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Recommended Citation

Benjamin Weintraub and Alan N. Resnick, *Involuntary Petitions Under The New Bankruptcy Code*, 97 *Banking L.J.* 292 (1980)

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INVOLUNTARY PETITIONS UNDER THE NEW BANKRUPTCY CODE

Benjamin Weintraub* and Alan N. Resnick**

The new Bankruptcy Code has relaxed the requirements for creditors who wish to successfully commence an involuntary bankruptcy case. All ramifications of these requirements are explained by the authors in detail. In addition, they consider the basic issue of whether a general creditor should opt for forcing a debtor into bankruptcy by filing an involuntary petition. The authors examine the advisability of alternative courses of action, as well as the risks creditors should weigh before filing an involuntary petition.

Statistics show that 199 bankruptcy liquidation cases out of every 200 are commenced by the debtor filing a voluntary petition.¹ It is not surprising, therefore, that bankruptcy is often viewed as being for the primary benefit of debtors. However, bankruptcy can also be an effective remedy for creditors. In fact, bankruptcy in Anglo-American law began exclusively as a creditor's remedy for the orderly distribution of the debtor's assets.² Modern bankruptcy laws may be used either as a debtor's remedy to achieve relief from indebtedness or as a creditor's remedy to compel a reorganization or liquidation of the debtor's estate.

The Bankruptcy Code, as well as the former Bankruptcy Act, permits creditors to take the initiative to force a debtor into

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This article is based on material prepared by the authors for *Bankruptcy Law Manual*, their forthcoming book on bankruptcy and debtor relief to be published by Warren, Gorham & Lamont. The Bankruptcy Code, which is Title 11 of the U.S. Code, was created by the Bankruptcy Reform Act of 1978 (Pub. L. 95-598) and governs all bankruptcy cases commenced on or after Oct. 1, 1979. The Code is cited as "11 U.S.C. § —."

¹ See Administrative Office of the United States Courts, *Tables of Bankruptcy Statistics* 6 (1978).

² See MacLachlan, *Handbook of the Law Bankruptcy* §§ 25-27 (1956); See also Donnelly, "The New (Proposed?) Bankruptcy Act: The Development of Its Structural Provisions and Their Impact on the Interests of Consumer-Debtors," 18 *Santa Clara L. Rev.* 291, 295-296 (1978), for a discussion of the history of bankruptcy law in America.

bankruptcy by filing an involuntary petition. A significant modification in the law as a result of the Bankruptcy Code is the relaxation of the requirements necessary for creditors to successfully commence an involuntary bankruptcy case. It is likely that the liberalization of these requirements will produce an increase in the number of involuntary petitions in the future.

Of the four types of bankruptcy cases available under the Bankruptcy Code, only two types may be commenced by an involuntary petition: liquidation under chapter 7 and reorganization under chapter 11.³ Although many of the same rules apply in liquidation and reorganization cases concerning involuntary petitions, the emphasis here is on liquidation cases.

Alternatives for Creditors

The general creditor and the creditor's counsel, in deciding whether to commence an involuntary liquidation case against a debtor, must first explore the available alternative courses.

No Legal Action

Legal action to collect a debt is advisable only if the prospect of recovery outweighs the inconvenience and expense of the collection effort. Unfortunately for creditors, the ability to recover payment is limited to the amount of the debtor's nonexempt assets. Also, our system of debt collection is based on grab law, that is, the first creditors to acquire liens in the debtor's property succeed to the detriment of the remaining creditors who are left empty-handed.⁴ Therefore, if a debtor is "judgment proof" because the debtor is without nonexempt assets and is unlikely to receive significant income or property in the future, and the debtor did not fraudulently convey property or make preferential payments to other creditors, it will often be in the creditor's best interest to refrain from further collection efforts.

³ 11 U.S.C. § 303(a). An involuntary petition may not be filed against a municipality for relief under chapter 9 of the Bankruptcy Code because to permit such filings would infringe on state sovereignty rights under the Constitution. It would also be unwise to permit involuntary petitions against individuals with regular income under chapter 13 because the unwilling debtor should not be compelled to continue working to repay his creditors.

⁴ See MacLachlan, *Handbook of the Law of Bankruptcy* 3 (1956); Countryman, "The Bill of Rights and The Bill Collector," 15 *Ariz. L. Rev.* 521 (1973).

State Collection Remedies

If the debtor has assets sufficient to pay at least a portion of the total indebtedness, the unsecured creditor may effectuate collection by pursuing judicial remedies under state law. The creditor should obtain a lien on the debtor's property by judicial process and levy before other creditors do the same or the debtor becomes the subject of a bankruptcy case. In addition, if the creditor does not know about the existence or location of the debtor's assets, state laws provide for post-judgment discovery for this purpose. State law also provides for provisional remedies, orders of attachment, receiverships, and other procedures for protecting a creditor from dissipation of the debtor's assets while an action for a money judgment is pending.⁵

Debtor Rehabilitation

It may be in the creditors' best interests for the debtor to be rehabilitated. The insolvent debtor who could pay only a small fraction of total debts if all assets are liquidated, but who has the ability to improve a dim financial situation so as to make periodic payments of a greater amount, should be given the opportunity to do so. A reorganization case under chapter 11 of the Bankruptcy Code may be commenced by an involuntary petition to compel the debtor to attempt such a rehabilitation.⁶

Under the former Bankruptcy Act, involuntary petitions were permitted in Chapter X reorganization cases,⁷ but not in Chapter XI arrangement cases or Chapter XII real property arrangements. Since a complex statement of facts had to be alleged in an involuntary petition for relief under former Chapter X,⁸ and creditors often preferred a simple arrangement under former Chapter XI, insolvent debtors were usually allowed to continue their businesses until a levy of execution, foreclosure of a security interest, or bank setoff against a deposit resulted in a voluntary petition for relief under former Chapter XI. This delay, however,

⁵ See, e.g., N.Y. Civ. Prac. Law Art. 52 (McKinney) for New York's procedures for the collection of a money judgment.

⁶ 11 U.S.C. § 303(a).

⁷ Former Bankruptcy Act § 126.

⁸ Former Bankruptcy Act § 130.

reduced the likelihood that the debtor could be rehabilitated successfully.

The Bankruptcy Code now makes this waiting unnecessary. The allegations for an involuntary petition for reorganization under the new chapter 11 are the same as the allegations made in an involuntary petition for liquidation.⁹ Also, the relief available under Chapters X, XI, and XII of the former Act are now available under chapter 11 of the Code. Therefore, petitioning creditors can easily and quickly commence an involuntary case for reorganization as they can for liquidation.

Involuntary Petition for Liquidation

There are situations in which a creditor will benefit from the debtor's bankruptcy under chapter 7 of the Bankruptcy Code, despite the debtor's discharge of debts. These situations are discussed below.

Purposes for Filing an Involuntary Petition for Liquidation

The purpose of filing an involuntary petition for liquidation is to achieve an equal distribution of the debtor's property among each class of creditors without preferential treatment. Also, an involuntary petition should result in the maximization of the debtor's estate by the accumulation of property, and possibly the elimination of certain voidable liens and encumbrances. Basically, these purposes are accomplished by the appointment of a trustee in bankruptcy who is given extraordinary powers with which to represent the class of general creditors. It is important, therefore, to understand the trustee's powers before determining whether to file an involuntary petition.

Suppose, for example, that a debtor has only nominal assets, but that a sizable payment of money to Creditor *A* was made within the previous ninety days. Under state law, Creditor *B* would be unable to effectuate collection because of the debtor's

⁹ See Suggested Interim Bankruptcy Form No. 9, which applies in both chapter 7 and chapter 11 cases.

lack of assets on which to levy. By filing an involuntary petition, however, Creditor *B* will commence a bankruptcy case and a trustee will be appointed who may be able to recover the preferential payment from Creditor *A* to be shared among the class of general creditors.¹⁰ Under state law, Creditor *B* would be without power to compel the return of the preferential payment.

Consistent with the trustee's power to avoid certain liens and to recover certain property in order to increase the size of the estate, the trustee also has powers that facilitate an investigation of the debtor's affairs so as to discover preferences, fraudulent transfers, and vulnerable liens.

An involuntary bankruptcy case may also be justified when the debtor has chosen a different method of liquidation, such as a state court receivership or assignment for the benefit of creditors.¹¹ Here, the creditors wish to accomplish a different goal, namely, substitution of a disinterested trustee for an assignee or receiver who may be friendly to the debtor. The creditor wants an impartial trustee who will investigate the debtor zealously to discover and expose fraudulent or other dishonest conduct. Moreover, the power of an assignee or receiver is often curtailed by statute, and the right to recover preferential or fraudulent transfers under state law is not always as broad as the avoiding powers of a bankruptcy trustee.

If it appears, however, that the debtor is without nonexempt assets, and that a trustee will be unable to recover preferences or fraudulent conveyances or otherwise accumulate assets for the estate, the filing of an involuntary petition will probably be a fruitless exercise that may only accomplish a discharge for the debtor. It is not unusual, therefore, for defunct corporations and other business debtors to go out of business without ever being the subject of a bankruptcy case.

¹⁰ See 11 U.S.C. § 547 on voidable preferences.

¹¹ Pendency of state or federal equity receivership proceedings does not prevent the filing of a voluntary or involuntary bankruptcy petition. *In re Allied Construction, Inc.*, 79 F. Supp. 141 (W.D. Pa. 1948); *In re American & British Mfg. Corp.*, 300 F.2d 839 (D. Conn. 1924). However, a federal court injunction may be issued in connection with a federal receivership proceeding to prohibit the filing of a voluntary or involuntary petition when such extreme relief is necessary. See *Jordan v. Independent Energy Corp.*, 446 F. Supp. 516 (N.D. Tex. 1978).

Debtors Against Whom an Involuntary Petition May Be Filed

Any person who may file a voluntary petition for liquidation may become the subject of an involuntary bankruptcy case, except for farmers and not-for-profit corporations.¹² Accordingly, an involuntary petition may be filed against a natural person, partnership, corporation, or unincorporated organization. As in a voluntary bankruptcy, the debtor in an involuntary case must have either a residence, domicile, place of business, or property located in the United States.¹³ The fact that the debtor was in bankruptcy in the recent past does not prohibit the commencement of an involuntary case, even though the previous bankruptcy may prevent another discharge.¹⁴

Those debtors who are ineligible to file voluntary petitions for liquidation may not be forced into involuntary bankruptcy. Therefore, the foreign and domestic insurance companies, banking institutions, and credit unions, as well as municipalities and railroads, that are excluded from eligibility for voluntary liquidation under the Code, need not be concerned about being subjected to an involuntary petition.^{14a}

Debtors Against Whom an Involuntary Petition May Not Be Filed

Farmers

As under the former Bankruptcy Act, the only way that a farmer may go into bankruptcy today is by filing a voluntary petition. The Bankruptcy Code continues to protect farmers from involuntary bankruptcy by expressly providing that they may not be the subject of an involuntary petition.¹⁵ The policy behind this exclusion is to protect farmers when they are experiencing temporary periods of financial distress due to the cyclical nature of the farming business. The farmer who is unable to pay creditors because of a period of low prices or drought may not be pushed into bankruptcy.

¹² See 11 U.S.C. § 303(a).

¹³ 11 U.S.C. § 109(a).

¹⁴ See 11 U.S.C. § 727(a)(8).

^{14a} See 11 U.S.C. § 109(b).

¹⁵ 11 U.S.C. § 303(a).

Several changes in the exclusion for farmers were made by using a new definition of "farmer" in the Bankruptcy Code. The former Act limited the definition of farmer to an "individual" who is "personally" engaged in farming.¹⁶ By contrast, the Code expands the scope of the farmer exclusion to cover partnerships, corporations, and other entities whose income is from a "farming operation" that is "owned or operated" by the entity.¹⁷ Therefore, a large corporation or conglomerate engaged in a multimillion-dollar agribusiness may now receive the same protection from involuntary bankruptcy as does the individual who operates a small family farm. In addition, "farming operation" is defined broadly so as to include dairy farming, ranching, and the production of poultry or livestock products in an unmanufactured state, as well as the traditional raising of crops.¹⁸

Whether a debtor is a farmer for the purpose of this exclusion depends on the portion of income received from farming operations. The former Act granted the exclusion to individuals whose "principal part of his income" was from farming.¹⁹ The vagueness of this standard resulted in much time-consuming and costly litigation.²⁰ The Code contains a more definite standard, however, by limiting the farm exclusion to persons who received more than 80 percent of their gross income during the taxable year immediately preceding the taxable year in which the petition is filed from a "farming operation."²¹

When an involuntary petition is filed against a debtor who claims an exemption as a farmer, the petitioning creditors have the burden of proving that the debtor is not a farmer.²²

¹⁶ Former Bankruptcy Act § 1(17).

¹⁷ 11 U.S.C. § 101(17).

¹⁸ 11 U.S.C. § 101(18).

¹⁹ Former Bankruptcy Act § 1(17).

²⁰ See *In re Hinrichs*, 314 F.2d 384 (7th Cir. 1963), where the court found that the debtor's principal source of income was from a farm implement business so that he was not a farmer and could be the subject of an involuntary bankruptcy petition, despite the fact that he worked as a farmer in the evenings and on weekends and vacations on the 870 acres of farmland that he owned. See also *In re White*, 238 F. Supp. 454 (D. Col. 1965), where the court held that a partner in a farming operation was not a "farmer" because his personal participation in the farming activities was negligible.

²¹ 11 U.S.C. § 101(17).

²² See *In re Brais*, 15 F.2d 693 (7th Cir. 1926); *In re White*, 238 F. Supp. 454 (D. Col. 1965).

Not-for-Profit Corporations

Although it may file a voluntary petition, a debtor corporation that is not a “moneyed, business or commercial corporation” may not be the subject of an involuntary bankruptcy case.²³ This category of excluded debtors includes all corporations and unincorporated associations that are not organized for the purpose of earning a profit. The general nature and purpose of the entity must be examined to determine whether it is primarily charitable or benevolent so as to be protected from involuntary bankruptcy.

Cooperative associations organized to benefit its members may be considered business or commercial corporations despite their organization under membership or nonprofit corporation laws, if the ultimate result is financial profit to the members of the cooperative.²⁴ However, a not-for-profit corporation that engages in incidental money-making activities still qualifies for this exclusion from involuntary bankruptcy if its primary purpose relates to benevolent activities. Accordingly, a university organized as a nonprofit educational corporation may not be the subject of an involuntary petition, even though it operates a day-care center and university apartments and offers printing services to the public for a fee.²⁵

Minimum Debt Requirement

The former Bankruptcy Act provided that a debtor could not become an involuntary bankrupt unless the total debts owed amounted to at least \$1,000.²⁶ The Bankruptcy Code eliminates this requirement. However, the petitioning creditors must have claims aggregating at least \$5,000 more than the value of liens securing their claims.²⁷ Therefore, it would be impossible for

²³ 11 U.S.C. § 303(a).

²⁴ See *Missco Homestead Ass'n v. United States*, 185 F.2d 280 (8th Cir. 1950), where the purpose of the Cooperative Society's formation was to use money borrowed from the government to lease real estate for division and subletting to tenant farms so as to help rehabilitate needy farm families. Despite this purpose, the court held that the society was a “moneyed, business or commercial corporation.” See also *In re American Grain & Cattle, Inc.*, 415 F. Supp. 270 (N.D. Tex. 1976).

²⁵ *In re Allen University*, 497 F.2d 346 (4th Cir. 1974).

²⁶ Former Bankruptcy Act § 4(b).

²⁷ 11 U.S.C. § 303(b). See 11 U.S.C. § 104 providing for the adjustment of dollar amounts every six years.

creditors to force a debtor into bankruptcy unless the debtor owes at least \$5,000 in debts above the value of any security. The requirement that petitioning creditors have \$5,000 in unsecured claims is significant because it will protect many low-income consumers from involuntary bankruptcy.

Dissolved Corporations, Insane or Deceased Debtors

The pendency of dissolution proceedings, liquidation of a corporation under state statutes, or cessation of business neither defeats bankruptcy jurisdiction nor prevents the filing of an involuntary petition because the corporation still exists as an entity. Some question exists as to the jurisdiction of the bankruptcy court when the bankruptcy case is commenced after the state dissolution proceedings have been terminated.²⁸ But, in any event, once instituted, the bankruptcy case is not terminated by a subsequent corporate dissolution. Similarly, a bankruptcy case does not terminate if an individual debtor dies or becomes insane during the pendency of the case.²⁹ Of course, an involuntary petition cannot be filed against an insolvent decedent's estate, but can be filed against the estate of a living incompetent.

Who May File an Involuntary Petition Against the Debtor?

Requisite Number of Petitioning Creditors

An involuntary petition must be executed by a specified number of creditors or indenture trustees.³⁰ These moving parties will be referred to as the "petitioning creditors."

One petitioning creditor is sufficient to commence an involuntary bankruptcy if the debtor has fewer than twelve creditors or indenture trustees.³¹ But, to determine whether there are fewer

²⁸ See *In re Peer Manor Bldg. Corp.*, 134 F.2d 839 (7th Cir. 1943), *cert. denied sub nom. Nicholas v. Witter*, 320 U.S. 211, where the court held that the bankruptcy court has no jurisdiction over a dissolved corporation. Compare *In re Thomas*, 78 F.2d 602 (6th Cir. 1935), *cert. denied* 296 U.S. 626.

²⁹ See Bankruptcy Rule 118.

³⁰ In general, an indenture trustee is a trustee under a mortgage, deed of trust, or other instrument under which securities either debt or equity of the debtor are outstanding. See 11 U.S.C. §§ 101(22), 101(23).

³¹ 11 U.S.C. § 303(b).

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than twelve of such creditors, the following creditors are not counted: (1) any employees of the debtor who are also creditors; (2) any "insiders"³² of the debtor who are creditors; and (3) any creditors who received a preference, fraudulent conveyance, statutory lien, postpetition transfer, or any other lien or interest in the debtor's property that is voidable by a trustee in bankruptcy.³³ The reason for not counting these creditors is that they probably would not want the debtor to go into bankruptcy because of their special relationship with the debtor. The employee will lose a job if the debtor is liquidated in bankruptcy, the insider is likely to be too closely connected to the debtor so as to be biased in favor of protecting the debtor against others, and the creditor who has a voidable lien or who received a voidable transfer does not want to be subjected to the trustee's extraordinary powers because of the creditor's own self-interest. Therefore, only creditors without these special reasons for wanting to avoid bankruptcy are counted to determine if there are fewer than twelve creditors. The exclusion of these types of creditors makes it easier for a single creditor to commence an involuntary case. Although employees, insiders, and holders of voidable liens or transfers are not counted to determine whether there are fewer than twelve creditors, however, these special types of creditors may act as petitioning creditors if they wish to force an involuntary bankruptcy.³⁴

If there are twelve or more creditors, the petition must be executed by at least three petitioning creditors. Suppose that an insolvent debtor has less than twelve creditors, but decides to discontinue its usual practice of paying small incidental bills on a monthly basis for the purpose of intentionally increasing the number of creditors to twelve or more, thereby preventing an

³² *Id.* The term "insider," which is new in bankruptcy, includes relatives, general partners and relatives of general partners, partnerships in which the debtor is a general partner, and corporations of which the debtor is a director, officer, or person in control. In the case of corporate debtors, a director, officer, or person in control is an insider. Managing agents or "affiliates" of a business debtor are also insiders. See 11 U.S.C. §§ 101(2), 101(25).

³³ See 11 U.S.C. § 303(b)(2).

³⁴ See *In re J.J.S. Co.*, 445 F.2d 138 (7th Cir. 1971), in which an active manager who was also an officer, director, and owner of 50 percent of the shares of the debtor corporation was qualified to be a petitioning creditor against the corporation.

involuntary petition by less than three petitioning creditors. For example, the debtor does not pay small monthly utility or telephone bills. It has been held that such manipulation by the debtor to increase the number of creditors will not prevent a single creditor with a large claim from filing an involuntary petition.³⁵

Requisite Amount of Claims

The petitioning creditors, regardless of their number, must have claims against the debtor that are not contingent as to liability and that aggregate to at least \$5,000 above the value of any security interests, mortgages, or other liens that the petitioning creditors have on the debtor's property.³⁶ Accordingly, the petitioning creditors must have claims that are unsecured to the extent of \$5,000 collectively. Fully secured creditors may not commence an involuntary bankruptcy case, but a partially secured creditor may act as a petitioning creditor to the extent of the deficiency over and above the value of the collateral.³⁷

The claims of petitioning creditors may not be contingent as to liability. When a claim of fraud against the debtor was reduced to judgment in state court, the mere fact that the debtor was appealing the fraud judgment at the time that the creditor executed an involuntary petition did not make the creditor's fraud claim contingent.³⁸ However, when the debtor is the indorser of an unmatured promissory note, the holder of the note should not qualify as a petitioning creditor because it cannot be shown that the principal obligor on the note had defaulted. Such

³⁵ Denham v. Shellman Grain Elevator, Inc., 444 F.2d 1376 (5th Cir. 1971).

³⁶ 11 U.S.C. § 303(b). Compare with Section 59(b) of the former Bankruptcy Act that required that petitioners' claims amount to the aggregate of only \$500. Also, the former Bankruptcy Act provided that unliquidated claims could not be counted in computing the number and aggregate amount of the claims of petitioning creditors if the court was unable to estimate the value of the total claims as aggregating to \$500 without unduly delaying the decision on the merits of the involuntary petition. Former Bankruptcy Act § 59(b). The Bankruptcy Code requires the court to convert a claim into a dollar value regardless of how unliquidated it is. See 11 U.S.C. § 502(c). In addition, the requirement under the former Act that the claims of petitioners must be "provable" no longer applies because the concept of provability was eliminated by the new Code. See Former Bankruptcy Act § 59(b).

³⁷ See *In re Hayes*, 127 F. Supp. 514 (D. Alaska 1955).

³⁸ Denham v. Shellman Grain Elevator, Inc., 444 F.2d 1376 (5th Cir. 1971).

claim against the indorser is too contingent as to liability because the debtor may never be required to pay the note if the maker does not default.³⁹

The fact that a creditor's claim is entitled to a priority in distribution does not disqualify the creditor from acting as a petitioner and does not affect priority rights. In fact, priority creditors often file involuntary petitions when the debtor makes an assignment for the benefit of creditors, or otherwise liquidates under state law so as to take advantage of priority rules under federal bankruptcy laws.

Transfers of Claims

It is the policy of the Bankruptcy Rules to discourage the transfer or acquisition of claims for the sole purpose of qualifying as a petitioning creditor to force a debtor into bankruptcy. A person who transfers or acquires a claim for this purpose is not eligible to be a petitioning creditor. To assist the debtor and the court in policing this rule, any petitioning creditor who is a transferor or transferee of a claim, regardless of the reason for the transfer, is required to annex to the petition copies of all documents evidencing the transfer, together with a signed statement setting forth the consideration and terms of the transfer. The statement must also contain an assertion that the claim was not transferred for the purpose of commencing a bankruptcy case. This reporting requirement must be met even if the claim was assigned by or to the petitioning creditor only as security.⁴⁰

Joinder of Petitioning Creditors After Filing

Suppose that three creditors execute and file a petition and the debtor has twelve or more creditors. Then, after the filing, the claim of one of the petitioning creditors is not recognized

³⁹ See *In re Gibraltar Amusements, Ltd.*, 187 F. Supp. 931 (E.D.N.Y. 1960), *aff'd* 291 F.2d 22 (2d Cir. 1961), for a case that held that a claim was too contingent for other reasons.

⁴⁰ Bankruptcy Rule 104(d); Suggested Interim Bankruptcy Rule 1003(b). A creditor who assigns a claim may be a petitioner if the claim is assigned as security and exceeds the amount of the debt secured thereby. *In re 69th & Crandon Bldg. Corp.*, 97 F.2d 392 (7th Cir. 1938), *cert. denied sub nom. Eastholm-Melvin Co. v. Hoffman*, 305 U.S. 629.

because it is contingent as to liability or for another reason. Does the court have to dismiss the petition? The Bankruptcy Code follows the Bankruptcy Rule that permits a creditor other than the petitioning creditors to join in the petition after filing with the same effect as if the joining creditor had been one of the original petitioners.⁴¹ If another creditor joins in the petition, therefore, the petition will not be dismissed for want of three qualified petitioning creditors.

If a petition is executed and filed by only one or two petitioning creditors because they believe that the debtor has fewer than twelve creditors, the debtor may allege in its answer that there are twelve or more creditors. In such event, however, the debtor must file with the answer a list of all creditors and their addresses, and a brief statement of the amounts and nature of their claims. If it appears that there are twelve or more creditors, the court must give the petitioning creditors a reasonable opportunity to have other creditors join in the petition before it is dismissed for want of the requisite number of creditors.⁴² This rule, designed to allow petitioning creditors to cure a defective petition, may not be used by a creditor who acted in bad faith. For example, if a single petitioning creditor falsely alleges that there are fewer than twelve creditors, knowing that there are actually twelve or more, the petitioner will not be entitled to have other creditors subsequently join in the petition, and the petition will be dismissed.⁴³

Partnerships

There are special rules governing the commencement of an involuntary bankruptcy case against a partnership entity. In

⁴¹ 11 U.S.C. § 303(c); Bankruptcy Rule 104(e).

⁴² Bankruptcy Rule 104(e). A petitioning creditor may solicit other creditors to join in filing an involuntary petition. *In re Kootenai Motor Co.*, 41 F.2d 403 (D. Idaho 1930). It is advisable that the creditor make such solicitations instead of the creditor's attorney so as to avoid a possible violation of the American Bar Association Code of Professional Responsibility.

⁴³ See *In re Crofoot, Neilson & Co.*, 313 F.2d 170, 171 (7th Cir. 1963), where the court said that "if a single creditor files a petition with knowledge that the allegation (less than twelve creditors) is false, the petition will be dismissed as a fraudulent attempt to confer jurisdiction upon the court where none exists and intervention 'presumably' will be denied." But see *In re Crown Sportswear, Inc.*, 4 Bankr. Ct. Dec. 476 (1st Cir. 1978), where the burden of proof to establish bad faith was not met.

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addition to an involuntary petition filed by petitioning creditors as discussed above, an involuntary case may be instituted by any one or more of the general partners without regard to the amount of claims or number of petitioners.⁴⁴ If all of the general partners join in the petition, however, it is treated as a voluntary petition.

Why would a general partner want to file an involuntary petition against the partnership entity? A partner who wants a discharge of debts may be sufficiently protected by filing a voluntary petition as an individual. A partner who files a voluntary petition as an individual may receive a discharge from both personal and partnership debts.

There are situations, however, in which a partner would want to have a petition filed against the firm. Suppose that a general partner has reason to believe that other partners embezzled partnership property causing the insolvency of the firm. When the innocent but insolvent partner files a voluntary petition as an individual, filing another petition against the firm may be advisable so that a partnership trustee would be appointed to investigate and recover fraudulently transferred property. The partnership trustee may succeed in recovering enough assets to pay at least a portion of the innocent petitioning partner's personal debts that are nondischargeable. Likewise, a partner may file an involuntary petition against the partnership to have the partnership trustee recover voidable preferences or to invalidate voidable liens. Another reason for a partner to file an involuntary petition against the firm is to achieve a reorganization under chapter 11 of the Bankruptcy Code.

If all of the general partners are in personal bankruptcy, a general partner, the bankruptcy trustee of any general partner, or the holder of any claim against the partnership may commence an involuntary case against the partnership without regard to the amount of claims or number of petitioners.⁴⁵ The purpose of this rule is to facilitate the administration of partnership assets when all general partners are in personal bankruptcy.

⁴⁴ 11 U.S.C. § 303(b)(3)(A). The requirement that petitioning creditors have claims aggregating to at least \$5,000 does not apply when less than all of the general partners file an involuntary petition.

⁴⁵ 11 U.S.C. § 303(b)(3)(B).

Foreign Proceedings

If a debtor's estate is the subject of a judicial liquidation or reorganization in a foreign country, the representative of that estate may file an involuntary petition against the debtor in the United States to permit the administration of assets located in this country.⁴⁶

As an alternative to the filing of an involuntary petition commencing a full bankruptcy case against a debtor involved in a foreign proceeding, the Bankruptcy Code provides that a foreign representative may commence a case "ancillary to a foreign proceeding."⁴⁷ A petition to commence an ancillary case is involuntary in nature and may be contested by the debtor. Such an ancillary case gives the bankruptcy court jurisdiction to facilitate the administration of assets located in the United States. The court has flexible powers to handle ancillary cases so as to give appropriate weight to principles of international comity and to cooperate with and recognize the insolvency laws of the foreign nation.

The importance of having sufficient flexibility in administering cases ancillary to foreign insolvency proceedings was shown in *Banque de Financement v. First National Bank of Boston*.⁴⁸ The debtor was a Swiss bank involved in a rehabilitation proceeding under Swiss law. The debtor had substantial bank deposits in the United States that were being attached by American creditors. To avoid the dissipation of assets located here pending reorganization efforts abroad, the debtor filed a petition under Chapter XI of the former Bankruptcy Act. However, because Swiss criminal law prohibits public disclosure of a bank's creditors, the debtor did not file the required list of creditors.⁴⁹

⁴⁶ 11 U.S.C. § 303(b)(4).

⁴⁷ 11 U.S.C. § 304.

⁴⁸ 568 F.2d 911 (2d Cir. 1977). See also Nadelmann, "Rehabilitating International Bankruptcy Law: Lesson Taught By Herstatt and Company," 52 N.Y.U.L. Rev. 1 (1977); Nadelmann, "Israel-British Bank (London) Ltd: Yet Another Trans-Atlantic Crossing," 52 Am. Bankr. L.J. 369 (1978), for discussions of two other cases that presented problems because of insolvency proceedings pending abroad.

⁴⁹ Under Section 7a(8) of the former Bankruptcy Act, the debtor was required to file a list of creditors. This requirement was similar to the debtor's duty to file a list of creditors under the Bankruptcy Code. 11 U.S.C. § 521(1).

Nonetheless, the Court of Appeals reversed the dismissal of the petition and suggested alternative procedures that may be used to effectuate an orderly administration while protecting the rights of local creditors. The bankruptcy court could exercise jurisdiction to set aside preferential attachments under United States bankruptcy law, transfer the assets located here to Geneva to be administered in the Swiss proceeding, and suspend the bankruptcy case here. A second alternative is to fully administer the estate in this country coordinated with the Swiss proceeding. In either event, the Swiss court, which has a confidential list of creditors, could notify depositors and local creditors who then may decide whether to file claims in the bankruptcy case here. Pro rata distribution could be achieved by marshaling assets in Switzerland that could take into account the dividends paid to local creditors who filed claims in the United States bankruptcy court. Such flexibility to effectuate an equitable administration in international bankruptcy situations is provided by the Bankruptcy Code.⁵⁰

When an involuntary petition for liquidation, reorganization, or the commencement of an ancillary case is filed, the foreign representative of the estate in the foreign proceeding may make a limited appearance in connection with the petition without being subjected to the general jurisdiction of the bankruptcy court or of any other court in this country.⁵¹

Jurisdiction, Venue, and Transfer of Cases

The United States district court, and the bankruptcy judge as an adjunct of the district court, has jurisdiction to entertain involuntary petitions.⁵² The involuntary case should be commenced by filing a petition with the clerk of the court where there is proper venue.

The venue rules in involuntary cases are the same as those in voluntary bankruptcies; the proper judicial district for commencing an involuntary case depends on the debtor's residence,

⁵⁰ See 11 U.S.C. § 304(c).

⁵¹ 11 U.S.C. § 306.

⁵² 28 U.S.C. § 1471.

domicile, place of business, or on the location of the principal assets. In addition, a petition may be filed in a district in which the bankruptcy case of an affiliate of the debtor is pending.^{52a} The liberal rules that permit the retention of cases despite improper venue and the transfer of cases in the interest of justice and the convenience of the parties in voluntary cases applies equally to involuntary cases.^{52b}

The Petition

An involuntary case is instituted by filing an involuntary petition, executed by the petitioners, in the office of the clerk of the court.⁵³ The petitioners must pay a sixty-dollar filing fee at the time of the filing in liquidation cases. The fee in reorganization cases is \$200.⁵⁴ An original petition plus three copies must be filed unless local court rules provide otherwise.⁵⁵ The petition should conform to the official form.⁵⁶

It is important to understand and appreciate that an involuntary petition is a pleading that commences a legal action and should contain allegations made in the form of a pleading. The petition must identify the debtor in the caption by inserting the debtor's name, as well as all other names used by the debtor within the previous six years, according to the petitioner's best information.⁵⁷ It should contain the names and addresses of the petitioners and an assertion that petitioning creditors have claims against the debtor, not contingent as to liability, amounting in the aggregate to \$5,000 or more in excess of the value of securities held by them.⁵⁸ The nature and amount of the petitioner's claims

^{52a} See 28 U.S.C. § 1475. The rules concerning venue are discussed in greater detail in chapter 1 of the authors' forthcoming book.

^{52b} See 28 U.S.C. § 1475. The rules concerning change of venue are discussed in greater detail in chapter 1 of the authors' forthcoming book.

⁵³ 11 U.S.C. § 303(b). Verification of the petition is not required if it contains an unsworn declaration. 28 U.S.C. 1746.

⁵⁴ 28 U.S.C. § 1930(a). If the petition is filed against a railroad seeking reorganization under chapter 11 of the Act, the filing fee is \$500.

⁵⁵ Suggested Interim Bankruptcy Rules 1002(b)(1), 1003(a).

⁵⁶ See Suggested Interim Bankruptcy Form No. 9.

⁵⁷ Bankruptcy Rule 106; Suggested Interim Bankruptcy Rule 1005.

⁵⁸ If petitioners are not creditors, such as when a general partner files a petition against a partnership, no allegation is necessary concerning petitioner's claims against the debtor.

should be described briefly. The petition should allege the basis of jurisdiction and venue and should state that the debtor is a person against whom an order for relief may be entered under the Code. In addition, the petition must allege that at least one of the grounds for an order for relief is satisfied. Since an involuntary petition may be filed to seek either liquidation or reorganization, the petition should specify whether it is for relief under chapter 7 or chapter 11 of the Bankruptcy Code.

**Requirements for an Order of Relief: Acts
of Bankruptcy Abolished**

When the former Bankruptcy Act was enacted in 1898, Congress was concerned about the prospect of creditors pushing a debtor into bankruptcy without sufficient justification. Involuntary bankruptcy was not intended as a remedy that creditors can invoke at any time and without good reason. To protect debtors against an unwarranted involuntary petition, the former Act permitted an involuntary bankruptcy adjudication only if the debtor had committed one of the six “acts of bankruptcy” within four months of the filing of the petition.⁵⁹

The acts of bankruptcy, that had to be pleaded in the petition with sufficient particularity to identify the specific occurrence,⁶⁰ were as follows: (1) the debtor made a fraudulent transfer or concealment of property while insolvent; (2) the debtor made a voidable preference to a creditor while insolvent; (3) a creditor obtained a judicial lien on the debtor’s property while the debtor was insolvent that was not vacated or discharged within thirty days after the date of the lien or at least five days before the date set for the sale; (4) the debtor made a general assignment for the benefit of creditors; (5) the appointment of a receiver or trustee to take charge of the debtor’s property while the debtor was insolvent or unable to pay his debts; and (6) the debtor admitted in writing the inability to pay debts and the willingness to be adjudged a bankrupt.⁶¹

The necessity of alleging and proving an act of bankruptcy

⁵⁹ Former Bankruptcy Act § 3(b).

⁶⁰ Bankruptcy Rule 104(c).

⁶¹ Former Bankruptcy Act § 3(a).

was most frustrating to creditors. Many of the acts, if committed, were not notorious and could have been ascertained only through an examination of the debtor's books and records. The debtor's books were not readily available to creditors except through the medium of judicial proceedings to enforce a money judgment under state law.⁶² Unless a creditor was able to identify and prove a specific act of bankruptcy, the creditor was powerless to commence an involuntary bankruptcy case, despite the debtor's dilatory tactics or inability to pay bills.

The requirement of alleging an act of bankruptcy was further complicated by the fact that the petition had to be filed within four months of the act.⁶³ If a creditor discovered that the debtor made a preferential payment five months ago, there would be no basis for filing a petition against the debtor. Moreover, in addition to the difficulty of obtaining facts as to several of these acts that were often clandestine, such as preferences and fraudulent conveyances, the creditor had to obtain evidence in most instances that the debtor was insolvent. Under the former Act, insolvency required that the aggregate of the debtor's property at a fair valuation not be sufficient in amount to pay all debts.⁶⁴ It was difficult for creditors to have information sufficient to determine whether the debtor met this "balance sheet" insolvency test.

The need to plead and prove an act of bankruptcy had been severely criticized as contributing to unnecessary delay between the time when a debtor first becomes unable to pay debts and the time of filing the involuntary petition.⁶⁵ The difficulty of discovering and proving an act of bankruptcy after the debtor defaulted on monetary obligations resulted in further deterioration of the debtor's assets by the time of liquidation or reorganization. The need to establish an act of bankruptcy by competent evidence made it extremely difficult to commence an involuntary bankruptcy case.

⁶² See, e.g., N.Y. Civ. Prac. Law §§ 5223, 5224 (McKinney).

⁶³ Former Bankruptcy Act § 3(b).

⁶⁴ See Former Bankruptcy Act § 1(19).

⁶⁵ See, e.g., MacLachlan, *Handbook of the Law of Bankruptcy*, Ch. 6 (1956); Trost & King, "Congress and Bankruptcy Reform Circa 1977," 33 *Bus. Law.* 489 (1978).

INVOLUNTARY PETITIONS

The Bankruptcy Code abolishes the concept of acts of bankruptcy and replaces it with grounds for relief that make it easier for creditors to file an involuntary petition promptly after the debtor first experiences serious financial difficulties. By commencing the bankruptcy case at an earlier date, creditors should be able to protect the debtor's assets from further dissipation and, in reorganization cases, to increase the likelihood that rehabilitation will be successful.

Grounds for Relief Under the Bankruptcy Code

If an involuntary petition is controverted by a timely answer, the court may not order the relief sought unless at least one of the following grounds exist: (1) that the debtor is generally not paying debts as they become due; or (2) within 120 days before the date of the filing of the petition, a custodian was appointed or took possession of substantially all of the debtor's property.⁶⁶

General Failure to Pay Debts

The Bankruptcy Code does not recognize mere balance sheet insolvency as a ground for an involuntary petition.⁶⁷ The fact that the debtor's total indebtedness is greater than the fair value of all of the debtor's nonexempt assets does not, in and of itself, justify the commencement of an involuntary case. This is due to the recognition that a debtor, although technically insolvent, may be able to pay current bills nonetheless. Moreover, a debtor could have total assets worth more than total liabilities but still have a serious cash flow problem that stands in the way of paying debts as they mature. For these reasons, the Code adopts as a ground for involuntary bankruptcy the so-called equity insolvency test that is based on a general failure to pay debts as they become due regardless of what the debtor's balance sheet looks like.⁶⁸

⁶⁶ 11 U.S.C. § 303(h).

⁶⁷ See 11 U.S.C. § 101(26) for the definition of "insolvent." See also former Bankruptcy Act § 1(19).

⁶⁸ 11 U.S.C. § 303(h)(1). The equity insolvency test is not new in bankruptcy legislation. It was used in the former Bankruptcy Act as an alternative to balance

What is a "general" failure to pay debts? Apparently, non-payment of only a small number or amount of debts will not constitute a general failure to pay. But at what point does the debtor's defaults justify an involuntary petition? Courts will have to deal with this question on a case-by-case basis, taking into consideration an analysis of the relationship of past-due debts to total liabilities.

An involuntary petition should set forth specific facts that support the allegation that the debtor is generally not paying debts as they become due.⁶⁹ In a recent case, an involuntary petition filed under chapter 7 of the Code alleged that the debtor had sent a letter to its creditors stating that the debtor did not have sufficient working capital to continue operations and intended to liquidate its assets and distribute the remaining funds pro rata to creditors.⁷⁰ Although this petition was not contested, it is interesting to speculate whether such an allegation is sufficient to withstand a motion to dismiss the petition on its face. Of course, it is conceivable that the debtor had not ceased paying its debts generally at the time the petition was filed, despite the intention to liquidate. Nonetheless, the likelihood that the debtor who sends such a letter is failing to pay current liabilities is so great that the petitioners should have their day in court to prove general nonpayment of debts. Similarly, a statement in a petition that the debtor convened a meeting of creditors at which the debtor sought a composition of debts also should be sufficient to support the allegation that the debtor is generally not paying debts as they become due.

When an involuntary petition alleges that the debtor is generally not paying debts as they become due, the debtor may file an answer denying the allegation. Upon such denial, the debtor is required to appear in court at the trial and must bring its books, papers, and accounts. In addition, the debtor may be required to appear for a pretrial examination on this issue.⁷¹

sheet insolvency in Chapter X reorganization cases. See former Bankruptcy Act § 130(1). Also, the equity insolvency test is used in the Uniform Commercial Code, UCC § 1-201(23).

⁶⁹ See Suggested Interim Bankruptcy Form No. 9.

⁷⁰ *In re* Great Shapes Leotard, Inc., No. 79-10025 (S.D.N.Y. 1979).

⁷¹ Suggested Interim Bankruptcy Rule 1008.

Appointment of a Custodian

There are several reasons for permitting involuntary bankruptcy upon the appointment of a custodian to take over the debtor's assets. First, if a custodian of all or substantially all of the debtor's property is appointed, it is a clear indication that the debtor is having serious financial difficulties. Ordinarily, custodians are appointed as the result of a state court receivership, an assignment for the benefit of creditors, or some other liquidation mechanism. Therefore, the Bankruptcy Code essentially recognizes the appointment of a custodian as creating an irrefutable presumption that the debtor is unable to pay debts as they mature.

Secondly, the appointment of a custodian is usually made to facilitate a liquidation of assets outside the context of a federal bankruptcy case. Once such a liquidation process is commenced by the custodian's appointment, the creditors who are affected by the liquidation should have the absolute right to have it proceed in bankruptcy court with the benefit of all of the protections afforded by federal bankruptcy law. In essence, the creditors have a right to convert the state liquidation proceeding to a federal bankruptcy case. Also, creditors may believe that it is in their best interest to force a reorganization under the bankruptcy laws to rehabilitate the debtor instead of having a liquidation.

Creditors may rely on the appointment of a custodian as a ground for relief in bankruptcy only if the petition is filed within 120 days of either the date of the appointment or the date on which the custodian took possession.⁷² Because of the notoriety of the appointment of a custodian, this time period is adequate to protect creditors. Of course, if the petition is filed more than 120 days after the custodian is appointed or takes possession, the petitioning creditors may rely on the debtor's general failure to pay debts as they become due as the ground for the petition without the time limitation.

Custodian, within the meaning of the Bankruptcy Code, in-

⁷² 11 U.S.C. § 303(h)(2).

cludes trustees, receivers, assignees, and liquidators, whether or not they are judicially appointed.⁷³ However, the appointment of a trustee, receiver, or agent appointed or authorized to take charge of less than substantially all of the debtor's property for the purpose of enforcing a lien is not sufficient.⁷⁴ For example, foreclosure of a mortgage on the debtor's real estate involving the appointment of a receiver to take charge of the property is not grounds for involuntary bankruptcy if the real estate is not substantially all of the debtor's assets.

Procedure After Filing an Involuntary Petition

Service of the Summons and Petition

Upon the filing of an involuntary petition, the clerk of the court issues a summons to be served on the debtor, together with a copy of the petition.⁷⁵ The petitioners have the choice of either serving the summons and petition by personal service or by mail.⁷⁶ In either case, service must be made within ten calendar days from the issuance of the summons. Otherwise, the petitioner will have to obtain a new summons from the clerk.⁷⁷ When service is made by mail, it must be made by first-class mail. A signed receipt from the debtor is not necessary as long as the person who mails it certifies that the mailing took place.⁷⁸ However, in order to avoid any contention that the papers were not served, it is advisable to serve the summons and complaint by certified or registered mail with a return receipt requested.

⁷³ 11 U.S.C. § 101(10). Compare *In re Blair & Co., Inc.*, 471 F.2d 178 (2d Cir. 1972), cert. granted 411 U.S. 930, remanded 414 U.S. 212, vacated as moot 495 F.2d 299 (2d Cir. 1974), in which it was held that the appointment of a liquidator by the New York Stock Exchange to take control of the debtor stockbroker's assets was not enough to trigger the creditors' right to commence an involuntary bankruptcy petition under the former Bankruptcy Act.

⁷⁴ 11 U.S.C. § 303(h)(2).

⁷⁵ See Suggested Interim Bankruptcy Form No. 10, the official summons form; Bankruptcy Rule 111.

⁷⁶ Bankruptcy Rules 111, 704(b), 704(c). See Bankruptcy Rule 704(c) to determine to whom the summons and petition are to be mailed.

⁷⁷ Bankruptcy Rules 111, 704(e). The 10-day period includes Saturdays, Sundays, and legal holidays, unless the tenth day is a Saturday, Sunday, or legal holiday in which event it will not count. See Bankruptcy Rule 906; Fed. R. Civ. P. 6(a).

⁷⁸ Bankruptcy Rules 111, 704(c), 704(g).

INVOLUNTARY PETITIONS

Rules governing service of a summons and involuntary petition are extremely liberal.⁷⁹ Personal service may be made by anyone who is an adult and not a party.⁸⁰ The attorney for the petitioner or the attorney's clerk often serves it by mail. If personal service or service by mail cannot be made, the court may order that the summons and petition be served by mailing copies to the last known address, if any, and by publication in the manner and form as directed by the judge.⁸¹ As long as there is no material prejudice to the debtor caused thereby, an error in the manner or proof of service or in the papers served will not affect the validity of the service, and the bankruptcy case will commence nonetheless.⁸²

If an involuntary petition is filed against a partnership, the Suggested Interim Bankruptcy Rules require that, within five days after the filing, the petitioning creditors or partners send a copy of the petition by first-class mail to the last known address of each general partner who has not joined in the petition or who has not been served. In lieu of mailing, however, a copy of the petition may be delivered to each general partner.⁸³

The Answer to the Petition

The debtor or, in the case of a petition against a partnership, any general partner who is not a petitioner may file and serve an answer to the petition.⁸⁴ Creditors and other persons may not file an answer to contest the petition.⁸⁵ The answer usually will challenge the standing of the petitioning creditors or the alleged grounds for involuntary bankruptcy. The answer should be in

⁷⁹ See Bankruptcy Rule 111.

⁸⁰ Bankruptcy Rules 111, 704(b).

⁸¹ Bankruptcy Rule 111.

⁸² Bankruptcy Rules 111, 704(h).

⁸³ Suggested Interim Bankruptcy Rule 1004(b).

⁸⁴ 11 U.S.C. § 303(d). See Bankruptcy Rule 112.

⁸⁵ Prior to 1938, creditors had standing to question the sufficiency of an involuntary petition. The former Bankruptcy Act was amended in 1938 to preclude creditors from challenging the petition and this preclusion is continued under the Bankruptcy Code. See former Bankruptcy Act § 18(b). It was held that a creditor may not challenge the petition even when it is so inadequate as to deprive the bankruptcy court of jurisdiction. *In re Ludlum Enterprises, Inc.*, 510 F.2d 996 (5th Cir. 1975).

the same form, and may contain defenses in the same manner, as answers in other types of civil actions in federal district courts.⁸⁶ However, the answer may include the statement of a claim against a petitioning creditor *only* for the purpose of defeating the petition because an affirmative judgment cannot be sought by way of a counterclaim in a bankruptcy case.⁸⁷ The answer must be served and filed within twenty calendar days after the issuance of the summons, unless a different time limit is stated in a court order for service by publication.⁸⁸ No other pleadings are permitted after an answer is filed and served, except for the rare occasion when the court orders the petitioners to reply to the answer.⁸⁹

As in other federal civil actions, the debtor may make any one or more of a number of motions, some of which may be made prior to the answer. For example, the debtor may make a motion to dismiss the petition for lack of jurisdiction, or for failure to state a claim upon which relief can be granted because the petition fails to adequately state a ground for an involuntary petition. The debtor also may make a motion for a more definite statement, although this will be a rare occurrence under the Bankruptcy Code because of the elimination of the need to plead an act of bankruptcy. The debtor may make any of the motions that are permitted by Rule 12 of the Federal Rules of Civil Procedure.⁹⁰ The timely service of a motion may have the effect of extending the time to answer pending a decision on the motion. If the court denies a motion or postpones its disposition until the trial on the merits, the answer need not be served until five days after the debtor receives notice of the court's action.⁹¹

If the answer alleges that one or more of the petitioning creditors is ineligible to be a petitioner or if such an allegation is

⁸⁶ Bankruptcy Rule 112. See Rule 12 of the Federal Rules of Civil Procedure on the requirements for an answer in federal civil actions.

⁸⁷ Bankruptcy Rule 112. See *Georgia Jewelers, Inc. v. Bulova Watch Co.*, 302 F.2d 362 (5th Cir. 1962); See also *Harris v. Capehart-Farnsworth Corp.*, 225 F.2d 268 (8th Cir. 1955).

⁸⁸ Bankruptcy Rule 112.

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ Bankruptcy Rules 112, 712(a).

made in a pretrial motion, the court must give the other petitioners reasonable time to have other creditors join in the petition before dismissing the bankruptcy case. If the petition is executed by less than three creditors and the debtor alleges that there are twelve or more creditors, thus requiring at least three petitioning creditors to commence an involuntary case, the debtor must file and serve with the answer a list of all of the creditors.⁹²

The Trial on Factual Issues

If a petition is contested, the court is required to determine the issues at the “earliest practicable time” and either order relief, dismiss the case, or enter other appropriate orders.⁹³ If there are genuine triable issues of fact, the court may not dispose of them without conducting a trial.⁹⁴ The Bankruptcy Code departs from prior law by permitting the judge to order that the issues in an involuntary case be tried without a jury.⁹⁵

In preparation for the trial, all parties may resort to all discovery methods that are applicable to other federal civil actions as contained in the Federal Rules of Civil Procedure.⁹⁶

Order for the Relief Requested in the Petition

The court will order the relief requested in the petition or enter other appropriate orders if the debtor defaults by failing to controvert the petition within the applicable time limits.⁹⁷ If the petitioners sought relief under chapter 7 of the Bankruptcy Code, the court will order the liquidation of the debtor. If the relief requested is a reorganization, the court will order it under chapter 11.

⁹² Bankruptcy Rule 104(e).

⁹³ Suggested Interim Bankruptcy Rule 1009(a).

⁹⁴ 11 U.S.C. § 303(h).

⁹⁵ 28 U.S.C. 1480(b). Under the former Bankruptcy Act, the debtor had a right to a jury trial on the issues of insolvency and presence of an act of bankruptcy. Former Bankruptcy Act § 19.

⁹⁶ Bankruptcy Rules 121, 726; Fed. R. Civ. P. 26.

⁹⁷ 11 U.S.C. § 303(h). See Suggested Interim Bankruptcy Rule 1009(b) requiring that the court order relief upon default “on the next day, or as soon thereafter as practicable.” An order for relief should conform to Suggested Interim Bankruptcy Form No. 11.

If the petition is controverted and a trial is held, the court will order the requested relief only if it is found that one of the grounds for involuntary bankruptcy is present, that is, that the debtor is generally not paying debts as they become due or that a custodian was appointed or took possession of the debtor's assets within 120 days before the filing of the petition.

List of Creditors, Schedules, and Statement of Affairs

The debtor's duty to file a list of creditors, schedules, and statement of affairs applies in involuntary as well as in voluntary cases.⁹⁸ These documents must be filed within ten days after the order for relief in an involuntary bankruptcy. The court may, on application, grant up to ten additional days for filing these documents, but any further extension may be granted only for cause and on notice as directed by the court.⁹⁹ Rules dealing with supplemental schedules are also applicable in involuntary cases.¹⁰⁰

When a partnership is the subject of an involuntary petition, the list of creditors, schedules, and statement of affairs must be prepared and filed by the general partners. Every general partner who is not in bankruptcy as an individual also must file a statement of personal assets and liabilities with the trustee of the partnership within ten days of the trustee's qualification or within a time period set by the court.¹⁰¹ The purpose of this requirement is to facilitate the marshaling of assets by the trustee when necessary.

If the debtor is a corporation, the duty to file these documents is imposed on the person or persons designated by the court to perform these functions.¹⁰²

If the debtor fails to file the required documents within the time permitted by the Rules or by court order, the court may direct the trustee or petitioning creditors, or anyone else who is an

⁹⁸ See 11 U.S.C. § 521. These documents are discussed in detail in chapter 1 of the authors' forthcoming book.

⁹⁹ See Bankruptcy Rule 108(b).

¹⁰⁰ Bankruptcy Rule 108(e).

¹⁰¹ Bankruptcy Rule 108(c). See *In re Ira Haupt & Co.*, 240 F. Supp. 369 (S.D.N.Y. 1965).

¹⁰² See Bankruptcy Rule 901(6).

interested party, to prepare and file the list of creditors, schedules, and statement of affairs.¹⁰³ In such a situation, it is often necessary for the trustee or petitioning creditors to employ accountants or other assistants in preparing the documents. The trustee or petitioning creditors should ask the court to authorize such employment so that these expenses will constitute a claim against the estate, which has priority as an administrative expense.¹⁰⁴ Moreover, in such a situation, it is possible that the debtor's failure to file these documents may result in punishment for contempt and the denial of a discharge.¹⁰⁵

Meeting of Creditors

After an order for relief is entered under the Bankruptcy Code, notice is sent by the clerk of the court to creditors and the debtor informing them of the date set for the meeting of creditors. The same rules that relate to meetings in voluntary cases are equally applicable in involuntary bankruptcies. The debtor has the duty to attend the meeting to be examined. In addition, the court may order a separate meeting of equity holders that the debtor must attend.^{105a}

After the order of relief is entered and the list of creditors, schedules, and statement of affairs is filed, the involuntary case follows essentially the same procedures as are followed in a voluntary case.

Joint Petitions, Joint Administration, and Consolidation

The Bankruptcy Code permits joint petitions to be filed only against husbands and wives.¹⁰⁶ However, in appropriate cases, separate involuntary petitions may be filed against related corporations or other debtors who are closely connected followed by either a joint administration of assets or a complete consolidation of the bankruptcy cases.^{106a}

¹⁰³ Bankruptcy Rule 108(d).

¹⁰⁴ See Bankruptcy Rules 215, 219; 11 U.S.C. §§ 503, 507(a)(1).

¹⁰⁵ See 11 U.S.C. § 727(a)(6).

^{105a} See 11 U.S.C. §§ 341, 343. See chapter 1 of the authors' forthcoming book for a discussion of the meeting of creditors in greater detail.

¹⁰⁶ 11 U.S.C. § 302(a).

^{106a} Joint administrations and consolidations are discussed in greater detail in chapter 1 of the authors' forthcoming book.

Appointment of an Interim Trustee

After an involuntary petition is filed, but before the court orders relief for liquidation or reorganization, continued possession of the property of the estate by the debtor could jeopardize the rights of creditors. For example, it is not unlikely that a business debtor served with an involuntary petition for liquidation will not continue to devote full energies to the business and may even permit the wasting of assets. In such a situation, any party in interest may request the appointment of an interim trustee to take possession of the debtor's property in order to preserve it or prevent loss to the estate.¹⁰⁷ The court may appoint an interim trustee only after notice to the debtor and such other parties in interest as the court may designate and after a hearing to determine whether the appointment is necessary to preserve the estate or to prevent such loss.¹⁰⁸ In a rare case, an interim trustee may be appointed without notice upon a showing that irreparable loss to the estate would otherwise result.¹⁰⁹ The order appointing an interim trustee must set forth the specific duties to be carried out and copies of the order must be delivered or mailed to the debtor or to other persons as the court may designate.¹¹⁰

The interim trustee, who may continue to operate the debtor's business, serves while the trial is pending and until the selection of a trustee at the meeting of creditors.¹¹¹ Until the interim trustee is appointed, the debtor may operate the business in the ordinary course, but persons who extend credit to the debtor during that time will not have first priority in distribution

¹⁰⁷ 11 U.S.C. § 303(g). Suggested Interim Bankruptcy Rule 2001(b) requires that the application for the appointment of an interim trustee state specific facts showing the necessity for the appointment. Because of the availability of procedures for the appointment of an interim trustee, the court does not have the power to appoint a receiver. 11 U.S.C. § 105(b).

¹⁰⁸ 11 U.S.C. § 303(g); Suggested Interim Bankruptcy Rule 2001(a). Suggested Interim Bankruptcy Rule 2001(c) requires that the applicant furnish a bond sufficient to indemnify the debtor for the costs, attorney's fee, expenses, and damages allowable upon dismissal of the petition. See 11 U.S.C. § 303(i).

¹⁰⁹ Suggested Interim Bankruptcy Rule 2001(a).

¹¹⁰ Suggested Interim Bankruptcy Rule 2001(d).

¹¹¹ See 11 U.S.C. § 702. Upon the appointment of a regular trustee, the interim trustee must turn over all records and property of the estate and, within thirty days thereafter, file a final report and account. Suggested Interim Bankruptcy Rule 2001(e).

as an administrative expense; instead the creditor will have a second priority claim.¹¹²

A debtor who wants to regain possession of the business or other property from an interim trustee prior to the order for relief may do so by posting a sufficient bond. The amount of the bond will be set by the court to assure that such property, or its monetary equivalent, is delivered to the trustee in the event that an order for liquidation is granted.¹¹³ Regaining possession by posting a bond will probably be a rare occasion because the collateral needed to obtain such a bond must come from sources outside the estate assets.

Allowance of Petitioner's Expenses as a Priority Claim

Petitioning creditors must incur expenses in commencing an involuntary case. If an involuntary petition results in an order for relief and ultimate distribution to creditors, the petitioning creditors may recoup at least some of their expenses as administrative expense claims entitled to priority above the claims of other creditors. Specifically, the Bankruptcy Code provides that petitioning creditors may claim as an administrative expense their "actual, necessary expenses,"¹¹⁴ as well as reasonable compensation for professional services rendered to the petitioners by an accountant or attorney.¹¹⁵ Such expenses include the filing fee, cost of serving the summons and petition, attorney's fees, and other related expenses. The rationale for permitting creditors to recoup expenses as a priority claim is that the actions of the petitioners benefit all general creditors and, therefore, the petitioners should be reimbursed for such expenses from the estate before a pro rata distribution is made to all general creditors.

Protecting the Debtor After the Involuntary Petition Is Filed

In the period between the filing of an involuntary petition

¹¹² See 11 U.S.C. §§ 502(f), 507(a)(2).

¹¹³ 11 U.S.C. § 303(g).

¹¹⁴ 11 U.S.C. § 503(b)(3)(A).

¹¹⁵ 11 U.S.C. § 503(b)(4).

and either the order of relief or the dismissal of the bankruptcy case, the debtor is given certain protections designed to minimize the disruptive impact on the debtor's business and financial affairs.

The most important protection given by the Bankruptcy Code is the debtor's right to continue to operate the business prior to an order for relief as if the involuntary petition had never been commenced. The debtor may continue to use, acquire, or dispose of property unaffected by the bankruptcy case.¹¹⁶ Debts incurred in the ordinary course of business after the petition is filed, but before the order for relief or appointment of a trustee, are treated as claims against the estate, and will receive priority in distribution so as to encourage persons to continue dealing with the debtor, but it should be noted that these gap claims have only a second priority.¹¹⁷

As discussed in the previous section, however, when there is evidence that the debtor is likely to abscond with assets, waste property, or sell goods for less than fair market value, the debtor may be deprived of possession of assets. The court may grant appropriate orders to control or limit the debtor's powers or, upon application by an interested party, an interim trustee may be appointed if necessary to preserve the estate.¹¹⁸ In fact, it can be expected that creditors will generally seek the appointment of an interim trustee to remove possession from the debtor in liquidation cases under chapter 7 of the Bankruptcy Code.

Another protection that benefits the debtor is the automatic stay.¹¹⁹ While the involuntary case is pending, the debtor will be free from further harassment and judicial process by creditors. The automatic stay becomes effective upon the filing of the involuntary petition so as to preserve the estate from the earliest possible time in the bankruptcy case. The automatic stay facilitates an orderly administration of the estate and, therefore, is

¹¹⁶ 11 U.S.C. § 303(f).

¹¹⁷ 11 U.S.C. §§ 502(f), 507(a)(2).

¹¹⁸ 11 U.S.C. § 303(g).

¹¹⁹ 11 U.S.C. § 362.

for the benefit of general creditors as well as the debtor. The rules that apply to automatic stays in voluntary cases apply equally in involuntary cases.

Withdrawal, Abstention, or Dismissal of an Involuntary Case

Withdrawal of the Petition

A debtor who files a voluntary petition does not have an absolute right to withdraw it to terminate a bankruptcy case. Similarly, petitioners in an involuntary case may not withdraw their petition as a matter of right. Suppose, for example, that after the creditors file and serve an involuntary petition alleging the debtor's general failure to pay debts, the petitioning creditors receive payment of their claims in full. May the petitioners merely withdraw their petition? Obviously, if voluntary dismissal by the petitioners is possible in such a situation, the door would be open for collusive settlement among the debtor and the petitioners. A creditor who files a petition against a debtor would have extraordinary powers to compel the debtor to make a preferential payment in order to avoid liquidation. Therefore, the Bankruptcy Code protects other creditors by not giving the petitioners the absolute right to withdraw a petition either before or after an answer is interposed.

The only way for a petitioner to withdraw an involuntary petition is to do so by motion, with notice to all creditors, followed by a hearing. The court may then dismiss the case if that would be in the best interests of creditors and the debtor. The requirement for notice to all creditors and a hearing applies even when the debtor and all petitioners consent to withdraw the petition or dismiss the case. Based on the same rationale, the Bankruptcy Code provides that an involuntary case may not even be dismissed for want of prosecution or nonpayment of the required filing fees unless the court holds a hearing on notice to all creditors and determines that such dismissal will best serve the interests of the debtor and creditors in general.¹²⁰

¹²⁰ 11 U.S.C. §§ 303(j), 305(a), 707.

Abstention

Even when the court has an adequate basis for jurisdiction and venue and there is a sufficient ground for ordering relief under the bankruptcy laws, it may still be in the best interests of the parties for the court to decline jurisdiction over a case. The Bankruptcy Code expressly gives the court the right to abstain by either dismissing a case or suspending all proceedings in a case if such dismissal or suspension would best serve the interests of the debtor and creditors generally.¹²¹ A dismissal or suspension may be warranted, for example, when an out-of-court arrangement is being worked out among creditors and the debtor followed by an involuntary petition for liquidation filed by a few petitioning creditors who wish to upset the settlement due to dissatisfaction with the arrangement. If the court is satisfied that the extrajudicial arrangement would be in the best interests of the debtor and creditors generally, it would be appropriate to dismiss or suspend the bankruptcy case pending the arrangement. Suspension may even aid the out-of-court arrangement by giving the debtor an opportunity to work out a settlement with creditors and, if the recalcitrants do not consent, consummate the arrangement through chapter 11 of the Bankruptcy Code.

Dismissal or suspension of a bankruptcy case pursuant to the court's abstention powers may occur at any time and the judge's decision, either to abstain or not to abstain, is not reviewable on appeal.¹²² Abstention powers apply in both voluntary and involuntary cases.

Dismissal

The court may dismiss the petition after trial for any one of a variety of reasons, in addition to the exercise of abstention powers. If the petitioners are unable to establish a ground for involuntary bankruptcy, or if the petitioners cannot prove that they have unsecured claims against the debtor aggregating at

¹²¹ 11 U.S.C. § 305. See 11 U.S.C. § 1112(b), which gives the court the discretion to dismiss or convert a reorganization case in the best interest of creditors.

¹²² 11 U.S.C. § 305(c).

least \$5,000, a contested petition will be dismissed.¹²³ In addition, a case may be dismissed prior to the trial on the merits of the petition if the debtor makes a pretrial motion to dismiss pursuant to the Federal Rules of Civil Procedure. Lack of jurisdiction, for example, may be raised in a motion to dismiss. Also, the petition may be dismissed for want of prosecution.¹²⁴ When the case is dismissed by pretrial motion, or after trial on the merits of the petition, no order of relief is entered in the case.

Unless the court orders otherwise, the dismissal of a bankruptcy case is without prejudice and will not stand in the way of a subsequent petition and discharge for the debtor.¹²⁵ In addition, after dismissal, the rights of parties are put back to their positions prior to the filing of the petition. Any liens or transfers that were voided are reinstated and property of the estate reverts in the persons who owned the property prior to commencement of the bankruptcy case.¹²⁶

Conversion of the Case

Suppose that a meritorious involuntary petition seeks a liquidation under chapter 7. Suppose further that, although the debtor would like to avoid bankruptcy altogether, the debtor would rather be subjected to a reorganization under chapter 11 than a liquidation under chapter 7 that ends the business. In this situation, the debtor has the absolute right to convert the case from a liquidation to a reorganization.¹²⁷ The rationale for giving the debtor this right is that the debtor should always be given the opportunity to rehabilitate and repay debts. The conversion may be made at any time, either before or after the default or trial, and the debtor's right to convert may not be waived.¹²⁸ Similarly, an individual debtor with regular income may convert

¹²³ 11 U.S.C. § 303(h).

¹²⁴ Before dismissing an involuntary petition for want of prosecution, the court must conduct a hearing upon notice to all creditors. 11 U.S.C. § 303(j)(3).

¹²⁵ However, if the debtor received a discharge before dismissal that is not revoked by the court, the debtor may not seek another discharge in a liquidation case for six years. 11 U.S.C. § 727(a)(8).

¹²⁶ 11 U.S.C. § 349.

¹²⁷ 11 U.S.C. § 706(a).

¹²⁸ *Id.*

the case to achieve an adjustment of debts under chapter 13.¹²⁹ As soon as a conversion is made, it becomes an order for relief under the chapter to which the case is transferred. Accordingly, a debtor may contest an involuntary petition for liquidation and, if unsuccessful, may convert the case to accomplish a rehabilitation instead of liquidation. If the involuntary petition originally seeks a reorganization, however, the debtor does not have the right to convert it to a case for liquidation, except that upon notice and a hearing, the reorganization case may be converted by the court for cause if it is in the best interests of creditors and the estate.¹³⁰

Risks Assumed by Petitioners in Involuntary Bankruptcy Cases

Petitioning creditors should carefully consider the risks incurred when an involuntary petition is filed. Before the filing, creditors should understand their exposure to possible liability in the event that the petition is dismissed.

Dismissal of a petition on consent of the debtor and all petitioning creditors will not result in liability for costs, expenses, or damages, even though notice to all creditors and a hearing is required. However, when an involuntary petition is dismissed for any other reason, the court may award the debtor costs and a reasonable attorney's fee to be paid by the petitioners, unless the debtor waives the right to recover such costs and expenses. In addition, if an interim trustee took possession of the debtor's assets prior to the dismissal, the debtor may recover damages proximately caused by such taking of possession.¹³¹

The petitioner's exposure to liability is generally limited to costs, an attorney's fee, and damages caused by loss of possession to an interim trustee. The unsuccessful petitioner who acted in good faith is not liable for loss resulting from damaged reputation or defamation. But, if the court finds that the petition was filed in bad faith, the petitioning creditors may be required to compensate the debtor for all damages proximately caused by

¹²⁹ *Id.*

¹³⁰ 11 U.S.C. § 1112(a)(2), 1112(b).

¹³¹ 11 U.S.C. § 303(i)(1).

the filing.¹³² If the debtor's reputation is damaged because of the involuntary petition, and such damage results in the loss of business either before or after the dismissal, the debtor would have a claim for such loss against the petitioners who acted in bad faith. In addition, the court may award punitive damages against any petitioner who filed an involuntary petition in bad faith.¹³³

A case that exemplifies a debtor's rights against creditors who caused an involuntary petition to be filed in bad faith is *Sachs v. Weinstein*.¹³⁴ After the involuntary petition was dismissed upon a jury verdict in the bankruptcy court, the debtor instituted a state court action for malicious prosecution against his creditors who had been instrumental in having the bankruptcy petition filed against him. The debtor alleged, among other things, that the creditors assigned their claim to their lawyer's stenographer and conspired to have the involuntary petition filed in her name in the hope that the real creditors would be protected against liability for malicious prosecution. The debtor alleged that the involuntary petition was filed, among other reasons, "to extort from plaintiff payment of said debt of approximately \$650"¹³⁵ and that it was filed upon false allegations of insolvency and fabricated acts of bankruptcy. The debtor, who was a retailer, sought damages, including counsel fees, loss of customers due to the inability to supervise the business during the pendency of the involuntary petition, and injury to his reputation and credit among his customers and suppliers. Moreover, he also sought exemplary damages. The appellate court agreed with the trial court that the complaint was sufficient and should not be dismissed, and it expressly held that exemplary damages may be given in such a case.

The Bankruptcy Code gives the bankruptcy court jurisdiction to award the debtor a judgment against the unsuccessful petitioners who filed in bad faith for proximate and punitive

¹³² 11 U.S.C. § 303(i)(2).

¹³³ 11 U.S.C. § 303(i)(2)(B).

¹³⁴ 203 N.Y.S. 449 (1st Dept. 1924).

¹³⁵ *Id.* at 450.

damages.¹³⁶ Therefore, there is no need for the debtor to go to a different forum to recover against the malicious petitioners. However, the bankruptcy court may grant judgment against persons who conspired to cause the petition to be filed, but who were not the named petitioners. In such a situation, if the court abstains, then the debtor may have to resort to a different forum as was done in the *Sachs* case.

The Bankruptcy Code permits the debtor in an involuntary case to request that a bond be posted to indemnify the debtor for his potential claim against the petitioners in the event of dismissal. The court may require the petitioners to file such a bond, but only if cause is shown at a hearing upon notice to the interested parties.¹³⁷ Whenever the debtor plans to contest an involuntary petition, the protection of a bond should be requested.

If the court exercises its abstention powers to dismiss or suspend a bankruptcy petition in the best interest of the debtor and creditors in general, the debtor will not have a claim for damages.

¹³⁶ 11 U.S.C. § 303(i).

¹³⁷ 11 U.S.C. § 303(e).