HANDLING INVOLUNTARY BANKRUPTCIES: TOP TWENTY TIPS FOR PETITIONERS, JUDGES, ALLEGED DEBTORS, ASSIGNEES, SECURED CREDITORS AND TRUSTEES [i]

PART I – TEN TIPS FOR PETITIONERS

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Editor's Note: This is part one of a two part series. The second part, which will be published in the March/April 2003 issue of the Commercial Law Bulletin, will present ten more tips for judges, alleged debtors, assignees, secured creditors and trustees.

Introduction

Because involuntary cases are just a small percentage of bankruptcy cases as a whole, parties do not always realize that the administration of such cases differs in significant respects from the more familiar voluntary cases. The purpose of this article is to provide some pointers to those who occasionally practice in this area. This two-part series will present my top twenty tips for petitioners, judges, alleged debtors, assignees, secured creditors and trustees.

Tips for Petitioners

1. You May File An Involuntary Only Under Chapter 7 Or Chapter 11

Section 303(a) of the Bankruptcy Code only permits involuntary cases under either chapter 7 or chapter 11 of the Code. No involuntary chapter 9, chapter 12 or chapter 13 cases are authorized. Further, an involuntary cannot be commenced against a farmer, family farmer or not for profit entity.

If your goal is simply to liquidate the assets of the debtor, chapter 7 is the preferred choice. If, however, your goal includes the possible rehabilitation of the debtor, chapter 11 is a better choice, especially if there is a business involved.

Remember that chapter 7 is less costly than chapter 11. The filing fee is less and there is no exposure for payment of U.S. Trustee quarterly fees payable under 28 U.S.C. § 1930, which arguably could be levied against you by virtue of having commenced the case.

2. You May Request A Trustee Be Appointed Before The Order For Relief

The debtor can be ousted from possession of its assets before an order for relief is entered, even if the debtor has not answered the petition or is vigorously contesting it. In a chapter 7 case the standard for this remedy under § 303(g) of the Code is the need to preserve assets or prevent loss of estate property. In a chapter 11 case, the standards under § 1104(a) & (b) are fraud, dishonesty, incompetence, gross mismanagement, or, alternatively, the best interests of creditors, equity security holders and the estate. If you are considering requesting a trustee, then what evidence you have under the differing standards is a factor in determining which chapter to file.

In that regard also remember that your input in the selection of the trustee is different in chapter 7 than in chapter 11. In chapter 7 the trustee is typically appointed by the U.S. Trustee from the private panel of trustees.[ii] The petitioner has no right to participate in the selection and generally will not be asked to do so. (Of course, in the event relief is ordered, creditors may exercise their right to vote for a trustee at the meeting of creditors. But this may not occur until weeks or months later). In chapter 11, on the other hand, the U.S. Trustee has the statutory obligation to consult with parties in interest, including you, about the selection, and you can request an election if you are not satisfied with the person the U.S. Trustee appoints.

3. You May Request That Debtor's Power To Act Be Limited

Whether the case is one under chapter 7 or chapter 11, the appointment of a trustee before the order for relief is a drastic remedy and one that you may not be able to or even wish to pursue. Nevertheless, there are other available ways to restrict the debtor's conduct. Generally, the debtor is free to act, to obtain and dispose of property, as if the involuntary case had not been commenced. That power to act, however, is subject to the exceptions clause of § 303(f) that provides that the court may order otherwise. Thus, if you know or have reason to believe that the debtor is contemplating some action that may adversely affect your interests, you may request the court to prohibit the debtor from engaging in that conduct.

4. You May Cure A Defective Petition Through Joinder Of Additional Creditors

As a petitioning creditor you may file an involuntary case against the debtor unless the debtor has twelve or more creditors, in which case you need at least two other creditors to join in the petition. If the debtor's answer asserts that there are twelve or more creditors, then pursuant to Fed.R.Bank.P. 1003(b) you should request a reasonable time within which to join at least two other creditors. If the others join, it is as if they were creditors from the commencement of the case, and the otherwise defective petition is considered cured pursuant to § 303(c).

5. There Is A New Rule For Involuntary Partnership Cases

Fed.R.Bank.P. 1014 "Partnership Petition" is amended effective December 1, 2002. The amended rule, retitled "Involuntary Petition Against a Partnership," makes stylistic changes and deletes former section (a) that had implied that one or more general partners may not commence a voluntary partnership case absent the consent of all the general partners. The effect of the amendment will be to permit a voluntary filing, if the partnership agreement permits less than all of the partners to bind all partners. Therefore, where state law allows a bankruptcy filing, the rule will no longer preclude it. Note, however, that since the partnership agreement controls, failure to achieve the requisite vote under the agreement in favor of filing the case will still require those who want to file to do so by an involuntary petition to which the dissenters may object.

Based on the new rule, if you are a general partner contemplating becoming a petitioner in an involuntary case against your partnership, carefully examine your partnership agreement before you do so. That agreement may allow you to file the partnership as a voluntary case, thereby expediting the administration of the case and saving you from needless litigation.

6. You May Dismiss An Involuntary Case Only On Notice To All Creditors

Section 303(j) severely limits your ability to cause the involuntary, once commenced, to be dismissed. The case may be dismissed only after a hearing on notice to all creditors. This rule applies notwithstanding the debtor's consent to dismissal or where you have done nothing to prosecute the case. According to the legislative history "the purpose of the subsection is 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 participate in the case, are left without sufficient protection." House Report No. 95-595, 95th Cong., 1st Sess. 324 (1977); Senate Report No. 95-989, 95th Cong., 2d Sess. 35 (1978). Moreover, pursuant to Fed.R.Bank.P. 1017(d), notice to all creditors is necessary even if the court decides to dismiss the case under the abstention provision of § 305(a)(1).

Because it is frequently difficult, if not impossible, to obtain a list of creditors, this requirement is not always enforced. You, however, should not assume that the rule will not be enforced in your case. Furthermore, in the event you are able to reach a settlement with the debtor and do wish to dismiss the case, your notice to creditors should make explicit the terms of the settlement in order to avoid its being deemed "collusive" and, therefore, subject to objection by creditors and rejection by the court for that reason. Of course, you should also realize that a notice that fully discloses your favorable settlement is likely to invite objections by other creditors who do not stand to receive such treatment.

7. You Should File Proof Of Service

As a petitioning creditor you must serve the debtor with a copy of the petition and a summons. Fed.R.Bank.P. 1011(b) allows the debtor 20 days from service to answer or otherwise plead. That time is extended to 23 days if service is by mail, as it often is. *See* Fed.R.Bank.P. 9006(f). Section 303(h) requires the court to enter an order for relief if the petition is not timely controverted, but the court should not do so unless it has a basis to conclude that service has been properly effected. You can provide that basis by filing your proof of service with the court. Once the proof of service is on is file and the time to answer or otherwise plead has expired, you may be able to simply submit to the court a proposed order for relief with your proof of service. Inquire from the clerk if that will suffice or whether a motion to enter the order for relief is necessary.

8. You May Request The Court Designate A Person To File Lists And Schedules

Once the order for relief is entered the debtor has fifteen days to file the list of creditors, schedules and statement of affairs. Fed.R.Bank.P. 1007(a)(2) & (c). Oftentimes, the debtor does not willingly comply and the case languishes. Without at least the list of creditors, the meeting of creditors cannot be noticed and no trustee election held. In order to expedite the administration of the case, you can request the court to designate someone as the responsible person for filing the lists and schedules. *See* Fed.R.Bank.P. 9001(5). The designation can be done either in the order for relief or in a separate order. Once the designation is ordered, you can enforce compliance though the contempt procedure of Fed.R.Bank.P. 9020. Note that if you do

not take the lead in designating someone to do these tasks, you risk being named as the person to do it yourself pursuant to Fed.R.Bank.P. 1007(k).

9. You Should Notify The U.S. Trustee When An Order For Relief Is Entered

Once the order for relief is entered, a trustee needs to be appointed. The U.S. Trustee makes the appointment, not the court, so if the U.S. Trustee is not informed that an order for relief has been entered, the appointment will not be made, the case will languish and creditors' rights may be adversely affected. Although the court may advise the U.S. Trustee that an order for relief has been entered, do not assume that it will do so or do so as quickly as you would like. As a famous maker of sporting goods likes to say, "just do it!"

10. You Should Promptly Make A Request For Payment Of Administrative Expense

Section 503(b)(3)(A) provides that you may be allowed an administrative expense for filing an involuntary petition and § 503(b)(4) extends the allowance to cover your attorney's fees. You will need to file a request for payment of administrative expense, not a proof of claim, and obtain a court order allowing the expense. You should do this promptly, while the matter is fresh, even if there is no money to immediately pay the allowance. (If there is never going to be any money in the estate, you should be asking yourself why you filed the case in the first place).

Note that allowable expenses do not cover general participation in the case, but merely what was necessary to file and prosecute the petition to the order for relief. While some courts may construe these allowance provisions somewhat liberally, there really is no statutory basis to do so and an excessive request is likely to invite an objection by the U.S. Trustee.

In this regard also remember that a more generous allowance is possible under a "substantial contribution" theory, but the standard is more difficult to satisfy than merely the "actual and necessary" standard for administrative expenses. Furthermore, "substantial contribution" allowances under § 503(b)(3)(D) are only available in chapter 9 (where there are no involuntaries) or chapter 11, and not under chapter 7.

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[i] The views expressed in this article are those of the author and do not necessarily represent the views of, and should not be attributed to, the United States Department of Justice or the United States Trustee Program. Contact the author at Richard.C.Friedman@usdoj.gov.

[ii] Section 701(a)(1) of the Code requires that an interim trustee selected after the order for relief either be a disinterested person who is a member of the panel of private trustees established under 28 U.S.C. § 586(a)(1) or have been serving immediately before entry of the order for relief. A "gap" trustee, therefore, is not required to be a panel trustee.

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