., LP,* 2007 U.S. Dist. LEXIS 22990 (E.D. Pa. Mar. 30, 2007) (dispute as to amount is sufficient to disqualify petitioning creditor) (dictum)	*Wishgard LLC v. Southeast Services LLC (In re Wishgard LLC)*, 2013 WL 1774707 (Bankr. W.D. Pa. April 25, 2013) *In re 3 Man Corp.*, No. 5-12-bk-00879-JJT, 2014 Bankr. LEXIS 3675 (Bankr. M.D. Pa. Aug. 29, 2014)
Fourth Circuit		*In re Tucker*, 2010 WL 4823917 (Bankr. N.D. W.Va. Nov. 22, 2010) *In re Mountain Country Partners LLC*, 2012 WL 2394714 (Bankr. S.D. W.Va. June 25, 2012) *In re Roselli*, 2013 WL 828304 (Bankr. W.D.N.C. March 6, 2013)

[32] COURTS REVERSE TREND ON INTERPRETATION OF § 303(B)(1), ABI Journal, Vol. XXXIII, No. 10 (October 2014).

Sixth Circuit		*In re Miller*, 489 B.R. 74 (Bankr. E.D. Tenn. 2013)
Seventh Circuit		*In re DemirCo Holdings Inc.,* 343 B.R. 898 (Bankr. C.D. Ill. 2006)
Ninth Circuit	*In re Excavation, Etc. LLC*, 2009 WL 1871682, at *2 (Bankr. D. Or. June 24, 2009)	
Tenth Circuit	*In re Hentges*, 351 B.R. 758 (Bankr. N.D. Okla. 2006)	*In re ELRS Loss Mitigation, LLC,* 325 B.R. 604 (Bankr. N.D. Okla. 2005)
Eleventh Circuit	*In re Rosenberg*, 414 B.R. 826, 845-46 (Bankr. S.D. Fla. 2009) *In re Orlinsky,* 2007 Bankr. LEXIS 1520 (Bankr. S.D. Fla. Apr. 24, 2007) *In re Vicor Techs.,* 2013 Bankr. LEXIS 1416 (Bankr. S.D. Fla. Apr. 5, 2013)	

2. Petitioning Creditors Beware—Bad Faith Dismissals & Forever Green

One question recently posed to the Third Circuit Court of Appeals: Even if petitioning creditors satisfy the statutory requirements for entry of an order for relief on an involuntary petition, can a court nonetheless dismiss the petition for bad faith? The Third Circuit in *In re Forever Green Ath. Fields, Inc.,* 804 F.3d 328 (3d Cir. 2015) ("*Forever Green*") answered that question in the affirmative.

Forever Green involved two familiar foes embroiled in contentious, prepetition litigation—Charles Dawson (petitioning creditor) and Forever Green Athletic Fields, Inc., a seller of artificial turf playing fields. Dawson filed an involuntary bankruptcy petition against Forever Green to cash in on a consent judgment he had against the company ahead of other creditors and to avoid arbitration in a separate lawsuit filed by Forever Green against his newly formed company, ProGreen, relating to a $5 million claim for diversion of corporate assets. Dawson had agreed to arbitration of the $5 million claim before he won a $300,000 consent judgment against Forever Green for wages and commission owed after he left the company. By that point, Forever Green was winding down its operations and drowning in debt.

In his deposition, Dawson testified that he intended to "[f]ind any available asset that Forever Green may have and try to use the lien to seize it." He testified, "I'm going to use that judgment to levy any monies I can find anywhere, whether it be the arbitrator or anyone else. So, yeah, if we can get the lien paid, that's my number one objective. If I can get it paid, I'm very happy." Dawson had also threatened to put Forever Green into bankruptcy if it did not suspend the arbitration proceeding against ProGreen. The court issued a scheduling order for the parties

to brief the issues identified in Forever Green's complaint against ProGreen, and Dawson's brief was due on May 3, 2012. They never filed it; instead, they chose a different tack—filing the involuntary petition. Although the petitioning creditors satisfied all the statutory requirements under section 303(b), the bankruptcy court dismissed the petition, reasoning that Dawson was a bad-faith creditor because he was motivated by two improper purposes: to frustrate Forever Green's efforts to litigate its claim against ProGreen and to collect on a debt.

After *Forever Green*, courts in the Third Circuit must evaluate petitioning creditors' good faith under the "totality of the circumstances" standard,[33] which includes a host of factors courts must consider in determining whether an involuntary petition was filed in bad faith. These factors include whether "the creditors satisfied the statutory criteria for filing the petition; the involuntary petition was meritorious; the creditors made a reasonable inquiry into the relevant facts and pertinent law before filing; there was evidence of preferential payments to certain creditors or a dissipation of the debtor's assets; the filing was motivated by ill will or a desire to harass; the petitioning creditors used the filing to obtain a disproportionate advantage for themselves rather than to protect against other creditors doing the same; the filing was used as a tactical advantage in pending actions; the filing was used as a substitute for customary debt-collection procedures; and the filing had suspicious timing."[34]

Although *Forever Green* has bad facts and includes harmful testimony by one of the petitioning creditors, the Third Circuit's articulation of the "totality of the circumstances" test will undoubtedly lead every involuntary debtor to assert bad faith as a basis for dismissing an otherwise valid petition against it. Practitioners should not file the petition and then reactively argue the *Forever Green* factors; instead, they should proactively plan for the fight over bad faith and spend weeks—if not months—preparing for the involuntary (time permitting).

Practice Pointers:

- One of the factors is whether "the creditors made a reasonable inquiry into the relevant facts and pertinent law before filing."
    - Practitioners should attempt to hold several meetings where the petitioning creditor is provided all relevant facts, including any e-mails and other documentary evidence, to be considered in determining whether to file the petition.
    - Although attorney-client communications are privileged, petitioning creditors should be able to later testify about the various legal topics they covered in considering whether to file the involuntary, including any analysis of claims, corporate waste, breach of fiduciary duties, or fraudulent transfers.
    - The petitioning creditors might consider listing the documents they considered, and perhaps draft an internal memo evidencing the various grounds supporting their decision to file.
- Many cases have prepetition litigation. Practitioners should be sensitive to the timing of the involuntary filing, especially if the filing occurs after a negative event in underlying litigation. Bad faith dismissal risk increases if the creditor is perceived to be trying to gain a tactical advantage in a pending action.

[33] *Forever Green*, 804 F.3d at 336.

[34] *Forever Green*, 804 F.3d at 336.

- The case must be more than a customary debt collection action; bankruptcies were created as collective actions and they are favored when they can prevent diminution of assets and provide equality of treatment among creditors. *In re Murray*, No. 14-10271 (REG), 2016 Bankr. LEXIS 105, at *33 (U.S. Bankr. S.D.N.Y. Jan. 13, 2016). The more petitioning creditors are able make the involuntary filing about something other than their own debts, the better.
    - For example, in *In re AMC Investors, LLC*, 406 B.R. at 487-88, the court acknowledged that the creditor's "primary, and perhaps only reason for filing the involuntary petition is to seek the appointment of a chapter 7 trustee, who will possess the authority to investigate and, if appropriate, to pursue claims against the officers and directors of the Alleged Debtors." The court acknowledged that "[w]hile such a purpose for seeking bankruptcy jurisdiction may not be proper in every case, under these facts, [the petitioning creditor] has a valid bankruptcy purpose."

3. Quick Note on Abstention

We offer a quick note on abstention because debtors often couple a motion to dismiss for bad faith with a request that the bankruptcy court abstain from exercising its jurisdiction. Section 305(a)(1) of the Bankruptcy Code provides that "[t]he court, after notice and a hearing, may dismiss a case under this title, or may suspend all proceedings in a case under this title, at any time if the interests of creditors and the debtor would be better served by such dismissal or suspension." 11 U.S.C. § 305(a). "The courts that have construed § 305(a)(1) are in general agreement that abstention in a properly filed bankruptcy case is an extraordinary remedy, and that dismissal is appropriate under § 305(a)(1) only in the situation where the court finds that both 'creditors and the debtor' would be 'better served' by a dismissal." *In re AMC Investors, LLC*, 406 B.R. at 487-88. Granting an abstention motion under section 305(a)(1) requires more than a simple balancing of harm to the debtor and creditors; rather, "the interests of both the debtor and its creditors must be served by granting the requested relief." *Id*. The alleged debtor bears the burden to demonstrate that the interests of the debtors and creditors would benefit from dismissal. *See id*.; *see also FMB Bancshares, Inc.*, 517 B.R. at 371 ("The party seeking abstention bears the burden of proof and it is substantial."). To refrain from exercising jurisdiction over an otherwise proper case, the court must make specific and substantiated findings that the interests of the creditors and the debtor will be better served by dismissal or suspension. *See In re Spade*, 269 B.R. 225 (D. Colo. 2001).

Recent cases have put forward a litany of factors to gauge the overall best interests of the creditors and debtor. They include: (1) the economy and efficiency of administration; (2) whether another forum is available to protect the interests of both parties or there is already a pending proceeding in state court; (3) whether federal proceedings are necessary to reach a just and equitable solution; (4) whether there is an alternative means of achieving an equitable distribution of assets; (5) whether the debtor and the creditors are able to work out a less expensive out-of-court arrangement which better serves all interests in the case; (6) whether a non-federal insolvency has proceeded so far in those proceedings that it would be costly and time-consuming to start afresh with the federal bankruptcy process; and (7) the purpose for which bankruptcy jurisdiction has been sought.[35]

[35] *In re AMC Investors, LLC*, 406 B.R. at 487-88; *In re TPG Troy, LLC*, 492 B.R. 150, 160 (Bankr. S.D.N.Y. 2013).

Practice Pointer: The decision to abstain is generally made on a case-by-case basis, and although courts consider all of the above factors, not all are given equal weight in every case. In practice, courts generally abstain when exercising bankruptcy court jurisdiction adds little to prepetition litigation or the purposes of bankruptcy—for example, equitable distribution of assets—are not served. In our experience, courts heavily focus on factors (2), (3), and (4) in abstaining from involuntary bankruptcies.

4. Litigating Attorney Fees Following Dismissal

Filing an involuntary petition is a high-stakes venture because of the serious consequences that can flow from an order of dismissal. Under section 303(i), if the bankruptcy court dismisses the case "other than on consent of all [petitioning creditors] and the debtor, and if the debtor does not waive the right to judgment," the court may award the debtor attorney's fees, costs, and, if the petition was filed in bad faith, damages—including punitive damages.[36]

a) Fees and costs litigation under section 303(i)(1)

As the plain language of the statute indicates, the decision whether to award attorney's fees under section 303(i) is squarely within the bankruptcy court's discretion, subject to only two preconditions: (1) the court must dismiss the petition other than by consent, and (2) the debtor must not waive the right to judgment.[37] Many courts have indicated that there is a "rebuttable presumption" that the debtor is entitled to an award of attorney's fees, and that the burden is on the petitioning creditors to demonstrate that an award of fees and costs is inappropriate under the "totality of circumstances," including the merits of the involuntary petition, whether dismissal was a close call, the conduct of the debtor, and any other relevant factor.[38]

Notwithstanding potential arguments concerning the totality of the circumstances, "any petitioning creditor in an involuntary case should expect to pay the debtor's attorney's fees and costs if the petition is dismissed."[39] Indeed, courts have observed that awarding attorney's fees is generally appropriate in all cases where a debtor successfully defends against an involuntary petition.[40] Once the court determines that a debtor is entitled to an award of fees, it must analyze various factors to determine a reasonable fee, including the time and labor required, the novelty

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[36] 11 U.S.C. § 303(i).

[37] *In re Rosenberg*, 779 F.3d 1254, 1264 (11th Cir. 2015), *cert. denied sub nom. U.S. Bank, N.A. v. Rosenberg*, 136 S. Ct. 805, 193 L. Ed. 2d 713 (2016).

[38] *Higgins v. Vortex Fishing Sys., Inc.*, 379 F.3d 701, 706 (9th Cir. 2004); *In re Ross,* 135 B.R. 230 (Bankr. E.D. Pa. 1991).

[39] *Higgins*, 379 F.3d at 707.

[40] *In re Lee*, 252 B.R. 565, 566 (Bankr. M.D. Fla. 2000) (citing *In re K.P. Enterprise,* 135 B.R. 174 (Bankr. D. Me. 1992)).

and difficulty of the legal issues presented, and other factors with which bankruptcy practitioners will be familiar.[41]

Assuming that the debtor is entitled to fees, there are also the related questions of what categories of fees are compensable, and who can be held liable for any fees that the bankruptcy court might award. As to the first issue, the vast majority of courts have held that a bankruptcy court may award not only fees and costs incurred in obtaining dismissal of the involuntary petition, but also post-dismissal fees that the debtor incurs enforcing the fee award and litigating a claim for damages under section 303(i)(2) (which can far outstrip the fees incurred securing dismissal).[42] Indeed, courts have indicated that losing creditors should be required to foot the bill for all proceedings that flow from an improper involuntary petition even if the evidence suggests that the petitioning creditors proceeded in good faith.[43] That is consistent with the plain language of section 303(i), which makes a finding of bad faith a precondition to an award of compensatory or punitive damages, but not a precondition to an award of attorney's fees and costs. It is also consistent with the broad grant of discretion to the bankruptcy court under the statute; a bankruptcy court could well determine that a "reasonable attorney's fee" includes post-dismissal fees irrespective of the petitioning creditors' intent.

The few circuit court decisions that have squarely addressed the types of fees available under section 303(i)—namely, decisions from the Eleventh, Sixth, and Ninth Circuits—generally agree that, under the statute, a bankruptcy court has authority to award all sorts of fees flowing from the involuntary, including fees incurred prosecuting a claim for damages under section 303(i)(2) and "fees on fees" incurred seeking to enforce and collect on a fee award under section 303(i)(1).[44] A good example of the statute's impressive reach is the Sixth Circuit's decision in *John Richards Homes*, where the court entered a substantial fee award in favor of the prevailing debtor under section 303(i)(1), and later awarded $2 million in *additional* fees-on-fees that the alleged debtor incurred prosecuting the first fee award for years after the involuntary was dismissed, including fees incurred participating in the petitioning creditor's own subsequent bankruptcy case (which sought to discharge the prior fee award).[45]

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[41] *Am. Benefit Life Ins. Co. v. Baddock (In re First Colonial Corp.),* 544 F.2d 1291 (5th Cir.), *cert. denied*, 431 U.S. 904 (1977) (articulating 12-factor test for evaluating attorney's fees awards).

[42] *See In re John Richards Homes Building Co.*, 405 B.R. 192, 198-200 (E.D. Mich. 2009) (collecting case law); *In re S. Ca. Sunbelt Devs., Inc.*, 608 F. 3d 456, 463-64 (9th Cir. 2010) ("If the court finds that the debtor is eligible for an award of fees, then … the fee award presumptively encompasses all aspects of the § 303 action, including proceedings on claims under § 303(i)(2)"); *In re Advance Press & Litho., Inc.*, 46 B.R. 700, 703 (Bankr. D. Colo. 1984) ("I find nothing in the Code or case authority limiting an award to the date of dismissal"); *In re Landmark Distribs., Inc.*, 195 B.R. 837, 846 (Bankr. D. N.J. 1996); *In re Glannon*, 245 B.R. 882, 894 (D. Kan. 2000).

[43] *John Richards Homes*, 405 B.R. at 214-217.

[44] *Rosenberg*, 779 F.3d at 1265; *Adell v. John Richards Homes Bldg. Co.*, 552 Fed. App'x 401 (6th Cir. 2013), *cert. denied*, 134 S. Ct. 2136 (2014) ("[Section] 303(i) authorizes bankruptcy courts to award fees for services rendered in direct appeals and in collateral proceedings enforcing a judgment after the dismissal of an involuntary petition."); *S. Ca. Sunbelt Devs., Inc. v. IBT Int'l, Inc.* (*In re S. Ca. Sunbelt Devs., Inc.)*, 608 F.3d 456, 463–64 (9th Cir. 2010) (fee award under § 303(i) "presumptively encompasses all aspects of the § 303 action").

[45] *John Richards Homes, supra*.

One point of disagreement among courts analyzing section 303(i)(1) is whether the statute authorizes bankruptcy courts to award appellate fees. The Ninth Circuit and certain bankruptcy courts have ruled that the debtor must seek those fees from the appellate court in a motion under Rule 38 of the Federal Rules of Appellate Procedure, which authorizes an award of fees if an appeal is "frivolous."[46] The Eleventh and Sixth Circuits, on the other hand, have both expressly ruled that section 303(i)(1) authorizes an award of appellate fees, reasoning that the legislative intent of the statute—to make a prevailing debtor completely whole—compels that interpretation.[47] The Eleventh Circuit further explained that requiring an alleged debtor to seek appellate fees under Rule 38 would be contrary to the language and intent of section 303(i)(1), which does not contain a frivolity requirement.[48]

With respect to the question of who may be held liable for fees, section 303(i) states that the court may grant judgment "against the petitioners." Obviously, the actual petitioning creditors face exposure if an involuntary petition is dismissed. The statute's reach, however, is not limited to the parties whose names are actually listed on the involuntary petition. Instead, courts have applied general principles of agency law to hold persons liable where they actually directed the filing of the petition or where they exercised control over the petitioning creditor.[49] For example, in *In re Rosenberg*, the Eleventh Circuit held that a "de facto" petitioning creditor was properly held liable for filing an improper involuntary petition when it signed the petition on behalf of several special purpose entities (most of which had been administratively dissolved at the time of the filing), listed its own business address as the address for each entity, and then actually directed the filing of the involuntary petition. Under those circumstances, the court of appeals affirmed the bankruptcy court's award of fees and costs against the servicer even though its name appeared nowhere on the petition.[50]

b) Damages litigation under section 303(i)(2)

In contrast to a claim for fees and costs under section 303(i)(1), in a claim for damages under section 303(i)(2) there is a presumption that the petitioning creditors acted in good faith, and the burden is on the debtor to prove that the involuntary petition was filed in "bad faith."[51] Once again, this requires the bankruptcy court (or the jury)[52] to analyze the "totality of the circumstances" surrounding the filing of the involuntary petition, such as, for example, whether

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[46] *Higgins*, 379 F.3d at 709; *see also John Richards Homes, supra* at 407-408 (discussing conflict over appellate fees generally and the ruling from *Higgins* specifically).

[47] *Rosenberg,* 779 F.3d at 1264-65; *John Richards Homes*, 552 Fed. App'x at 407-408.

[48] *Rosenberg, supra*.

[49] See *In re Oakley Custom Homes, Inc.,* 168 B.R. 232 (Bankr. D. Colo. 1994); *DVI Receivables XIV, LLC v. Rosenberg*, 500 B.R. 174, 188 (S.D. Fla. 2013), *aff'd in part, vacated in part, remanded sub nom. In re Rosenberg*, 779 F.3d 1254 (11th Cir. 2015).

[50] *See Rosenberg*, 779 F.3d at 1268-69.

[51] *In re John Richards Homes Bldg. Co., LLC*, 439 F.3d 248, 254 (6th Cir. 2006).

[52] At least one court has concluded that a claim for damages under section 303(i)(2) is akin to a common law malicious prosecution claim and that, therefore, the defendants in such an action are entitled to a trial by jury. *See In re Rosenberg*, 779 F.3d at 1260 (discussing district court's ruling to this effect).

the petitioning creditors filed the involuntary in order to exert pressure or otherwise gain an improper advantage in a dispute with the debtor, and whether the decision to file the involuntary was motivated by personal ill-will or malice.[53]

Because creditors that venture into the choppy waters of involuntary bankruptcy will usually (hopefully) retain bankruptcy counsel to investigate and prepare the petition, the creditors' liability under § 303(i)(2) will often turn on their ability to prove up an advice-of-counsel defense. Whether that defense is available depends on whether the creditor's alleged bad faith was motivated by an "improper use" or "improper purpose." Improper use occurs when a creditor improperly uses the bankruptcy system to obtain an otherwise legitimate goal; for example, filing an involuntary petition against a debtor to collect a debt. If an attorney advises the creditor that involuntary bankruptcy is an appropriate alternative to routine debt collection methods, the attorney, rather than the creditor, is responsible for the improper use, and those facts would not support a finding of bad faith. On the other hand, if the creditor is motivated by an improper purpose, such as personal ill-will, then courts generally reason that the creditor came to the attorney with that purpose in mind and thus cannot rely on the attorney's advice as a defense to shield it from a finding of bad faith.[54]

Irrespective of the petitioning creditor's purpose, the advice-of-counsel defense requires the creditor to prove that it made a reasonable inquiry into the debtor's financial circumstances and armed its attorney with a full and honest statement of all material information, such that the creditor actually relied on good faith on the attorney's advice (and is not merely using an attorney to insulate their improper motive).[55] Courts therefore reject the advice of counsel defense when the facts show that material information was withheld from bankruptcy counsel, especially information that, if shared, might have caused the attorney to advise against filing the involuntary petition.[56] Thus, as noted above, it is incumbent upon counsel considering filing an involuntary petition to conduct a complete and thorough investigation of the circumstances before moving forward.

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[53] *John Richards Homes*, 439 F.3d at 255 (collecting cases and affirming finding of bad faith where the petitioning creditor was motivated to coerce the debtor into a settlement or, failing that, destroy its business).

[54] *In re Better Care, Ltd.*, 97 B.R. 405, 412-13 (Bankr. N.D. Ill. 1989); *see also Gen. Trading Inc. v. Yale Materials Handling Corp.*, 119 F.3d 1485, 1493 (11th Cir. 1997) (citing *Better Care* and distinguishing improper use from improper purpose).

[55] *Landmark Distribs., Inc.*, 189 B.R. 290 (Bankr. D. N.J. 1995).

[56] *Landmark Distribs., supra; John Richards Homes,* 439 F.3d at 260 (affirming bankruptcy court's rejection of advice of counsel defense where bankruptcy counsel testified that in filing the petition he had relied on creditor's incorrect representation as to undisputed status of claim over $12,000, and that he was unaware of several key documents, which he would like to have seen).

C. Other Important Considerations for Involuntary Bankruptcies

1. The Bermuda Triangle—Gap Period Transfers and Trustees

a) Section 303(f)

The period between the filing of an involuntary petition under section 303 and the entry of an order for relief is often referred to as the "gap period." Great uncertainty exists as to how creditors can safely transact business with an alleged debtor during this period, and the protections afforded the alleged debtor are greater than those afforded creditors transacting business with the alleged debtor in the gap period. For example, while section 303(f) of the Bankruptcy Code allows the involuntary debtor to operate its business as if the bankruptcy petition had not been filed, the automatic stay prohibits creditors from taking any action against the involuntary debtor and its assets. And certain transfers of the alleged debtor's property made after the filing of the involuntary petition but before the order for relief can be avoided and the property recovered by a bankruptcy trustee or a debtor-in-possession.[57] Similarly, creditors who provide goods or services to a debtor after the order for relief are generally entitled to an administrative priority claim, whereas creditors providing similar goods or services during the gap period are only entitled to priority after all other administrative claims are satisfied.[58] Thus, the alleged debtor recognizes significant protections offered by the automatic stay during the gap period, yet creditors remain in limbo and are not afforded the same certainties and protections during the gap period as after entry of the order for relief. Traps exist for the unwary creditor, so practitioners must give careful consideration to dealing with an involuntary debtor in the ordinary course.

The other situation petitioning creditors may face is one in which management or insiders have or are about to engage in transactions that are potentially fraudulent or that are not in the best interest of creditors. For example, a debtor can use a secured creditor's collateral or dispose of proceeds such as rents (1) without making any payments on the obligation, (2) without affording the secured creditor adequate protection for the use of the collateral and (3) without disclosing the use to the secured creditor. Meanwhile, the secured creditor is barred by the automatic stay from taking action to protect its interest in collateral to which it would be entitled under non-bankruptcy law had no petition been filed. So section 303(f) can be used by a debtor to frustrate the legitimate rights of secured creditors by disposing of collateral proceeds such as rents in violation of the secured creditor's rights.

Section 303(f) of the Bankruptcy Code may provide an avenue to shut down questionable transactions and provides the court an avenue to condition the alleged debtor's use of its property. Section 303(f) does not specify either the cause sufficient to give rise to relief

[57] *See* 11 U.S.C. § 549. Subsection (b) provides a special exception to the trustee's avoidance powers in involuntary bankruptcy cases to the extent the party doing business with the involuntary debtor gave value, including by rendering services.

[58] *See* 11 U.S.C. §§ 507(a)(2) and 502(f).

thereunder or the nature of the relief available to an aggrieved party.[59] But the legislative history instructs that an alleged debtor should remain in control of his assets unless it is shown that he "may attempt to abscond with assets, dispose of them at less than their fair market value, or dismantle his business, all to the detriment of [its] creditors."[60] One recent case in which a court granted a motion to condition the debtor's use of its property is *In re Texas Rangers Baseball Partners*,[61] a case in which the court required that, prior to entry of an order for relief, the equity holders manage their sole asset—the alleged debtor—in a fashion consistent with the fiduciary responsibilities of debtors-in-possession, meaning that they had the same fiduciary duties to creditors as would a trustee.[62]

b) Gap Period Trustees in Chapter 7 Cases and Chapter 11 Cases

Oftentimes, if the conduct of the debtor is so egregious, petitioning creditors will file a motion to appoint an interim trustee under section 303(g) of the Bankruptcy Code in lieu of a motion under section 303(f). Under section 303(g) of the Bankruptcy Code, a motion for the appointment of an interim trustee in an involuntary chapter 7 case may be made to the court by a party in interest. Gap period trustees are sometimes necessary to preserve the property of the estate or to prevent loss, especially in cases in which current management is engaged in fraudulent or dishonest activities or is incompetent or is grossly mismanaging the business of the debtor or conflicts among management threaten the going concern value of the enterprise.[63]

Involuntary petitions are rare; gap period trustees are rarer and an even more extreme remedy. A recent example is the Judge Silverstein's denial of a motion to appoint an interim trustee in the *Diamondhead Casino Corp.* case[64] in the United States Bankruptcy Court for the District of Delaware. The standard that the court articulated in that case is that "a request for an interim trustee should be denied 'in the absence of an exceptionally strong need for doing so' or 'where not facts are alleged showing a necessity for the appointment'" because the "movant must show a substantial risk of loss to the estate."[65] The court must also determine that there is a "reasonably likelihood that an order for relief will be entered."[66]

Section 303(g) applies only to chapter 7 cases, but courts have held that chapter 11 trustees may be appointed during the gap period under section 1104 of the Bankruptcy Code. The plain language of section 1104(a) provides that a chapter 11 trustee may be appointed at any

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[59] As to the latter issue, Collier suggests that "[a]n order imposing restrictions on the operations of the business may conform to the restrictions mentioned in section 363." 2 Lawrence P. King, *Collier on Bankruptcy,* ¶ 303.35[2], at p. 303-121 (15th ed. 1992).

[60] *See* H.R. Rep. 95-595, 95th Cong., 1st Sess. 323 (1977); Senate Rep. No. 95-989, 95th Cong., 2d Sess. 33 (1978), U.S. Code Cong. & Admin. News 1978, 5787, 6279, 5819.

[61] 434 B.R. 393 (Bankr. N.D. Tex. 2010).

[62] *Id.* at 405.

[63] 2-25 Collier Bankruptcy Practice Guide P 25.04 (2015).

[64] *In re Diamondhead Casino Corp.*, 540 B.R. 499, 500 (Bankr. D. Del. 2015).

[65] *Id.*

[66] *Id.*

time after commencement of a case; an order for relief need not necessarily have been entered first.[67] Courts that have appointed chapter 11 trustees during the gap period have done so to prevent or stop gross mismanagement or suspected fraudulent activity. For example, in *In re Prof'l Accountants Referral Servs., Inc*., the court appointed a trustee to prevent further harm to the debtor's estate and its creditors where the debtor's current management seemed to be working at odds with the success of the corporate entity. That is, the court found that, "as opposed to fulfilling his fiduciary duties, [the company's chief officer] had been engaged in a substantially similar and competing business. . . ."[68]

c) Unringing the Bell—Dismissal of Involuntary Cases

For an involuntary debtor, it is not always easy to unring the bell of the involuntary case by paying off or otherwise settling with the petitioning creditors. The court may dismiss an involuntary bankruptcy case under section 303(j) of the Bankruptcy Code (1) on motion of a petitioner, (2) on consent of all petitioners and the debtor, or (3) for want of prosecution. Unlike section 305, which requires the court to consider the interests of both the debtor and creditors, the court need not consider the interests of the debtor and all creditors under section 303(j).[69] The bases for dismissal by a petitioning creditor under subsection 303(j)(1) are therefore broad and include, for example, a determination by the petitioning creditor that proceeding with the involuntary bankruptcy is no longer necessary.[70]

Not only must the debtor and petitioning creditors file a motion to dismiss, but also they must provide notice to all creditors under Bankruptcy Rule 1017(a). The notice requirement of section 303(j) serves at least two purposes. First, it is designed "to prevent collusive settlements among the debtor and the petitioning creditors while other creditors, that wish to see relief ordered with respect to the debtor but that did not participate in the case, are left without sufficient protection."[71] Second, it protects the rights of creditors who may have relied on the petition and affords them the opportunity to intervene.[72] All creditors of the alleged debtor have standing to object to the proposed dismissal; they need not meet the qualifications necessary to initiate or join in an involuntary petition.[73] Many contested matters in bankruptcy are dismissed

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[67] *In re Prof'l Accountants Referral Servs., Inc.*, 142 B.R. 424, 429 (Bankr. D. Colo. 1992) (approving appointment of chapter 11 trustee during the "gap period"); *In re C.W. Min. Co.*, No. 08-20105, 2008 WL 3539795 (Bankr. D. Utah 2008) (noting that the movant in an involuntary chapter 11 could have moved for the appointment of an interim trustee but failed to do so); Collier on Bankruptcy ¶ 303.29 (Alan Resnick & Henry J. Sommer 16th ed. 2011) ("[A] trustee can be appointed in the chapter 11 case prior to the entry of the order for relief."). *Cf.* 11 U.S.C. § 701 ("Promptly after the order for relief . . . the United States Trustee shall appoint one disinterested person . . . [to] serve as trustee").

[68] *Id.* at 429.

[69] *See, e.g., Wechsler v. Macke Int'l Trade, Inc. (In re Macke Int'l Trade, Inc.)*, 370 B.R. 236 (B.A.P. 9th Cir. 2007).

[70] *See Collier's on Bankruptcy*, ¶ 303.34 (16th ed. 2008).

[71] H.R. Rep. No. 595, 95th Cong., 1st Sess. 324 (1977); S. Rep. No. 989, 95th Cong. 2nd Sess. 35 (1978), *reprinted in* U.S. Code Cong. & Admin. News 1978, pp. 5787, 5821, 6280.

[72] *See* 11 U.S.C. § 303(c); Fed. R. Bankr. P. 1003(b); *Wynne v. Rochelle,* 385 F.2d 789 (5th Cir.1967) (construing former § 59(g) of the Bankruptcy Act).

[73] *In re Broshear,* 122 B.R. 705, 707 (Bankr. S.D. Ohio 1991).

on the stipulation of the litigants. But the Bankruptcy Code does not permit that result in cases commenced by involuntary petitions without appropriate notice and an opportunity for other creditors to object.

2. Rules of the Sea—Key Procedural Rules for Involuntary Bankruptcies

Because of the rarity of involuntary petitions, even seasoned bankruptcy practitioners forget all the procedural rules affecting involuntary bankruptcies. Following are the key rules of which practitioners should be aware, along with a short summary of what the rules concern:

- Rule 1003—transferor or transferees of a claim; joinder of petitioners after filing. One court recently held that "Bankruptcy Rule 1003 provides for a reasonable waiting period after the debtor files his list of creditors to allow additional creditors the opportunity to join as petitioning creditors."[74] Also, a transfer of a claim for the purpose of commencing an involuntary is a ground for disqualification of a party to the transfer as a petitioner.

- Rule 1004—special rules for service of process in involuntary filings against partnerships.

- Rule 1010—requirements for service of the involuntary petition and the requirement that petitioners file a corporate ownership statement consistent with Rule 7007.1

- Rule 1011—Rule setting for the procedures for responding to an involuntary petition. The responsive pleading or a Rule 12(b) motion must be filed within 21 days after service of the summons.

- Rule 1013—direction to the court that it 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. In reality, involuntary cases can drag on for months.

- Rule 1018—this rule makes involuntary petitions much like adversary proceedings, directing that the discovery rules and other procedural rules apply, including motions for summary judgment. One procedural aspect of this rule that practitioners should think about using is a motion for summary judgment on the involuntary petition. For petitioning creditors, this approach may short-circuit the involuntary debtor's attempt to drag out the entry of an order for relief.

[74] *In re Barkats*, Case No. 14-00053 (Bankr. D.C. Feb. 9, 2015) (Teel, J.).