CREDITOR RIGHTS: SHOULD CREDITORS FILE AN INVOLUNTARY BANKRUPTCY AGAINST A DEBTOR WHO IS IMPROPERLY DISPOSING OF ASSETS?

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Defaults are increasing, and creditors are looking for relief. Many are working closely with debtors to restructure deals and protect collateral. In some instances, however, creditors become aware that clients are attempting to liquidate assets and pay some creditors ahead of others. This is usually when you receive a call from your client. Typically, a creditor's first question is whether it should push the debtor into bankruptcy. Often, what the creditor is really asking is whether it should attempt to file an involuntary bankruptcy on behalf of the debtor. Of course, the creditor does not really want the debtor to be in bankruptcy. The creditor wants the debt to be paid. So is filing an involuntary bankruptcy the best option?

Although it may seem like a good solution, filing an involuntary bankruptcy is fraught with risk and may not be the best alternative. First, a creditor probably cannot file an involuntary bankruptcy by itself. Unless the debtor has fewer than twelve creditors, a minimum of three creditors are needed to file an involuntary bankruptcy petition. Bankruptcy Code, 11 U.S.C. § 303(b)(1)-(2) (2006). But these creditors cannot be any three creditors. The Bankruptcy Code requires that the debt owed to these creditors (1) cannot be contingent; (2) cannot be subject to a bona fide dispute as to liability or amount; and (3) if the debt is secured by liens, the aggregate amount owed must be at least $13,475 more than the value of any liens on the property. So a creditor usually needs help from other creditors to force a debtor into bankruptcy.

Second, if the debtor disputes the filing, the court will have a trial to determine whether the debtor should be in bankruptcy. The court will order bankruptcy relief if the debtor is generally not paying its debts as the debts become due, unless the debts are subject to a bona fide dispute as to liability or amount, or a custodian was appointed to take possession of the debtor's assets no more than 120 days before the bankruptcy filing. Of course, having a trial means incurring attorney fees. Although the court may allow the creditor's fees to be reimbursed, the creditor is forced to spend money now in hopes of recovering it later.

Third, if the creditor loses and the petition is dismissed, the creditor may be required to pay the debtor's attorney fees, costs, or even damages, including punitive damages. The Bankruptcy Code provides that if the court dismisses a petition other than with the consent of all petitioners and the debtor, the court can award costs or reasonable attorney fees against the petitioners. Furthermore, if the court finds that the petition was filed in bad faith, the court can award damages proximately caused by the filing, or it can award punitive damages. Also, after the creditor files the petition and after notice and a hearing, the court can order the creditor to post a bond to indemnify the debtor for costs, attorney fees, or damages. A number of attorneys have spent many sleepless nights worried about this issue.

Different situations call for different strategies. Single asset real estate entities may present an example in which an involuntary bankruptcy filing makes perfect sense. The debtor in that situation may even acquiesce in the filing. In other situations, however, utilizing state law remedies may be better.

The creditor may consider filing for a temporary restraining order and a temporary injunction. The stated purposes of a temporary restraining order and temporary injunction are to maintain the status quo until the court can hold a hearing or trial on the merits. The creditor would be filing for injunctive relief to immediately stop the debtor from liquidating assets. The creditor must (1) plead for some form of permanent relief; (2) prove a probable right to relief; and (3) prove a probable injury by showing imminent harm, irreparable injury, and no adequate remedy at law other than injunctive relief. All of this information must be verified.

If your client is requesting ex parte relief in Tarrant County, do not forget to comply with Local Rule 3.30, which addresses contacting opposing counsel. In fact, the first question the judge will probably ask you at the ex parte hearing is whether you have complied with this rule.

Even with injunctive relief, however, creditors can still win the battle but lose the war. For example, the court may grant injunctive relief, but set a bond at such a high amount that the creditor cannot post the bond. And finding a company that will issue a surety bond can be difficult.

Prejudgment writs are another state law alternative to consider. In fact, prejudgment writs often work well with injunctive relief. Prejudgment writs of attachment, sequestration, or garnishment can be useful. A prejudgment writ of attachment is appropriate to prevent a debtor from removing property, which could be used to repay the debt, from the jurisdiction. A prejudgment writ of sequestration is different from a writ of attachment in that sequestration requires that the creditor have an interest in the property to be sequestered. A prejudgment writ of garnishment is used to prevent property in the hands of a third party from being disposed of. Like requesting injunctive relief, all of these writs require affidavits and bonds. Once a writ is issued, the sheriff's office or the constable's office takes the property and places it in the court's custody until the matter is resolved. Improperly attaching, sequestering, or garnishing a debtor's assets, however, could drive a debtor out of business and result in extensive damages, so creditors should exercise caution.

With defaults on the rise and expected to continue rising, attorneys will be receiving more calls from creditors about enforcing their rights. Although involuntary bankruptcies are often what creditors request, other options may be better. Knowing the risks and rewards of various remedies will help you better counsel your clients.