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WHY CREDITORS FILE SO FEW INVOLUNTARY PETITIONS AND WHY THE NUMBER IS NOT TOO SMALL

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With its enactment of the Bankruptcy Reform Act of 1978[1] Congress abolished the "acts of bankruptcy"[2] as the standard for commencement of involuntary bankruptcy cases, and replaced it with the "general failure to pay" test.[3] It adopted the "general failure to pay" standard at the suggestion of the Commission on Bankruptcy Laws,[4] in part, because it was viewed as an easier standard for creditors to prove. By liberalizing the standard, Congress hoped to encourage creditors to file involuntary petitions against a debtor before the situation becomes "hopeless" and "the assets are largely depleted."[5] Despite this change in the

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[1] Pub. L. No. 95-598, 1978 U.S.C.C.A.N. (92 Stat. 2549) 5787 (codified at 11 U.S.C. §§ 101-1329 (1988)). The Bankruptcy Reform Act of 1978, as amended, is commonly referred to as the "Code," or the "Bankruptcy Code," and I have adopted these references here.

[2] *See* Bankruptcy Act of 1898, ch. 541, § 3a, 30 Stat. 544, 546 (codified at 11 U.S.C. § 21(a) (amended 1938) (repealed 1978)). In contrast to the common reference to the Bankruptcy Reform Act of 1978, as amended, as the "Code," the former Bankruptcy Act of 1898, as amended, is commonly referred to as the "Act" or the "Bankruptcy Act" or the "former Act," and I have followed this common usage.

[3] *See* Bankruptcy Code, 11 U.S.C. § 303(h)(1). The "general failure to pay" standard is not the only standard for commencement of an involuntary bankruptcy case under the Code, however. *See* 11 U.S.C. § 303(h)(2) (permitting commencement of case upon appointment of custodian of, or custodian's possession of, a substantial portion of debtor's assets).

[4] The Commission on the Bankruptcy Laws of the United States was established by Pub. L. No. 91-354, 84 Stat. 468 (1970). For a description of the Commission and its work, see REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, 93d Cong., 1st Sess., pt. I, at v-xix (1973), *reprinted in* LAWRENCE P. KING ET AL., COLLIER ON BANKRUPTCY App. vol. 2 (15th ed. 1979) [hereinafter "COMMISSION REPORT"].

[5] COMMISSION REPORT, *supra* note 4, at 14.

applicable standard for commencement of an involuntary case, the vast majority of bankruptcy petitions are, as they historically have been, brought voluntarily by debtors rather than involuntarily by creditors.[6]

Of course, these statistics do not present a clear picture of the extent to which debtors are coerced into bankruptcy. The line between voluntary and involuntary filings is an ambiguous one because debtors often file voluntary petitions in reaction to creditors' collection efforts.[7] A voluntary filing triggers the automatic stay and stops creditors from coercing repayment on delinquent debts.[8] Eligibility for voluntary filing is a snap to establish,[9] and there are tactical advantages to controlling the time and place of the filing. By filing a voluntary petition, the debtor can control the venue of the case and most of the proceedings litigated with the case.[10] The debtor can time the filing either to preserve or lose the ability to avoid pre-petition preferential and other transfers, depending upon whether the debtor wants to insulate a particular transferee from avoidance liability.[11] It can time the filing either to preserve or lose employees' limited priority for wages relating to services rendered within the statutorily prescribed pre-petition period, for example, by filing after

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[6] Statistics show that during the 10-year period since the enactment of the Bankruptcy Code, the ratio of involuntary petitions to the total number of petitions has actually decreased by several times. *See* ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, BANKRUPTCY STATISTICAL TABLES TWELVE MONTH PERIODS ENDED JUNE 30 (1970-88). This ratio may be misleading. Between 1978 and 1988, the number of involuntary bankruptcies filed per year has averaged nearly 300 more filings than the period from 1970 to 1978, however, during that same time span, the average number of all bankruptcies filed per year has increased by over 180,000 as compared to the period before the 1978 Code. The impact of the legislative changes to the standard for commencement of involuntary cases is most evident in involuntary reorganization cases. The average number of involuntary reorganization petitions filed since 1978 is more than 14 times the average number for the preceding period and is effectively responsible for the increase in the total number of involuntary filings. See Appendix A to this article.

[7] *See, e.g.*, TERESA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS 21-23 (1989).

[8] *See* 11 U.S.C. § 362(a).

[9] *Id.* § 109.

[10] 28 U.S.C. § 1408 (1988). *See* Douglas G. Baird, *Loss Distribution, Forum Shopping and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 818 (1987) (complaining that pursuit of the Code's distributional advantages causes debtors to engage in this "troublesome forum shopping"); Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 353-54 (arguing that geographic concerns explain much about why creditors appear to prefer their nonbankruptcy collection remedies).

[11] *See* 11 U.S.C. §§ 544-553.

payday.[12] It can time its filing to maximize the amount of unencumbered cash or accounts receivable, or otherwise to put itself in a favorable position to negotiate with a post-petition lender.[13]

Yet despite the creditor's ability to deprive the debtor of these procedural advantages by striking first, a surprisingly small number of involuntary petitions are filed each year.[14] This article attempts to explain why creditors have not taken up Congress's invitation to file more involuntary petitions against their debtors, and suggests some possible reforms.

Part I sets the groundwork for this task by contrasting the current standard for commencement of an involuntary bankruptcy case with its predecessor under the former Bankruptcy Act of 1898.[15] It explains why Congress decided to open up the standard for commencement of an involuntary case so drastically in 1978 and notes that, in doing so, it sought to accommodate competing interests. On the one hand, Congress was aware that creditors found the "acts of bankruptcy" too difficult to prove, and adopted the current "general failure to pay" standard in an effort to ease these problems of proof. In making the standard easier for creditors to prove, Congress intended both to streamline hearings on contested petitions and also to encourage creditors to file involuntary petitions at an earlier stage in a debtor's financial troubles, before value is lost. On the other hand, Congress also was aware that debtors and their creditors may be able to resolve their financial troubles more quickly and inexpensively outside of the bankruptcy court. It sought to avoid interference with these efforts by limiting the negotiating leverage this liberal standard might provide to creditors and by encouraging the use of state collective remedies.[16]

Part II explains the consistently small number of involuntary filings as the inevitable result of these competing interests. Creditors file few involuntary petitions because they often prefer

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[12] *See id.* § 507(a)(3), (4).

[13] *See id.* §§ 363, 364.

[14] For example, of the 594,567 petitions filed during the fiscal year ending June 30, 1988, only 1,409 were involuntary petitions. BANKRUPTCY STATISTICAL TABLES, (1988), *supra* note 6.

[15] Ch. 541, 30 Stat. 544 (1898) (repealed 1978).

[16] "State collective remedies" are state laws that provide creditors with a collective means for the repayment of obligations that are pursued by a debtor's creditors as a group. State collective remedies include an assignment for the benefit of creditors and equitable receivership.

a negotiated resolution of a debtor's financial troubles. This preference for nonbankruptcy solutions is strongest in the case of an individual debtor[17] but also exists in the case of debtors that are corporations[18] and partnerships.[19] Congress was aware of these preferences, sought to accommodate them, and has been successful in its efforts to prevent creditors' use of bankruptcy to disrupt consensus. Of course, the more that creditors rely on nonbankruptcy solutions to their debtors' financial troubles, the fewer creditors' petitions they will file.

To a limited degree, creditors also do not file involuntary petitions because of difficulties in proving the standard for commencement of an involuntary case. Congress did not entirely resolve creditors' evidentiary troubles with its repeal of the "acts of bankruptcy," since the current standard presents its own obstacles, some of which were created with a 1984 amendment to the standard.[20] The more difficult it is for creditors to establish the standard for commencement of an involuntary bankruptcy case, the fewer petitions creditors will file. Congress sought to make this standard provable with reference to publicly available data, not simply for improvement's sake, but also because it reasoned that creditors' distributions from bankruptcy estates would increase if creditors' petitions were filed sooner, and creditors' petitions would be filed sooner if the standard were simpler to establish. But in inviting creditors to file involuntary petitions more often, or at least earlier on, Congress forgot what it already knew: that creditors' reluctance to file involuntary petitions is explained, not only by their problems of proof, but also by their preference for a negotiated resolution of a debtor's financial difficulties. Changing the standard did not alter creditors' preference for nonbankruptcy solutions, it just made things easier for those creditors who had decided that bankruptcy made sense for them.

Part III proposes reforms to the standard for commence-

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[17] The Code does not explicitly define the term "individual" but consistently uses the term to mean a natural person or human being. *See* 11 U.S.C. § 101(35) ("person" defined to "include[] individual, partnership, and corporation").

[18] *Id.* § 101(8) (definition of "corporation").

[19] Although the Code does not expressly define the term "partnership," it incorporates the state law definitions and concepts. *See, e.g.*, UNIF. PARTNERSHIP ACT § 6(1), 6 U.L.A. 22 (1969 & Supp. 1991).

[20] *See* text accompanying notes 230-34 *infra*.

ment of an involuntary bankruptcy case. These changes would make the standard provable with evidence readily available to creditors. Because the Code adequately accommodates creditors' strong interests in noncoercive collection efforts, these proposals should not have an enormous impact on the frequency of involuntary bankruptcy petitions. Although involuntary bankruptcy can be made a more effective creditors' remedy, it probably cannot be made the remedy to which creditors first turn.

I. CHANGES TO THE STANDARDS FOR COMMENCEMENT OF AN INVOLUNTARY BANKRUPTCY CASE: CONGRESS'S MIXED MESSAGES

Under the former Bankruptcy Act of 1898,[21] as amended in 1938,[22] three petitioning creditors[23] whose provable claims,[24]

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[21] For a history of involuntary bankruptcy under the various Bankruptcy Acts enacted and repealed prior to 1898, see, e.g., CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY (1935); John C. McCoid, *Occasion for Bankruptcy*, 61 AM. BANKR. L.J. 195, 196-212 (1987).

[22] While there were numerous amendments made to the Bankruptcy Act, the most important and far-reaching amendments were made by the Act of June 22, 1938, ch. 575, 52 Stat. 840 (1938), commonly known as the Chandler Act. For a complete description of this legislative history, see 1 LAWRENCE P. KING ET AL., COLLIER ON BANKRUPTCY ¶¶ 0.00-0.10, at 2-28.1 (14th ed. 1974).

[23] If the debtor had fewer than 12 creditors, then an involuntary petition could have been commenced under the Act by a single creditor holding a provable claim of $500 or more. Act § 59b (codified at 11 U.S.C. § 95(b) (repealed 1978)). See note 24 *infra* for the discussion of the term "provable claim" under the Act. Complex rules governed the computation of the number of a debtor's creditors for purposes of determining whether three creditors were required to join in the petition. *See* Act § 59e (codified at 11 U.S.C. § 99(e) (repealed 1978)). For example, fully secured creditors, employees and relatives of the "bankrupt" were excluded from the count of creditors. *See* 2 LAWRENCE P. KING ET AL., COLLIER ON BANKRUPTCY ¶ 303.06, at 303-14 (15th ed. 1989). In addition, courts may have excluded de minimis claims from the count of a debtor's creditors. *Compare* Denham v. Shellman Grain Elevator, Inc., 444 F.2d 1376 (5th Cir. 1971) (de minimis claims excluded) *with* Hornblower & Weeks-Hemphill, Noyes v. Okamoto (*In re* Okamoto), 491 F.2d 496 (9th Cir. 1974) (de minimis claims included). Excluded creditors did not necessarily lack standing to join in an involuntary petition, however. *See* 2 COLLIER ON BANKRUPTCY, *supra*, ¶ 303.06, at 303-14.

[24] Act § 63a (codified at 11 U.S.C. § 103(a) (repealed 1978)) (defining "provable claim"). For a general discussion of the concept of a "provable claim," see, e.g., JAMES A. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY § 40, at 33, §§ 139-149, at 124-44 (1956) ("There [were] nine separate classes of provable claims listed in the statute, but the general effect is that tort claims, except those reduced to judgment, and except those for negligence in litigation at the filing of the bankruptcy petition, are excluded, but other claims are usually provable."). The term "provable claim" has no continuing relevance under the current Bankruptcy Code.

fixed as to liability and liquidated as to amount, aggregated $500 or more in excess of the value of liens held by them,[25] could file an involuntary petition against an eligible[26] debtor.[27] If the debtor contested the filing, petitioning creditors were required to show that the debtor had committed an "act of bankruptcy"[28] within four months prior to the filing of the petition[29] before the debtor would be adjudicated a bankrupt and a Chapter VII liquidation case[30] would be commenced.[31] An involuntary reorgani-

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[25] Thus, the Act permitted secured creditors to join in an involuntary petition. However, because the $500 threshold referred only to unencumbered claims, fully secured creditors were less likely than unsecured or undersecured creditors to have joined in an involuntary petition. Secured creditors also did not face the same incentives to commence an involuntary case since permitted the remedy of self-help repossession and commercially reasonable sale of collateral. *See* U.C.C. § 9-504 (1988).

[26] Certain types of debtors were not amenable to involuntary liquidation or reorganization under the Act: farmers, wage earners, unincorporated companies, and corporations that were not moneyed. Act § 4b (codified at 11 U.S.C. § 22 (repealed 1978)). The term "wage earner" was defined as an individual earning wages or salary not exceeding $1,500 per year. Act § 1(32) (codified at 11 U.S.C. § 1(32)) (repealed 1978). Otherwise, any person who was eligible for voluntary relief under the Chapter under which the petition had been filed could be forced into a similar proceeding by the filing of an involuntary petition. Thus a building and loan association, municipal railroad, insurance company or bank were not amenable to an involuntary filing because ineligible for voluntary relief. *See* MACLACHLAN, *supra* note 24, § 36, at 27-28. Short of these narrow exclusions, however, all persons were eligible to file a voluntary petition under the Act and adjudication of the debtor as a bankrupt generally followed as a matter of course. *See id.* § 49, at 39-40.

[27] The Act generally referred to a "debtor" as a "bankrupt," but this terminology was removed with Congress's enactment of the current Bankruptcy Code in an effort to diminish the stigma associated with bankruptcy.

[28] *See* Act § 3a (codified at 11 U.S.C. § 21(a)) (repealed 1978). *See* text accompanying notes 37-42 *infra*.

[29] The Act imposed complex tests to determine when each of the various acts of bankruptcy had occurred: the third act (failure to vacate lien by legal proceedings of distraint) was said to occur on the date the lien was obtained; the first and fourth acts (concealment or fraudulent transfer of property, and general assignment for benefit of creditors) occurred when the transfer or assignment was perfected against bona fide purchasers; and the second act (preferential transfer) occurred when the transfer was perfected in accordance with the tests set forth in the preference provision. Act § 3b (codified at 11 U.S.C. § 21(b)) (repealed 1978). *See* 1 COLLIER ON BANKRUPTCY, *supra* note 22, ¶¶ 3.701-.707, at 522-32; MACLACHLAN, *supra* note 24, § 61, at 51-54.

[30] Under the Bankruptcy Act liquidation cases were governed by Chapters I to VII of the Act. A liquidation case under Chapter VII of the Act should be distinguished from a reorganization case commenced under Chapters X, XI, XII or XIII of the Act.

[31] The filing of an involuntary petition was distinct from the adjudication of the debtor as a bankrupt. *See* MACLACHLAN, *supra* note 24, § 49, at 39-40. The petition merely created the potential for the commencement of a case; an order adjudicating a debtor as a bankrupt actually commenced the bankruptcy proceeding, and the entry of this order generally did not occur until after a hearing on the contested involuntary peti-

zation case could also be commenced under Chapter X (but no other reorganization chapter) of the Act[32] against a corporate debtor that was insolvent or unable to pay its debts as they matured, but only if petitioning creditors established that (i) the debtor had committed an "act of bankruptcy,"[33] (ii) a receiver or trustee, or indenture trustee or mortgagee under a mortgage, had taken possession of the greater portion of the debtor's property,[34] (iii) a proceeding to foreclose a lien against the greater portion of the property of the debtor had been brought,[35] or (iv) the debtor had been adjudged a bankrupt in a case pending under another Chapter of the Act.[36]

The 1898 Act identified six different "acts of bankruptcy":

(a) fraudulent transfers under Section 67 or 70 of the Act (concerning avoidance of certain statutory liens and other fraudulent transfers);[37]

(b) preferential transfers under Section 60a of the Act;[38]

(c) the failure to vacate a judicial lien in a timely manner, within the later of 30 days after imposition of the lien or 5 days before a scheduled judicial sale, if the debtor was insolvent during this period;[39]

(d) making a state law assignment for the benefit of creditors;[40]

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tion. Technically, the filing of a voluntary petition under the Act also was distinct from the adjudication of the debtor as a bankrupt. A court's adjudication of a voluntary debtor as a bankrupt was a mere formality, however, for there were far fewer grounds on which a voluntary petition could have been contested. The present Bankruptcy Code no longer refers to debtors as "bankrupts." *See* note 27 *supra*. It, thus, also does not adjudicate a debtor as a "bankrupt." Instead, the Code distinguishes between the filing of a petition and the entry of an order for relief. *See* 11 U.S.C. § 301.

[32] Chapter X provided limited reorganization relief under the Bankruptcy Act. *See, e.g.*, MACLACHLAN, *supra* note 24, § 310, at 372.

[33] *See* Act § 131(5) (codified at 11 U.S.C. § 531(5) (repealed 1978)). *See also id.* § 3a (codified at 11 U.S.C. § 21(a) (repealed 1978)) (acts of bankruptcy defined).

[34] *See id.* § 131(2), (3) (codified at 11 U.S.C. § 531(2), (3) (repealed 1978)).

[35] *See id.* § 131(4) (codified at 11 U.S.C. § 531(4) (repealed 1978)).

[36] *See id.* § 131(1) (codified at 11 U.S.C. § 531(1) (repealed 1978)).

[37] For a general discussion of the elements of Act §§ 67 & 70, see, e.g., 4B COLLIER ON BANKRUPTCY, *supra* note 22, ¶¶ 67, 70; MACLACHLAN, *supra* note 24, §§ 221-246, 282-287. For a discussion of case law interpreting the first "act of bankruptcy," see 1 COLLIER ON BANKRUPTCY, *supra* note 22, ¶¶ 3.101-.109.

[38] For a general discussion of the elements of Act § 60a, see 3 COLLIER ON BANKRUPTCY, Pt. 2, *supra* note 22, ¶¶ 60.07-.35; MACLACHLAN, *supra* note 24, §§ 247-277. For a discussion of case law interpreting the second "act of bankruptcy," see 1 COLLIER ON BANKRUPTCY, *supra* note 22, ¶¶ 3.201-.208.

[39] For a general discussion of the state law remedies of attachment, garnishment, execution and levy, see STEFAN A. RIESENFELD, CASES AND MATERIALS ON CREDITORS' REMEDIES AND DEBTORS' PROTECTION chs. 1-3 (4th ed. 1987).

[40] For a general discussion of the state law collective insolvency remedy of assign-

(e) the appointment under state law of a receiver of property when the debtor was insolvent or unable to pay its debts;[41] and

(f) the admission in writing of an inability to pay debts and a willingness to be adjudicated bankrupt.[42]

Although it was widely assumed by practitioners, courts and commentators alike that only an insolvent[43] debtor could be thrust into bankruptcy involuntarily,[44] the debtor's solvency was a defense only to an involuntary petition grounded on the first act of bankruptcy (concealment or fraudulent transfer).[45] This

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ment for the benefit of creditors, see DOUGLAS J. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS AND MATERIALS ON BANKRUPTCY 1289-1301 (1990); LAWRENCE P. KING & MICHAEL L. COOK, CREDITORS' RIGHTS, DEBTORS' PROTECTIONS AND BANKRUPTCY 580-91 (2d ed. 1989); RIESENFELD, *supra* note 39, at 430-41; Robert A. Greenfield, *Alternatives to Bankruptcy for the Business Debtor*, 51 L.A. B.J. 135 (1975).

[41] For a general discussion of the state law collective insolvency remedy of receivership, see, e.g., KING & COOK, *supra* note 40, at 599-604; RIESENFELD, *supra* note 39, at 443-54.

[42] MacLachlan criticized this sixth "act of bankruptcy" as "so close to voluntary bankruptcy as to be of minor importance" because it required proof not only of the debtor's written admission of its inability to pay debts, but also of its willingness to be adjudicated a bankrupt. MACLACHLAN, *supra* note 24, § 58, at 49. *See also* 1 COLLIER ON BANKRUPTCY, *supra* note 22, ¶¶ 3.601-.609, at 509-22. Despite this criticism, MacLachlan advocated the retention of this sixth "act of bankruptcy." MACLACHLAN, *supra* note 24, §67, at 58.

[43] "Insolvency" was defined under the Bankruptcy Act by providing that "a person shall be deemed insolvent within the provisions of this Act whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, or removed, or permitted to be concealed, removed, with intent to defraud, hinder, or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts." Act § 1(19) (codified at 11 U.S.C. § 1(19) (repealed 1978)).

[44] *Compare* H.R. REP. No. 595, 95th Cong., 1st Sess. 323 (1977), *reprinted in* 1978 U.S.C.C.A.N., 5963, 6279-80 (mistakenly stating that the Act "requir[ed] [proof of] balance sheet insolvency *and* an act of bankruptcy") (emphasis added) *with* S. REP. No. 989, 95th Cong., 2d Sess. 34 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5820 (correctly stating that: "Proof of the commission of an act of bankruptcy has frequently required a showing that the debtor was insolvent on a 'balance-sheet' test when the act was committed.") *See also* MACLACHLAN, *supra* note 24, § 15, at 11-12 (noting that this assumption was generally correct as a practical matter).

[45] Prior to its amendment in 1938, Act § 3c provided that: "It shall be a complete defense to any proceedings in bankruptcy instituted *under the first subdivision of this section* to allege and prove that the party proceeded against was not insolvent as defined in this Act at the time of the filing of the petition against him . . . ." (emphasis added). In West Co. v. Lea, 174 U.S. 590 (1899), the Supreme Court interpreted the underscored phrase as permitting a bankrupt to raise its solvency as a defense to an involuntary petition only when the petition had alleged the first "act of bankruptcy." In 1938 Congress codified this ruling by substituting "under the first act of bankruptcy" for the ambiguous underscored phrase. Act of June 22, 1938, ch. 575, §3, 52 Stat. 840, 845. *See* 1 COLLIER ON BANKRUPTCY, *supra* note 22, § 3.109[1], at 430 n.2; Israel Treiman, *Acts of*

misconception arose because, although petitioning creditors were required to prove, as a prerequisite to bringing a bankruptcy case against the debtor's wishes, that the debtor had committed an act of bankruptcy rather than that the debtor was insolvent, many of the acts of bankruptcy implicitly required a showing of the debtor's insolvency as an element of their proof. Thus, if petitioning creditors relied on the first act of bankruptcy and alleged the debtor's commission of a constructive (rather than actual) fraudulent transfer,[46] they may have been required to prove the debtor's insolvency at the time of the alleged fraudulent transfer. Creditors were also required to prove insolvency as an element of the second and fifth acts of bankruptcy (preferential transfer[47] and appointment of receiver[48]). As a practical matter then, proof of an act of bankruptcy often required proof of the debtor's insolvency.

There were several problems of proof associated with establishing a debtor's insolvency as that term was defined under the Act. First, petitioning creditors found that a debtor's "insolvency" was difficult to establish because it "describe[d] a purely *internal* condition, the existence of which [could] be legally ascertained only through a comprehensive examination of the debtor's entire financial condition."[49] In addition, the Act's definition of the term was vague.[50] While clearly the term required a comparison of the debtor's assets and liabilities to determine whether the asset side of this balance sheet was less valuable than the liability side, the definition did not specify how this was to be done. It provided only that a debtor's assets should be

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Bankruptcy: A Medieval Concept in Modern Bankruptcy Law, 52 HARV. L. REV. 189, 197-210 (1938).

[46] *See* Act § 67d (codified at 11 U.S.C. § 107(d) (repealed 1978)) (insolvency among possible elements of constructive fraudulent transfer).

[47] *Compare* Act § 60 (codified at 11 U.S.C. § 96 (repealed 1978)) (requiring proof that transferee had reasonable cause to know of debtor's insolvency) *with* Code, 11 U.S.C. § 547(f) (debtor rebuttably presumed insolvent within 90 days preceding filing of petition for purposes of preference provision).

[48] After a 1938 amendment to the fifth "act of bankruptcy," however, petitioning creditors could have commenced an involuntary case against a debtor whose property was in the possession of a receiver when the debtor was either insolvent or in general default. Ch. 575, § 3, 52 Stat. 840, 844-45 (1938). *See* 1 COLLIER ON BANKRUPTCY, *supra* note 22, § 3.505[1], at 504.

[49] Treiman, *supra* note 45, at 211.

[50] *See* Act § 1(19) (codified at 11 U.S.C. § 1(19) (repealed 1978)).

measured "at a fair valuation."[51] Thus, attempts to determine a "fair valuation" of a debtor's assets involved resolution of theoretical questions surrounding the conditions of the liquidation; differences in the assumptions about the circumstances of the hypothetical liquidation substantially altered the appraiser's conclusions about the value of the debtor's assets. And "no adequate theories of valuation ha[d] been developed or applied."[52] The Act's definition of insolvency also was ambiguous in that it appeared to invite courts to assign a theoretical value to the debtor's assets rather than to ascertain the assets' actual liquidation value.[53] Nor did the Act unambiguously define what property was to be included in calculating the value of the "aggregate of the debtor's property."[54] Finally, the Act required the

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[51] *Id.*

[52] *See* MACLACHLAN, *supra* note 24, § 15, at 12. *See also* JAMES C. BONBRIGHT, VALUATION OF PROPERTY (1937) (generally describing difference between liquidation and going-concern valuation of debtor's assets); Chaim J. Fortgang & Thomas M. Mayer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061, 1063-94 (1985) (same).

[53] *See* MACLACHLAN, *supra* note 24, § 16, at 13; James C. Bonbright & Charles Pickett, *Valuation to Determine Solvency Under the Bankruptcy Act*, 29 COLUM. L. REV. 582, 594-603 (1929) (generally describing difference between liquidation value and going-concern value, and lamenting that courts interpreted Act definition of insolvency to require determination of "intrinsic" or "real" valuation of debtor's property "which is neither its liquidation value or its value to the going business"). In this regard the Act's definition of insolvency differed from that of the Uniform Fraudulent Conveyance Act (UFCA). *See* UFCA § 2(1), 7A U.L.A. 442 (1985) ("A person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."). *See also* MACLACHLAN, *supra* note 24, § 16, at 13 (distinguishing definition of insolvency under former Act with that under UFCA). MacLachlan noted that the bankruptcy definition:

> [D]emands a fair valuation of the debtor's assets (as distinguished from fair *saleable* valuation) thus inviting a theoretical consideration of what the assets ought to bring, quite apart from what they will bring. The reference in the Uniform Act to fair saleable value, instead of simply to fair value or to saleable value, suggests a consideration of what the assets might actually bring, under normal conditions and times.

Id.

[54] Act § 1(19) (codified at 11 U.S.C. § 1(19) (repealed 1978)) (excluding from asset side of balance sheet only assets transferred to debtor with actual fraudulent intent). *See* Bonbright & Pickett, *supra* note 53, at 589-93, 606-18 (noting that, perhaps because the statute only expressly excluded property that had been conveyed by debtor prior to bankruptcy with intent to defraud creditors, many courts included exempt assets in calculation of balance sheet insolvency under the Act, and were undecided on inclusion of good will and similar intangible assets). *But see* UFCA § 1, 7A U.L.A. 430 (1985) (definition of "assets" excludes fraudulently transferred and exempt property). *See also* Code, 11 U.S.C. § 101(31) (definition of insolvency excludes fraudulently transferred and ex-

court to determine whether this theoretical value of assets was insufficient in amount to pay the debtor's obligations, and thus to assign values to the debtor's contingent and unliquidated liabilities.[55]

Because of these ambiguities, trials on contested involuntary petitions often dragged on for long periods of time at considerable expense to petitioning creditors and others. Not only was insolvency extremely difficult to prove, but the determinations as to whether the debtor had committed an act of bankruptcy and whether it was insolvent were questions of fact on which the debtor was entitled to a jury trial.[56] As a result of this lengthy gap between the filing of the involuntary petition and either the adjudication of the debtor as a bankrupt or the dismissal of the petition, a business debtor and its creditors stood to suffer substantial disruption to the business, as well as a diminution to the value of the estate that often occurred during the period after the filing of the petition and before the conclusion of the trial contesting the filing.[57]

The legal community nearly uniformly criticized the "acts

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empt assets); Uniform Fraudulent Transfer Act (UFTA) § 1(2), 7A U.L.A. 644 (1985) (definition of "assets" excludes exempt, encumbered and certain entireties property).

[55] According to MacLachlan: "This means that a debtor who has slow assets which cannot be liquidated at a theoretically fair valuation may be immune from involuntary bankruptcy until his situation deteriorates greatly." MACLACHLAN, *supra* note 24, § 15, at 12. For this reason, MacLachlan preferred the UFCA definition of insolvency because it "seems to involve some of the elements of bankruptcy insolvency and some of the elements of ordinary or equity insolvency" in that it asks whether the present fair saleable value of the debtor's assets is "less than the amount that will be required to pay his probable liability on his existing debts *as they become absolute and matured.*" *Id.* § 16, at 13 (emphasis added).

[56] *See* Act § 19a (codified at 11 U.S.C. § 42(a) (repealed 1978)) (providing bankrupt with absolute right, upon timely demand, to trial by jury on questions of (i) insolvency and (ii) occurrence of alleged "act of bankruptcy").

[57] Under the Act, creditors who transferred property to the debtor after an involuntary petition had been filed and before the debtor's adjudication as a bankrupt were provided only limited protection. Creditors who were aware of the petition were protected only if they could prove that they had reasonable cause to believe that the petition was ill-founded. Act § 70d(3) (codified at 11 U.S.C. § 110(d)(3) (repealed 1978)). *See* 4B COLLIER ON BANKRUPTCY, *supra* note 22, ¶ 70.68, at 743-62; COMMISSION REPORT, *supra* note 4, pt. I, at 190. Furthermore, this limited protection existed under the Act only after amendments made in 1938 with enactment of the Chandler Act. *Id. See* note 22 *supra*. Debtors also may have been entitled to some remedy for the improper filing of an involuntary petition under the Act. *See* Act § 69b (codified at 11 U.S.C. § 109(b) (repealed 1978)); FED. R. BANKR. P. 115(e), 411 U.S. 1003 (1973). *See also* 4 COLLIER ON BANKRUPTCY, *supra* note 22, ¶ 69.05; COMMISSION REPORT, *supra* note 4, pt. II, at 80.

of bankruptcy"[58] as an anachronism[59] that impeded the smooth workings of the modern credit economy[60] either by delaying resolution of a contested involuntary petition[61] or by deterring creditors from bringing an involuntary case.[62] Several eminent bankruptcy scholars called for reform in this area, proposing that the standard for commencement of an involuntary case be liberalized to encourage creditor filings.[63] While diverse in their

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[58] *Compare* James W. Moore & Philip W. Tone, *Proposed Bankruptcy Amendments: Improvements or Retrogression?*, 57 YALE L.J. 683, 708-10 (1948) *with, e.g.*, 1 COLLIER ON BANKRUPTCY, *supra* note 22, ¶ 1.19[1], at 98-103; MACLACHLAN, *supra* note 24, §§ 52, 65; Asa S. Herzog, *Bankruptcy Tomorrow*, 45 AM. BANKR. L.J. 57, 59-60 (1971); Reuben G. Hunt, *National Bankruptcy Legislation — Past, Present and Future*, 8 J.N.A. REF. BANKR. 13, 20 (1933); A.B. Kreft, *What Is the "Subject of Bankruptcies"?*, 6 TEMP. L.Q. 141 (1932); Treiman, *supra* note 45; Israel Treiman, *Escaping Creditors in the Middle Ages*, 48 LAW Q. REV. 230 (1927); Weinstein et al. *Suggestions for Revision of Bankruptcy Act and Comments Thereon*, 8 AM. BANKR. REV. 388, 394-95 (1932); Note, *"Acts of Bankruptcy" in Perspective*, 67 HARV. L. REV. 500 (1954). *See also* REPORT OF THE STUDY COMMITTEE ON BANKRUPTCY AND INSOLVENCY LEGISLATION IN CANADA § 3.2.019, at 106-07 (1970) (recommending, under Canadian bankruptcy law, abandonment of concept of acts of bankruptcy) [hereafter "CANADA STUDY COMMITTEE REPORT"]. For criticism leveled at the specifics of the statutory language, see James A. MacLachlan, *Aspects of the Chandler Bill to Amend the Bankruptcy Act*, 4 U. CHI. L. REV. 369, 373 (1937). For a historical discussion of criticism of the "acts of bankruptcy," see McCoid, *supra* note 21, at 210-12.

[59] Treiman traced the origins of "acts of bankruptcy" as the standard for commencement of an involuntary case and the conceptual change of this standard over time. *See* Treiman, *supra* note 45, at 192-210, and Treiman, *supra* note 58, at 230-37.

[60] The Commission on the Bankruptcy Laws of the United States used the term "open credit economy" to refer "to the role of private credit generally in the economy of the country." COMMISSION REPORT, *supra* note 4, pt. I, at 68. It contended that an important goal of the federal bankruptcy laws is to support the "open credit economy" and that it did so in part by "improving the administration of creditors' rights laws." *Id.*

See also, e.g., MACLACHLAN, *supra* note 24, § 14, at 10 ("Next to a sound currency, the sine qua non for business confidence, the framers of the United States Constitution recognized the need for the establishment of sound conditions for the extension of private credit. To this end the provision which made bankruptcy a federal matter was included in the Constitution [*e.g.*, the Bankruptcy Clause]."); Kreft, *supra* note 58, at 145 ("[T]he main purpose of bankruptcy legislation is the protection of credit, between the time the debtor is insolvent, or has committed an act of bankruptcy and the time he makes an adjustment with his creditors, or comes into court."); LoPucki, *supra* note 10, at 315 ("The state remedies/bankruptcy system exists to facilitate the lending of money.").

[61] *See, e.g.*, MACLACHLAN, *supra* note 24, § 65; Treiman, *supra* note 45, at 211-15.

[62] *See* Treiman, *supra* note 45, at 211-12 (implicitly arguing that creditors are more likely to have access to information of debtor's failure to pay current debts, than of debtor's balance sheet insolvency).

[63] For example, MacLachlan proposed that the debtor's inability to pay debts as they mature "be the ultimate controlling fact" in determining the propriety of an involuntary petition, but also that the fourth and sixth acts of bankruptcy be retained. He

specifics, these scholars generally suggested that American bankruptcy law should be brought in line with the laws of the Commonwealth and civil law countries.[64] They proposed that a standard permitting the institution of an involuntary case when a debtor was unable to pay its current obligations be substituted for the "acts of bankruptcy."[65] Others more broadly proposed improvements to the definition of the term "insolvent."[66]

In 1973 the Commission on Bankruptcy Laws recommended in its report to Congress that the area of involuntary bankruptcy be reformed so that "[t]he concept of 'an act of bankruptcy' be abolished and the debtor be made amenable to involuntary pro-

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also proposed that the third and fifth acts of bankruptcy, as well as absconding or a general stoppage of payments by the debtor, should constitute prima facie evidence of the debtor's inability to pay debts. *See* MACLACHLAN, *supra* note 24, §§ 62-71. Treiman argued that balance sheet insolvency describes an internal financial condition ascertainable only after comprehensive review of the debtor's books and records, and valuation of the debtor's assets and liabilities, whereas equitable insolvency—inability to pay current obligations—is both an internal financial condition and its external manifestation, and contended that the acts of bankruptcy should be replaced with a debtor's equitable insolvency for these practical problems of proof. Treiman, *supra* note 45. He also suggested that "a general assignment for the benefit of creditors, unsatisfied liens obtained through legal proceedings, receiverships, recent admissions of inability to pay debts, and similar conduct or events," as well as "excess of liabilities over assets," be presumptive of the debtor's equitable insolvency. *Id.* at 211-15.

[64] *See, e.g.*, MACLACHLAN, *supra* note 24, §§ 62-71 (numerous references to English, Canadian, Scottish and French bankruptcy law); Treiman, *supra* note 45, at 211-12 (same). *See also* John Honsberger, *Failure to Pay One's Debts Generally As They Become Due: The Experience of France and Canada*, 54 AM. BANKR. L.J. 153 (1980).

[65] Treiman favored an "inability to pay" standard for the commencement of involuntary bankruptcy cases and suggested various conduct and events that should presumptively indicate a debtor's equitable insolvency. Treiman, *supra* note 45, at 211-15. MacLachlan similarly argued that an "inability to pay" standard should govern, but also would have retained several "acts of bankruptcy" as appropriate bases for commencement of an involuntary case. MACLACHLAN, *supra* note 24, §§ 13-17, at 62-71. *See also* note 63 *supra*. The Canadian study appeared to follow the lead of Treiman and MacLachlan when it concluded that a "debtor's inability to pay" should be the standard for commencement of an involuntary bankruptcy case, rather than "acts of bankruptcy" or balance sheet insolvency, but also recommended the retention of a number of conclusive and rebuttable presumptions of a debtor's "inability to pay." CANADA STUDY COMMITTEE REPORT, *supra* note 58, at 105-06. Earlier commentators had argued that the "acts of bankruptcy" should be replaced with an insolvency standard, however. *See* Kreft, *supra* note 58, at 153.

[66] Bonbright and Pickett proposed a new standard of insolvency that resembled the equitable definition of insolvency: "[A] person is insolvent who cannot fairly be expected, if left to his own devices, to pay off his debts (including not only existing debts but also those debts he may incur to pay off existing debts) within a reasonable period of time." Bonbright & Pickett, *supra* note 53, at 621-22. *See generally* McCoid, *supra* note 21, at 209 (discussing scholarly criticism of balance sheet definition of insolvency).

ceedings when he has [generally] ceased to pay his debts or will be generally unable to pay his current liabilities."[67] The primary reason for the Commission's recommendation that the "concept of an act of bankruptcy be abolished" was a practical one:

> It is time to abandon the complex, litigation-producing constraints and substitute the test of inability or failure to pay debts as the basis for initiating involuntary bankruptcy. Creditors have a very real stake in a debtor's assets; state and federal laws recognize this stake and allow unpaid creditors to reach assets before and after judgment, although the ability to do so before judgment has been restricted recently by considerations of due process. It is better policy to accommodate a proceeding for the benefit of all creditors under the federal legislation than to require individual creditor action which only benefits the aggressive creditor.[68]

The Commission sought to encourage creditors to bring an involuntary case by changing the standard for commencement from the "acts of bankruptcy" to the "general failure to pay" standard, in part because they understood that creditors were more likely to have access to the sorts of information necessary to prove the debtor's general default than the debtor's insolvency, which often was an element of the debtor's act of bankruptcy.[69] They accepted the view that a debtor's general default is an external event, that the debtor's insolvency is an internal financial condition, and that an external event is more readily determinable by creditors than an internal condition.[70] In addition, the Commission viewed a liberal standard for bringing an involuntary case as good policy because it encourages creditors to file an involuntary petition at an earlier stage in the debtor's financial difficulty—early enough either to rehabilitate the debtor's business, or to prevent the debtor from becoming "more insolvent" as a result of the continued devaluation of its assets.[71] In doing so the Commission hoped to increase dividends distributed to

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[67] COMMISSION REPORT, *supra* note 4, pt. I, at 15. *See also id.* pt. II, at 74-76 (Proposed § 4-205(c)(1) & (2)).

[68] *Id.* pt. I, at 188.

[69] *See id.* pt. I, at 14, 188. *See also* H.R. REP. No. 595, *supra* note 44, at 321-24, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6277-81; S. REP. No. 989, *supra* note 44, at 34, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5820.

[70] *See* COMMISSION REPORT, *supra* note 4, pt. I, at 186-87. *See also* McCoid, *supra* note 21, at 211.

[71] COMMISSION REPORT, *supra* note 4, pt. I, at 14, 186-88.

creditors in bankruptcy cases, which had been abysmally low.[72]

Although Congress did not incorporate all of the Commission's suggestions on this topic[73] when it enacted the Bank-

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[72] *Id.* at 14, 186. The statistics to which the Commission referred had actually been accumulated in 1932. *See* SOLICITOR GENERAL THACHER'S REPORT TO THE PRESIDENT ON THE BANKRUPTCY ACT AND ITS ADMINISTRATION IN THE COURTS OF THE UNITED STATES 69-72 (1932) [hereinafter "Thacher Report"]; COMMISSION REPORT, *supra* note 4, pt. I, at 186-87 nn. 31-36 (containing references to the Thacher Report). Although the Thacher Report concluded that alternatives to liquidation, rather than a change to the standard for commencement of an involuntary case, would remedy the problem of small dividends to creditors in bankruptcy, the Commission did not believe that increased dividends to creditors adequately could be accomplished simply by encouraging debtors to file reorganization, rather than liquidation, cases. The Commission reasoned that:

> Although alternatives to liquidation are desirable, they did not and will not, without further reform, increase the return to creditors. The only substantial chance of an improvement in this respect is to encourage and facilitate earlier resort to relief [by creditors].

COMMISSION REPORT, *supra* note 4, pt. I, at 187.

[73] With regard to involuntary bankruptcy, the Commission had recommended that:

(1) The concept of "an act of bankruptcy" be abolished and the debtor be made amenable to involuntary proceedings when he has ceased to pay his debts or will be generally unable to pay his current liabilities.
(2) A debtor be protected against the risks of ill-founded petitions by requiring the court to hold a hearing immediately after the filing of an involuntary petition to determine whether the relief sought is in the best interests of the debtor and its creditors.
(3) A general assignment or general receivership continue to be a basis for involuntary proceedings without regard to whether the debtor was insolvent or unable to pay his debts at the time of the filing of the petition, on the premise that such a disposition or proceeding contemplates a liquidation and that creditors be able to require it to be conducted subject to the safeguards provided by the Bankruptcy Act.
(4) There be no jury trial of any issue raised on an involuntary petition.
(5) A creditor or creditors who have aggregate claims of $2,500 be able to file an involuntary petition for liquidation of the debtor, and one or more creditors having claims of $10,000 or more be able to file a petition seeking reorganization of the debtor.
(6) The estate be protected against the risk of depletion and deterioration of assets pending a determination of the issues on an involuntary petition by allowing the Bankruptcy Administration with court approval to take immediate possession to preserve the property during the interim before determination of the issues on the petition.
(7) During the interim between the filing of the petition and the determination of the issues thereon, persons dealing with the debtor in the ordinary course of his business be protected by being allowed to retain money or property acquired and to have claims against the estate for credit extended, and the Bankruptcy Administration be authorized to give express approval to specific transactions pending the resolution of the issues on the petition.
(8) The exclusion of corporations other than those that are moneyed, business,

ruptcy Reform Act of 1978, it removed the "acts of bankruptcy" as the standard for commencement of an involuntary case and replaced it with a standard that considered, among other things, the debtor's general failure to pay its debts as they came due.[74]

As the law currently exists,[75] three creditors[76] holding claims[77] that are neither contingent[78] nor the subject of a bona

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or commercial from amenability to involuntary proceedings be eliminated, as well as the meaningless "wage earner" exclusion.

COMMISSION REPORT, *supra* note 4, pt. I, at 15.

[74] 11 U.S.C. § 303(h)(1).

[75] Section 303 of the Code was amended in 1984 as a part of the omnibus substantive and jurisdictional amendments that Congress made at that time. *See* Bankruptcy Amendments and Federal Judgeships Act of 1984, Pub. L. No. 98-353, 98 Stat. 353 (1984) (codified at 11 U.S.C. §§ 701-766) (commonly referred to as "BAFJA"). *See also* Susan Block-Lieb, *Using Legislative History to Interpret Bankruptcy Statutes, in* BANKRUPTCY PRACTICE AND STRATEGY 2-1, 2-8 (Alan N. Resnick ed., 1987) (general discussion of legislative history of 1984 Amendments).

Like many of the 1984 amendments to the Code, there is virtually no legislative history to explain the need for, or meaning of, the changes made to section 303. But the history relating to this provision is particularly sparse. The only legislative discussion of the provision are several paragraphs of unilluminating remarks made by the proponent of the provision which appear in the Congressional Record for the day on which the Senate passed its omnibus bill for House approval. *See* 130 CONG. REC. S.7618 (June 19, 1984) (remarks of Sen. Baucus). Unlike all other substantive amendments made in BAFJA, the amendments to section 303 were explicitly intended by Congress to apply to pending cases and proceedings. *Compare* BAFJA § 553(b) *with* BAFJA § 553(a) & (c). Ironically, this special favor appears not to have benefitted the party for whom it was intended. *See* Rubin v. Belo Broadcasting Corp. (*In re* Rubin), 769 F.2d 611 (9th Cir. 1985).

[76] *But see* 11 U.S.C. § 303(b)(2) (permitting single creditor to file involuntary petition when debtor has fewer than 12 creditors; in counting debtor's creditors for this purpose, employees, insiders and creditors whose claims are voidable are excluded). *See also, e.g.*, Blackmon v. Runyan (*In re* Runyan), 832 F.2d 58 (5th Cir. 1987) (creditors holding $600-$800 claims counted in determining whether involuntary debtor has fewer than 12 creditors; court found it unnecessary to decide if Denham v. Shellman Grain Elevator, Inc., 444 F.2d 1376 (5th Cir. 1971), was good law since $600 claim not de minimis); Jefferson Trust & Savings Bank v. Rassi (*In re* Rassi), 701 F.2d 627 (7th Cir. 1983) (declining to follow *Denham*, court held that bona fide, small, recurring claims must be included in § 303(b) count). *But see, e.g., In re* Smith, 123 B.R. 423 (Bankr. M.D. Fla. 1990) (citing *Denham* with approval); *In re* Hill, 5 B.R. 79 (Bankr. D. Minn. 1980) (same). For a general discussion of the intricacies of counting a debtor's creditors for purposes of § 303(b), see 2 COLLIER ON BANKRUPTCY, *supra* note 23, ¶¶ 303.07[1][b], at 303-19 to -21, & 303.08[12], at 303-41 to -45. For a discussion of whether small claims should be counted in determining the number of the debtor's creditors, see *id.*, ¶ 303.08[12][d], at 303-44 to -45.

[77] 11 U.S.C. § 101(5) (broad definition of "claim"). Although there exists no explicit requirement that a petitioning creditor have exhausted its state collection remedies as a prerequisite to commencement of an involuntary bankruptcy case, courts are divided on this issue. *Compare, e.g., In re* Win-Sum Sports, Inc., 14 B.R. 389, 392-93 (Bankr. D.

fide dispute,[79] and that aggregate more than $5,000[80] more than the value of any lien[81] on the debtor's encumbered property, can file an involuntary petition—either a petition for a chapter 7 liquidation or a chapter 11 reorganization[82]—against an eligible

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Conn. 1981) (exhaustion not required) *with, e.g., In re* F.R.P. Indus., Inc., 73 B.R. 309 (Bankr. N.D. Fla. 1987) (petition dismissed as having been filed in bad faith, where debtor appeared solvent, petitioning creditors did not first pursue state collection remedies, and creditor's true motive in filing was to effectuate takeover of debtor); *In re* Dwoskin, 24 B.R. 41 (Bankr. S.D. Fla. 1982) (involuntary petition dismissed where sole creditor of debtor would not be prejudiced by pursuit of state collection remedies); *In re* R.V. Seating, Inc., 8 B.R. 663 (Bankr. S.D. Fla. 1981) (same). *See also* LoPucki, *supra* note 10, at 352.

[78] Although the Code does not explicitly define the term "contingent," courts have generally agreed on its meaning. *See, e.g., In re* Caucus Distribs., Inc., 83 B.R. 921, 928 (Bankr. E.D. Va. 1988) ("It is well settled that a contingent claim is one which is dependent on some future event for liability to attach."). *Accord, e.g.*, Semel v. Dill (*In re* Dill), 731 F.2d 629, 631 (9th Cir. 1984). This limitation on petitioning creditors' standing probably derives from the requirement under the Act that petitioning creditors' claims have been provable, although the concept of provable claims no longer exists under the Code. *See* 2 COLLIER ON BANKRUPTCY, *supra* note 23, ¶ 303.08[11][a], at 303-32 to -33 ("When the duty to pay a claim does not rest upon the occurrence of a future event, the claim is not contingent. Moreover, a claim is not contingent merely because the debtor disputes the creditor's claim and has asserted a counterclaim against it."). *See also* 11 U.S.C. § 101(5)(A) (definition of "claim" includes, inter alia, right to payment of disputed amount).

[79] Since 1984 petitioning creditors have been required by statute to show that their claims were not "the subject of a bona fide dispute." 11 U.S.C. § 303(b)(1). *See* note 75 *supra*.

[80] By increasing the aggregate dollar value of petitioning creditors' claims from $500 to $5,000, Congress only generally followed the Commission's recommendation. The Commission had recommended that the dollar thresholds be increased but had suggested that the figure be $2,500 for an involuntary liquidation case and $10,000 for an involuntary reorganization case. Congress did not adopt this two-tiered approach and increased the monetary requirement by an amount between the two figures suggested by the Commission. *See* COMMISSION REPORT, *supra* note 4, at 15, 185. *See also* note 73 *supra* (Commission's suggestions).

[81] Nothing in section 303 precludes a fully secured creditor from joining in an involuntary petition. *See* Paradise Hotel Corp. v. Bank of Nova Scotia, 842 F.2d 47 (3d Cir. 1988) (fully secured creditor entitled to join in involuntary bankruptcy petition); *In re* Crabtree, 32 B.R. 837 (Bankr. E.D. Tenn. 1983) (same). *But see* Pleas Doyle & Assocs. v. James Plaza Joint Venture (*In re* James Plaza Joint Venture), 67 B.R. 445 (Bankr. S.D. Tex. 1986) (fully secured creditors not entitled to commence involuntary bankruptcy case). Nonetheless, fully secured creditors probably have less incentive to force their debtor into bankruptcy than do undersecured or unsecured ones. *See* note 25 *supra*.

[82] Involuntary chapter 12 and 13 cases are not permitted under the Code. *See, e.g.*, Foster v. Heikamp (*In re* Foster), 670 F.2d 478 (5th Cir. 1982) (stating in dicta that involuntary chapter 13 case would not be permissible). *See also* 1 COLLIER ON BANKRUPTCY, *supra* note 23, ¶ 303.03. Chapter 12 involves the debt adjustment of a family farmer. 11 U.S.C. § 109(f). *See also* 11 U.S.C. § 101(18). Chapter 13 involves the debts adjustment of an individual with a regular income. 11 U.S.C. § 109(e). *See also* 11 U.S.C.

debtor.[83] The debtor is entitled to contest an involuntary petition within twenty days of the filing.[84] If the petition is timely controverted, the court must determine whether to enter an order for relief commencing the case or to sustain the debtor's objections to the petition.[85] Among other grounds,[86] a debtor can argue that an insufficient number of creditors joined in the petition (because the debtor has 12 or more creditors),[87] or that one

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§ 101(29).

[83] With narrow exceptions, section 303(a) of the Code permits the filing of an involuntary petition against any debtor eligible for relief under the relevant chapter by the filing of a voluntary petition: involuntary petitions may not be filed against farmers, family farmers, and corporations that are not moneyed, business, or commercial corporations. *See* 11 U.S.C. § 109 (governing eligibility for relief under each chapter of title 11); *id.* § 303(a) (excluding farmers, family farmers, and corporations that are not moneyed, business, or commercial corporations from amenability to involuntary case). *See also* 11 U.S.C. § 303(k) ("Notwithstanding subsection (a) of this section, an involuntary case may be commenced against a foreign bank that is not engaged in such business in the United States only under chapter 7 of this title and only if a foreign proceeding concerning such bank is pending.").

Thus Congress did not follow the Commission's recommendation to eliminate the Act's exclusion of "corporations other than those that are moneyed, business, or commercial from amenability to involuntary proceedings," but did eliminate the Act's "wage earner" exclusion that the Commission had criticized as "meaningless." COMMISSION REPORT, *supra* note 4, at 15, 186. The Commission had suggested that farmers continue to be protected against the possibility of an involuntary petition and Congress continued this exclusion. *See* COMMISSION REPORT, *supra* note 4, at 186. The family farmer exclusion was added in 1986 when Congress added chapter 12 to the Bankruptcy Code, which permits the reorganization of family farmers. The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 254, 100 Stat. 3088 (1986) (family farmer exclusion codified at 11 U.S.C. §§ 1201-1231).

[84] Congress effectively adopted the Commission's recommendation that the court be required to hold a hearing on a contested petition immediately after the filing. *See* COMMISSION REPORT, *supra* note 4, at 15, 190. Although section 303(h) provides only that a court shall order relief against the debtor in an involuntary case "[i]f the petition is not timely controverted," the Federal Rules of Bankruptcy Procedure expressly set forth the time by which an involuntary petition must by contested. *See* 11 U.S.C. § 303(h); FED. R. BANKR. P. 1011 (generally requiring presentation of defenses and objections to involuntary petition be filed and served within 20 days after service of the summons); *id.* Rule 1013 (requiring court to enter order for relief prayed for in involuntary petition as soon as practicable after expiration of 20-day period referred to in Rule 1011 without filing of defenses and objections to petition). *But see* Wynn v. Eriksson (*In re* Wynn), 889 F.2d 644 (5th Cir. 1989) (two year gap between filing of involuntary petition and entry of order for relief did not violate requirement of timeliness where delay largely caused by involuntary debtor's discovery tactics).

[85] 11 U.S.C. § 303(h).

[86] For a more complete list of the grounds for defending against or objecting to an involuntary petition, see 2 COLLIER ON BANKRUPTCY, *supra* note 23, § 303.23, at 303-100 to -104.

[87] *See* 11 U.S.C. § 303(b) (requisite number of petitioning creditors).

or more of the petitioning creditors does not have standing to file (because a petitioning creditor's claim is contingent or subject to a bona fide dispute, or because the aggregate of petitioning creditors' claims does not total the requisite $5,000),[88] or that the standard for the commencement of an involuntary case has not been established.[89]

If a sufficient number of petitioning creditors have standing, a bankruptcy court will enter an order for relief commencing an involuntary case over the debtor's objection upon proof that "the debtor is generally not paying such debtor's debts as such debts become due unless such debts are the subject of a bona fide dispute,"[90] or that "within 120 days before the date of the filing of the petition, a custodian, other than a trustee, receiver or agent appointed or authorized to take charge of less than substantially all of the property of the debtor for the purpose of enforcing a lien against such property, was appointed or took possession."[91]

Under the first and more commonly cited[92] avenue for bringing an involuntary case creditors must allege that the debtor is "generally not paying [its] debts as [they] come due," excluding contingent and certain disputed obligations.[93] The Code does not define this "general failure to pay" standard, and

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[88] *See id.* § 303(b) (standing of petitioning creditors).

[89] *See id.* § 303(h) (standard for commencement of involuntary case).

[90] *Id.* § 303(h)(1). The requirement that petitioning creditors show that their debtor is "generally not paying [its] debts as [they] come due" was amended in 1984 to remove debts subject to the debtor's bona fide dispute from this determination. This amendment to the Bankruptcy Code did not accomplish any enormous change to the law, however. With regard to the standard that petitioning creditors must meet, several courts had refused to view an involuntary debtor's dispute of its claims as irrelevant, although they disagreed on the circumstances under which such a dispute would affect the calculation of a debtor's inability to pay its debts as they came due. *Compare In re* Covey, 650 F.2d 877 (7th Cir. 1981) (providing for complicated balancing process under which bankruptcy courts were to determine whether disputed claims were included in calculation of debtor's general default) *with* B.D. Int'l Discount Corp. v. Chase Manhattan Bank N.A. (*In re* B.D. Int'l Discount Corp.), 701 F.2d 1071, 1076-77 (2d Cir. 1983) (declining to follow *Covey*, but commenting in dicta that there is "difficulty in believing that . . . a claim qualifies under § 303(h) when the claim is subject to serious dispute"), *aff'g on other grounds* 24 B.R. 876 (S.D.N.Y. 1982), *cert. denied*, 464 U.S. 830 (1983); Semel v. Dill (*In re* Dill), 731 F.2d 629 (9th Cir. 1984) (declining to follow *Covey*, but instructing bankruptcy court on remand to balance interests of creditors and debtor in determining whether to include disputed debt in calculation of debtor's general default).

[91] 11 U.S.C. § 303(h)(2).

[92] *See* note 116 *infra*.

[93] 11 U.S.C. § 303(h)(1).

courts have found the standard "woefully lacking in clarity."[94] Legislative history indicates that Congress intended to give courts considerable discretion in making this determination.[95] Courts have rejected the contention that the term "generally" means a majority of the time, and have declined to apply an invariable mathematical formula;[96] instead they have applied a flexible standard that "look[s] to the totality of the circumstances."[97] In doing so they consider both the number and amount of unpaid claims[98] as of the filing of the petition,[99] and also may consider other related and unrelated factors[100] such as

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[94] *B.D. Int'l Discount Corp.*, 701 F.2d at 1075.

[95] COMMISSION REPORT, *supra* note 4, at 75 ("The scope and meaning of generally unable and generally failed are left to the courts; it is not possible to lay down guidelines that will fit all cases."). *See also B.D. Int'l Discount Corp.*, 701 F.2d at 1075-76.

[96] *See, e.g., In re* All Media Properties, Inc., 5 B.R. 126, 142 (Bankr. S.D. Tex. 1980), *aff'd*, 646 F.2d 193 (5th Cir. 1981) (rejecting contention that "to be generally not paying his debts a debtor would have to be not paying at least 51% of his debts"). *See also* 2 COLLIER ON BANKRUPTCY, *supra* note 23, § 303.12[4], at 303-58. Indeed, such a construction would appear to be foreclosed by a review of the legislative history. *See B.D. Int'l Discount Corp.*, 701 F.2d at 1075-76 (rejecting similar contention based on review of the legislative history). *See also* note 95 *supra*.

[97] 2 COLLIER ON BANKRUPTCY, *supra* note 23, § 303.12[4], at 303-58. *Accord, e.g.*, Bartmann v. Maverick Tube Corp., 853 F.2d 1540 (10th Cir. 1988); *In re* Bishop, Baldwin, Rewald, Dillingham & Wong, Inc., 779 F.2d 471 (9th Cir. 1985).

[98] *See, e.g., In re* Bishop, Baldwin, Rewald, Dillingham & Wong, Inc., 779 F.2d at 475; *B.D. Int'l Discount Corp.*, 701 F.2d at 1076; *In re* All Media Properties, Inc., 5 B.R. at 142, *aff'd*, 646 F.2d 193 (5th Cir. 1981); *In re* Walnut Street Four, 106 B.R. 56 (Bankr. M.D. Pa. 1989); Boston Beverage Corp. v. Turner, 81 B.R. 738 (D. Mass. 1987). *But see, e.g., In re* B.D. Int'l Discount Corp., 15 B.R. 755, 763 (Bankr. S.D.N.Y. 1981) (nonpayment of single claim can constitute general nonpayment), *aff'd*, 24 B.R. 876 (S.D.N.Y. 1982), *aff'd on other grounds*, 701 F.2d 1071 (2d Cir.), *cert. denied*, 464 U.S. 830 (1983); *In re* J.B. Lovell Corp., 80 B.R. 254 (Bankr. N.D. Ga. 1987) (same); *In re* Hill, 5 B.R. 79 (Bankr. D. Minn. 1980) (same); *In re* Kreindler Import Corp., 4 B.R. 256 (Bankr. D. Md. 1980) (same).

[99] Although the Code is silent, courts uniformly have concluded that the "general non-payment" standard must be satisfied as of the date of the filing of the involuntary petition. *See, e.g.*, Bartmann v. Maverick Tube Corp., 853 F.2d 1540, 1543 (10th Cir. 1988); *In re* Bishop, Baldwin, Rewald, Dillingham & Wong, Inc. 779 F.2d at 475.

[100] *See* 2 COLLIER ON BANKRUPTCY, *supra* note 23, § 303.12[4], at 303-61:

> Other criteria which have been examined are: the debtor's ability to meet only small, periodic debts and not long-term obligations; the fact that the debtor's assets had declined dramatically and that the reduction in debt was due to the sale of assets rather than generation of profits; the debtor's liquidity; the amount of the debtor's debts compared to the amount of the debtor's yearly income; the fact that insiders deferred payment on account of loans payable to them; the fact that the debtor voluntarily closed down; the existence of serious allegations concerning irregularities in the conduct of the debtor's business; and the apparent lack of good faith by a debtor's officers in taking loans from

the manner in which the debtor has conducted its financial affairs.[101] Absent special circumstances,[102] the majority of courts do not find that the debtor's failure to pay a single debt constitutes a failure generally to pay its debts as they come due.[103]

Since 1984 courts have been directed to exclude debts as to which the debtor has raised a "bona fide" dispute from the determination of whether the debtor generally is paying its debts

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the debtor in spite of the debtor's financial distress. (citations omitted).

[101] *See, e.g., In re* Bishop, Baldwin, Rewald, Dillingham & Wong, Inc., 779 F.2d at 471; *In re* Covey, 650 F.2d 877, 884 (7th Cir. 1981); Boston Beverage Corp. v. Turner, 81 B.R. 738 (D. Mass. 1987); *In re* Arriola Energy Corp., 74 B.R. 784 (S.D. Tex. 1987). *See also In re* Trans-High Corp., 3 B.R. 1, 3 (Bankr. S.D.N.Y. 1980) (interpreting § 303(h)(1) to mean that order for relief proper when debtor is not paying its debts "in the ordinary course of business"; petition dismissed for failure to establish deviation from ordinary course).

[102] Recognizing the general rule that nonpayment of a single debt does not constitute general default, the bankruptcy court in *In re* 7H Land & Cattle Co., 6 B.R. 29 (Bankr. D. Nev. 1980), relied on Canadian courts' interpretations of a similar standard for commencement of an involuntary bankruptcy case under Canadian law and found two exceptions: (i) when the debtor has only one creditor and that creditor would otherwise be without an adequate remedy under either state or federal law; or (ii) when the petitioner can show special circumstances, such as fraud, trick, artifice or scam. *In re* 7H Land & Cattle Co., 6 B.R. at 34 (denying motion to dismiss involuntary petition filed by single creditor on grounds that genuine issues of material fact existed as to whether petitioner had adequate remedy at state law, and as to whether special circumstances warranted commencement of involuntary case). Although many courts have referred to these exceptions, "[i]t appears that no court, however, has determined that the granting of an involuntary petition on the basis of unusual factors alone is proper." *In re* Caucus Distrib. Inc., 106 B.R. 890, 921 (Bankr. E.D. Va. 1989) (dicta). *See, e.g.*, Concrete Pumping Serv., Inc. v. King Constr. Co. (*In re* Concrete Pumping Serv., Inc.), 943 F.2d 627 (6th Cir. 1991); *In re* Gold Bond Corp., 98 B.R. 128 (Bankr. D.R.I. 1989); *In re* Charon, 94 B.R. 403 (Bankr. E.D. Va. 1988); *In re* General Trading, Inc., 87 B.R. 216 (Bankr. S.D. Fla. 1988). *See also* Bankers Trust Co. BT Serv. Co. v. Nordbrock (*In re* Nordbrock), 772 F.2d 397, 400 (8th Cir. 1985) (reference to "special circumstances" doctrine in dicta); First Florida Nat'l Bank, N.A. v. Smith (*In re* Smith), 129 B.R. 262 (M.D. Fla. 1991) (same).

[103] *See, e.g.*, Bankers Trust Co. BT Serv. Co. v. Nordbrock (*In re* Nordbrock), 772 F.2d 397 (8th Cir. 1985). *See also* Paradise Hotel Corp. v. Bank of Nova Scotia, 842 F.2d 47, 51 n.7 (3d Cir. 1988) (noting in dicta that nonpayment of single debt is insufficient proof of debtor's general default absent "truly extraordinary circumstances"). *But see In re* B.D. Int'l Discount Corp., 15 B.R. 755, 763 (Bankr. S.D.N.Y. 1981) (nonpayment of single claim can constitute general nonpayment), *aff'd*, 24 B.R. 876 (Bankr. S.D.N.Y. 1982), *aff'd on other grounds*, 701 F.2d 1071 (2d Cir.), *cert. denied*, 464 U.S. 830 (1983); Concrete Pumping Serv., Inc. v. King Constr. Co. (*In re* Concrete Pumping Serv., Inc.), 943 F.2d 627 (6th Cir. 1991) (same); *In re* J.B. Lovell Corp., 80 B.R. 254 (Bankr. N.D. Ga. 1987) (same); *In re* Karber, 25 B.R. 9, 11 n.1, 14-15 (Bankr. N.D. Tex. 1982) (same); *In re* Hill, 5 B.R. 79 (Bankr. D. Minn. 1980) (same); *In re* Kreindler Import Corp., 4 B.R. 256 (Bankr. D. Md. 1980) (same).

as they come due.[104] Although courts have had little difficulty in defining the "bona fide dispute" standard,[105] this amendment represents a retreat from Congress's original goal of establishing a standard dependent only upon external events readily ascertainable by a creditor body in that petitioning creditors may be required to show that the debtor's dispute of other creditors' claims is not bona fide.[106]

The Code does not define the term "bona fide" dispute. Nonetheless, with minor variation,[107] courts have concluded that debt is subject to a "bona fide" dispute if an objective basis exists from which to conclude that the debtor's dispute as to the validity of the debt is supported either by a substantial question of fact or a meritorious issue of law.[108] This standard does not require the bankruptcy court to resolve the dispute, only to identify its presence or absence.[109] Courts often have concluded that an obligation is subject to a bona fide dispute when it is the subject of pending litigation.[110] When the debtor is merely disputing the amount of money owed, rather than liability itself,

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[104] *See* notes 75 & 79 *supra*. Petitioning creditors whose debts were disputed by the debtor would not have been entitled to join in an involuntary petition under the former Act, since only the holders of provable claims could have joined in a petition and disputed debts were not provable claims.

[105] *See* text accompanying notes 107-14 *infra*.

[106] *See* text accompanying notes 230-34 *infra*.

[107] While courts of appeals have agreed on the definition of the term "bona fide" dispute, bankruptcy court decisions have not been so uniform. *Compare In re* Johnston Hawks, Ltd., 49 B.R. 823 (Bankr. D. Haw. 1985) (applying balancing approach that considered, inter alia, debtor's subjective good faith in raising dispute) *with In re* Stroop, 51 B.R. 210 (D. Colo. 1985) (applying same standard as applicable to motion for summary judgment) *and In re* Lough, 57 B.R. 993 (Bankr. E.D. Mich. 1986) (applying standard ultimately adopted in *In re* Busick, 831 F.2d 745 (7th Cir. 1987)). *See generally* 2 COLLIER ON BANKRUPTCY, *supra* note 23, § 303.8[11][c] at 303-38 to -40.

[108] *See, e.g., In re* Busick, 831 F.2d 745 (7th Cir. 1987). *See also, e.g.*, Rimell v. Mark Twain Bank (*In re* Rimell), 946 F.2d 1363 (8th Cir. 1991) (following *Busick*); B.D.W. Assocs., Inc. v. Busy Beaver Bldg. Ctrs., Inc., 865 F.2d 65 (3d Cir. 1989) (same); Bartmann v. Maverick Tube Corp., 853 F.2d 1540 (10th Cir. 1988) (same).

[109] *In re* Busick, 831 F.2d at 750; *Bartmann*, 853 F.2d at 1544. Nonetheless, some courts appear unable to resist the temptation to resolve disputes determined to be without merit. *See, e.g., In re* Tikijian, 76 B.R. 304 (Bankr. S.D.N.Y. 1987) (court found that debtor's legal defenses to liability on guarantee were without merit); *In re* B.D.W. Assocs., Inc., 75 B.R. 909 (Bankr. W.D. Pa. 1987) (that petitioners were owed obligations by sister corporation of debtor was found not to be indicative of bona fide dispute since court concluded that corporate veil should be pierced).

[110] *See, e.g., In re* Reid, 107 B.R. 79 (Bankr. E.D. Va. 1989); *In re* General Trading, Inc., 87 B.R. 216 (Bankr. S.D. Fla. 1988); Boston Beverage Corp. v. Turner, 81 B.R. 738 (D. Mass. 1987).

however, it may be insufficient to support the finding of a bona fide dispute.[111] Courts also have held that a claim may not be the subject of a bona fide dispute due to the mere pendency of the debtor's appeal.[112] Some courts have suggested that a claim is not subject to a bona fide dispute if the debtor first disputed the indebtedness after the involuntary petition was filed.[113] The debtor's post-petition payment of the disputed debt will not always preclude its contention that the debt is subject to a bona fide dispute.[114]

The second standard for commencing an involuntary case—involving the appointment of a custodian or the custodian's possession of the debtor's property[115]—is less often relied upon by creditors.[116] The Code defines "custodian" to include a "receiver,"[117] "assignee under a general assignment for the benefit of the debtor's creditors,"[118] as well as a "trustee, receiver or agent . . . appointed or authorized to take charge of property of

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[111] *See, e.g., In re* Drexler, 56 B.R. 960 (Bankr. S.D.N.Y. 1986) (debtor's colorable counterclaims did not preclude finding that claim was not subject to bona fide dispute since only effect of debtor's success on counterclaims would be to reduce debtor's liability to plaintiff).

[112] *See, e.g., In re* Raymark Indus., Inc., 99 B.R. 298 (Bankr. E.D. Pa. 1989) (creditors holding stayed judgment against debtor hold claim subject to bona fide dispute; claims of creditors holding unstayed judgments were not subject to bona fide dispute); *In re* Caucus Distrib. Inc., 83 B.R. 921 (Bankr. E.D. Va. 1988) (debtor had not obtained stay pending appeal); *In re* Galaxy Boat Mfg. Co., 72 B.R. 200 (Bankr. D.S.C. 1986) (same); *In re* Drexler, 56 B.R. 960 (Bankr. S.D.N.Y. 1986) (same).

[113] *See, e.g., In re* Taylor, 75 B.R. 682, 684 (Bankr. N.D. Ill. 1987) (insufficient evidence of debtor's bona fide dispute when debtor had made single complaint before filing of involuntary petition and petitioner had made attempts to repair); *In re* CLE Corp., 59 B.R. 579, 584 (Bankr. N.D. Ga. 1986) (that debtor had paid petitioning creditors' recurring claims without dispute before involuntary petition was filed tended to indicate that dispute was not bona fide).

[114] *See Bartmann*, 853 F.2d at 1544.

[115] 11 U.S.C. § 303(h)(2). This ground for the commencement of an involuntary bankruptcy case combines two of the standards that had been recommended by the Commission. *See* COMMISSION REPORT, *supra* note 4, pt. II, at 74-76 (Proposed § 4-205(c)).

[116] A search for cases citing 11 U.S.C. § 303(h)(2), conducted in July 1990, produced only 10 cases. Moreover, in only two of those cases did the petitioners actually rely on § 303(h)(2) as an alternative ground for commencement of the involuntary case. *See In re* B.D. Int'l Discount Corp., 15 B.R. 755 (Bankr. S.D.N.Y. 1981), *aff'd*, 24 B.R. 876 (Bankr. S.D.N.Y. 1982), *aff'd on other grounds*, 701 F.2d 1071 (2d Cir.), *cert. denied*, 464 U.S. 830 (1983); *In re* North County Chrysler Plymouth, Inc., 13 B.R. 393, 400 (Bankr. W.D. Mo. 1981).

[117] 11 U.S.C. § 101(10)(A).

[118] *Id.* § 101(10)(B).

the debtor" either for purposes of enforcing a lien against the property or the general administration of the property.[119] Despite the seeming breadth of this definition,[120] courts have limited its application to instances in which the debtor has given up both possession and ownership of its property.[121] Moreover, section 303(h)(2) limits this ground for commencement of an involuntary bankruptcy case to instances in which the custodian was appointed or took possession of all or substantially all of the debtor's property[122] within 120 days before the date of the filing of the petition.[123]

In addition to modifying the grounds available to creditors desiring to file an involuntary petition, Congress also reformed the law to minimize the costly loss in value that may result from lengthy contested hearings. First, the Code expedites a contested involuntary petition hearing by denying debtors the right to a jury trial on these issues.[124] In addition, it protects against lost

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[119] *Id.* § 101(10)(C). Thus, although it appears to have been derived from the fifth "act of bankruptcy" under the former Act (appointment of receiver), section 303(h)(2) also subsumes the fourth "act of bankruptcy" (assignment for benefit of creditors) as well.

[120] *See* H.R. REP. No. 595, *supra* note 44, at 310, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6267 (definition of custodian intended to include nonbankruptcy court officials whose functions are substantially similar to those of receiver or trustee, such as prepetition liquidator of debtor's property). *Accord* S. REP. No. 989, *supra* note 44, at 23, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5809.

[121] *See, e.g., In re* B.D. Int'l Discount Corp., 15 B.R. at 765 (attorney for debtor not "custodian" although debtor had turned over all of its cash assets to attorney as escrow agent); *In re* North County Chrysler Plymouth, Inc. 13 B.R. at 400 (auctioneer hired by debtor to conduct sale of all of debtor's property and remit proceeds to debtor held not to be custodian).

[122] *See* 2 COLLIER ON BANKRUPTCY, *supra* note 23, § 303.13, at 303-66 ("Section 303(h)(2) does not contemplate an involuntary case when an appointment of a state court receiver and foreclosure for less than substantially all of the debtor's real estate has occurred.").

[123] *But see id.* § 303.13, at 303-65 ("If the creditors wait beyond the 120 day period they are not precluded from filing an involuntary petition. Creditors are simply relegated to proving the first ground for relief under section 303(h)(1) rather than the more easily provable alternative under section 303(h)(2)."). *Accord* H. REP. No. 595, *supra* note 44, at 324, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6280-81; S. REP. No. 989, *supra* note 44, at 34, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5820.

[124] *See* 28 U.S.C. § 1411 (added in 1984). Prior to the 1984 amendments to the judiciary code provisions applicable to bankruptcy cases, 28 U.S.C. § 1480 also explicitly denied debtors' the right to a trial by jury on the issues presented in a contested involuntary petition. The Commission had recommended the elimination of the right to a jury trial on contested involuntary petitions in its Report. *See* COMMISSION REPORT, *supra* note 4, at 15, 190. In light of the Supreme Court's recent decision in Granfinanciera, S.A.

value by encouraging suppliers and others to continue to do business with an involuntary debtor pending resolution of a debtor's objections to a creditors' petition. Creditors who do business with an involuntary debtor during the "gap" period between the filing of the involuntary petition and the decision on whether an order for relief should be entered are accorded a statutory priority for their claims, second only to the priority of administrative claims incurred after an order is entered and the case has been commenced.[125]

Congress sought to balance competing interests by repealing the "litigation-producing" acts of bankruptcy as the grounds for initiating an involuntary case. When it reformed the requirements for involuntary bankruptcy, Congress was concerned, not only with encouraging creditors' petitions, but also with minimizing the leverage that this liberalized standard might create. It recognized the frequency with which debtors repaid their delinquent obligations outside of bankruptcy. It also worried about abusive creditors unnecessarily pushing debtors into bankruptcy.[126] Congress sought to discourage these scurrilous filings in several ways. First, Congress tightened the standing requirements for petitioning creditors by increasing the threshold aggregate value of petitioning creditors' claims from $500 to $5,000,[127] and by precluding creditors with contingent or validly disputed claims from joining in an involuntary petition.[128] It also omitted debts that are either contingent or the subject of a debtor's bona fide dispute from calculation of the debtor's general default.[129] Congress also roughly approximated the goal of collective consensus by continuing the pre-Code requirement that three petitioners join in an involuntary filing, unless the

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v. Nordberg (*In re* Chase & Sanborn Corp.), 492 U.S. 33 (1989), the constitutionality of this Congressional limitation upon an involuntary debtor's right to a jury trial on these issues may be questioned. *See, e.g., In re* United Missouri Bank of Kansas City, N.A., 901 F.2d 1449 (8th Cir. 1990).

[125] *See* 11 U.S.C. §§ 502(f), 507(a)(2). The Commission had recommended that these "gap" claims be accorded priority. *See* COMMISSION REPORT, *supra* note 4, at 15, 190. Under the Act, these "gap" creditors were provided only limited protection. *See* note 57 *supra*.

[126] COMMISSION REPORT, *supra* note 4, at 189-91.

[127] 11 U.S.C. § 303(b)(1), (2).

[128] *Id.*

[129] *Id.* § 303(h)(1).

debtor has an unusually small number of creditors.[130]

Finally, it provided debtors redress for improvidently filed involuntary petitions.[131] As a preliminary measure to protect involuntary debtors until the hearing on the contested petition, the court may require the petitioning creditors to file a bond to indemnify the debtor "for such amounts as the court may later" award in the event of the dismissal of the petition.[132] Moreover, if the petition ultimately is dismissed for any reason other than consent of all petitioners and the debtor (and if the debtor does not waive the right to judgment),[133] the court can award the debtor costs and attorneys' fees.[134] Unlike section 303(i)(2), section 303(i)(1) does not explicitly require a showing of the petitioning creditors' bad faith as a prerequisite to an award of costs and attorneys' fees. Nonetheless, courts are divided on whether proof of the petitioners' bad faith should be established before

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[130] *Id.* § 303(b)(1). *See, e.g.*, Basin Elec. Power Coop. v. Midwest Processing Co., 769 F.2d 483 (8th Cir. 1985) ("The three creditor requirement is designed to prevent the use of involuntary bankruptcy proceedings by creditors as a means of harassing an honest debtor."), *cert. denied*, 474 U.S. 1083 (1986). *See also In re* Caucus Distrib., Inc., 106 B.R. 890 (Bankr. E.D. Va. 1989) (extensive discussion of historical and policy reasons for three creditor requirement). Although section 303(c) generally permits creditors to join in an involuntary petition, even where the initial petition does not satisfy section 303(b)'s requirements, courts have dismissed involuntary petitions as filed in bad faith, and have refused to permit joinder of additional petitioners, when a single creditor filed the petition despite actual knowledge that the debtor had more than twelve creditors. *See* note 150 and accompanying text *infra*.

[131] 11 U.S.C. § 303(e), (i). LoPucki argues that the availability of actual and punitive damages for improvidently filed involuntary petitions largely explains why creditors have been so reluctant to pursue their bankruptcy collection remedies. LoPucki, *supra* note 10, at 353.

[132] 11 U.S.C. § 303(e). Legislative history indicates that the bonding requirement was intended to "discourage frivolous petitions as well as the more dangerous spiteful petitions based on a desire to embarrass the debtor . . . or to put the debtor out of business without good cause . . . ." H. REP. No. 595, *supra* note 44, at 323, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6279-80. *See also* 2 COLLIER ON BANKRUPTCY, *supra* note 23, § 303.34, at 303-113.

[133] Courts have held that a debtor's voluntary conversion of an involuntary chapter 7 case to a chapter 11 reorganization does not amount to such a waiver. *See* Paradise Hotel Corp. v. Bank of Nova Scotia, 842 F.2d 47, 52 (3d Cir. 1988); Captran Creditors Trust v. North Am. Title Ins. Agency (*In re* Captran Creditors Trust), 84 B.R. 812 (Bankr. M.D. Fla. 1988).

[134] 11 U.S.C. § 303(i)(1). This provision does not mandate that bankruptcy courts award costs and attorneys' fees, and courts generally have held that "any such award is solely within the court's discretion." *In re* Fox Island Square Partnership, 106 B.R. 962, 966 (Bankr. N.D. Ill. 1989); *accord, e.g.*, Susman v. Schmid (*In re* Reid), 854 F.2d 156 (7th Cir. 1988); Bankers Trust Co. BT Serv. Co. v. Nordbrock (*In re* Nordbrock), 772 F.2d 397, 400 (8th Cir. 1985).

allowing such an award.[135] Alternatively,[136] if the petition is dismissed against any petitioner found to have filed in bad faith, the award can include any damages proximately caused by the filing,[137] as well as punitive damages.[138]

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[135] *See, e.g., In re* Fox Island Square Partnership, 106 B.R. at 967; *In re* Allen Rogers & Co., 34 B.R. 631 (Bankr. S.D.N.Y. 1983). *See also Susman*, 854 F.2d at 159-61 (holding that court's discretionary award of attorneys' fees and costs should take into consideration, not only good or bad faith of petitioners, but also merit of creditors' position that petition was properly filed). *But see, e.g., In re* Leach, 102 B.R. 805 (Bankr. D. Kan. 1989) (debtor entitled to attorneys' fees whether involuntary filing was in bad faith or not); *In re* Exchange Network Corp., 85 B.R. 128 (Bankr. D. Colo. 1988), *aff'd*, 92 B.R. 479 (D.C. Colo. 1988) (bankruptcy court awarded debtor costs and attorneys' fees since clear that filing unjust, but failed to find that petition had been filed in bad faith to support award of either actual or punitive damages); *In re* Howard, Neilsen & Rush, Inc., 2 B.R. 451 (Bankr. M.D. Tenn. 1979) (attorneys' fees and costs awarded, absent finding of bad faith, because court found that Bankruptcy Rules contemplate routine award of such amounts following dismissal of involuntary petition).

[136] Congress intended the use of the word "or" in section 303(i) to be cumulative. H. REP. No. 595, *supra* note 44, at 324 ("[The word or] is not exclusive in this paragraph. The court may grant any and all of the damages provided for under this provision."); S. REP. No. 989, *supra* note 44, at 35 (same). *Accord, e.g., In re* West Side Community Hosp., Inc., 112 B.R. 243 (Bankr. N.D. Ill. 1990); *In re* Fox Island Square Partnership, 106 B.R. at 966.

Courts generally agree that the measure of damages provided in section 303(i) are not the exclusive methods of recovery for an improper involuntary filing, and have permitted recovery under FED. R. CIV. P. 11, FED. R. APP. P. 38 and 28 U.S.C. § 1297, as well as under state law tort actions for malicious use of civil process. *See, e.g., Paradise Hotel Corp.*, 842 F.2d at 52; *In re* American President Lines, Ltd., 804 F.2d 1307, 1310 (D.C. Cir. 1986); *Bankers Trust Co. BT Serv. Co.*, 772 F.2d at 400-01; *In re* Omega Trust, 110 B.R. 665 (Bankr. S.D.N.Y. 1990), *aff'd in part, remanded in part*, 120 B.R. 265 (S.D.N.Y. 1990); *In re* Fox Island Square Partnership, 106 B.R. at 969-70; Emerald City Records, Inc. v. First Media Corp. (*In re* Emerald City Records, Inc.), 9 B.R. 319 (Bankr. N.D. Ga. 1981). *See also* Baker v. Latham Sparrowbush Assocs. (*In re* Cohoes Indus. Terminal, Inc.), 931 F.2d 222 (2d Cir. 1991) (discussing circumstances under which Rule 11 sanctions would be imposed for voluntary petition filed in bad faith, court of appeals reversed bankruptcy court order imposing sanctions on ground that party who now sought sanctions had not objected to filing as frivolous during pendency of case). *But see Susman*, 854 F.2d at 161-62; Gonzales v. Parks, 830 F.2d 1033 (9th Cir. 1987); *In re* Ashby Enters., Ltd., 47 B.R. 394 (D.D.C. 1985).

[137] *See, e.g., In re* Tarasi & Tighe, 88 B.R. 706, 712-13 (Bankr. W.D. Pa. 1988); *In re* McDonald Trucking Co., Inc., 74 B.R. 474, *reconsid. denied*, 76 B.R. 513 (Bankr. W.D. Pa. 1987); *In re* Johnston Hawks Ltd., 72 B.R. 361, 368 (Bankr. D.C. Haw. 1987); *In re* Camelot, Inc., 25 B.R. 861, 868 (Bankr. E.D. Tenn. 1982), *aff'd*, 30 B.R. 409 (E.D. Tenn. 1983). *But see, e.g., In re* Advance Press & Litho, Inc., 46 B.R. 700 (Bankr. D. Colo. 1984) (attorneys' fees and costs awarded; actual damages not awarded, despite finding of bad faith, because proof too speculative).

[138] 11 U.S.C. § 303(i)(2). *See, e.g., In re* Johnston Hawks, Ltd., 72 B.R. at 367 ("The purpose of punitive damages is to deter similar acts in the future, both by the petitioning creditors and to serve as an example for others in similar circumstances . . . . A second purpose for punitive damages is to punish the petitioning creditors for wrongdoing in

There is no single definition of bad faith for purposes of section 303(i). Some courts emphasize petitioners' desires to harass, embarrass or harm the debtor as indicative of bad faith.[139] Others have found bad faith in the petitioning creditors' attempts to use bankruptcy as a substitute for their state collection remedies.[140] Collusive behavior has also often been held to constitute bad faith.[141] That one or more creditors solicited others to join in the involuntary petition is not alone indicative of collusion or bad faith.[142] Although one court was persuaded that a petitioning creditor did not act in bad faith when it relied on erroneous legal advice,[143] several others have found that the petitioners' reliance on legal advice is not dispositive of their

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filing the petition in bad faith.") (citations omitted). For examples of cases in which punitive damages were thought appropriate, see *In re* Omega Trust, 110 B.R. 665 (Bankr. S.D.N.Y. 1990) (bankruptcy court awarded punitive damages upon showing that petitioner filed to embarrass and harass debtor and to gain advantage in pending divorce action); *In re* Fox Island Square Partnership, 106 B.R. at 968-69 (punitive damages awarded against petitioning partners in favor of non-petitioning partner when petitioning partners were "well aware" that the partnership-debtor disputed their debts); *In re* Better Care, Ltd., 97 B.R. 405, 411 (Bankr. N.D. Ill. 1989) (punitive damages awarded); *In re* Laclede Cab Co., 76 B.R. 687 (Bankr. E.D. Mo. 1987) (same); *In re* McDonald Trucking Co., Inc., 74 B.R. at 482 (same); Camelot, Inc. v. Hayden (*In re* Camelot), 30 B.R. at 411 (punitive damages upheld because found appropriate to punish petitioning creditors for their bad faith filing and necessary to deter similar wrongdoing by others). *But see In re* SBA Factors of Miami, Inc., 13 B.R. 99, 101 (Bankr. S.D. Fla. 1981) (actual damages, other than attorneys' fees, not shown; punitive damages not awarded because filing resulted from poor legal advice). *See also* Sjostedt v. Salmon (*In re* Salmon), 128 B.R. 313 (Bankr. M.D. Fla. 1991) (punitive damages awarded against petitioning creditor held nondischargeable in subsequent bankruptcy case commenced voluntarily by petitioner/debtor).

[139] *See, e.g.*, Basin Elec. Power Coop. v. Midwest Processing Corp., 769 F.2d 483, 486-87 (8th Cir. 1985); *In re* Coppertone Communications, Inc., 96 B.R. 233, 236 (Bankr. W.D. Mo. 1989); *In re* Advance Press & Litho, Inc., 46 B.R. 700, 703-04 (Bankr. D. Colo. 1984); Camelot, Inc. v. Hayden (*In re* Camelot), 30 B.R. 409 (E.D. Tenn. 1983).

[140] *See, e.g., In re* Tarasi & Tighe, 88 B.R. 706 (Bankr. W.D. Pa. 1988); *In re* Johnston Hawkes, Ltd., 72 B.R. 361, 366 (Bankr. D. Haw. 1987), *aff'd*, 885 F.2d 875 (9th Cir. 1989); *In re* Grecian Heights Owners' Ass'n, 27 B.R. 172, 173 (Bankr. D. Or. 1982). *But see In re* Caucus Distribs., Inc., 106 B.R. 890 (Bankr. E.D. Va. 1989).

[141] *See, e.g., In re* Winn, 49 B.R. 237 (Bankr. M.D. Fla. 1985); *In re* Quality Trading Co., Inc., 36 B.R. 265, 269 (Bankr. D. Haw. 1984); *In re* Eden Assocs., 13 B.R. 578 (Bankr. S.D.N.Y. 1981); *In re* G-2 Realty Trust, 6 B.R. 549 (Bankr. D. Mass. 1980).

[142] *See, e.g., In re* West Side Community Hosp., Inc., 112 B.R. 243 (Bankr. N.D. Ill. 1990); *In re* CLE Corp., 59 B.R. 579, 583-84 (Bankr. N.D. Ga. 1986); U.S. Fidelity & Guar. Co. v. DJF Realty & Suppliers, Inc., 58 B.R. 1008 (Bankr. N.D.N.Y. 1986); *In re* Manchester Lakes Assocs., 47 B.R. 798, 802 (Bankr. E.D. Va. 1985).

[143] *See, e.g.*, Bankers Trust Co. BT Serv. Co. v. Nordbrock) (*In re* Nordbrock), 772 F.2d 397, 400 (8th Cir. 1985).

good faith.[144]

Courts also disagree on the nature of the bad faith standard that should be applied. Some have adopted a purely objective standard of bad faith.[145] Others have applied a standard that incorporates both objective and subjective elements, inquiring not only whether a reasonable creditor in the petitioner's position would have joined in the involuntary petition, but also whether this creditor's beliefs were honest and purposes permissible.[146] Still others have emphasized the creditors' actual knowledge in finding bad faith, without clarifying whether actual knowledge must be found.[147]

Although the Code does not explicitly require that an involuntary petition be filed in good faith, it also does not validate every creditors' motive for coercive collection. In permitting courts to compensate debtors for some or all of the loss that an improper involuntary petition can cause, the statute implicitly recognizes that creditors may be influenced to file an involuntary petition for no good reason, for example to secure a negotiating advantage, or in bad faith, and provides injured debtors with a remedy. Moreover, despite the lack of express statutory authority, courts have dismissed involuntary petitions found to have

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[144] *See, e.g., In re* Turner, 80 B.R. 618, 623 (Bankr. D. Mass. 1987); *In re* Godroy Wholesale Co., Inc., 37 B.R. 496, 500 (Bankr. D. Mass. 1984). *See also* Walden v. Bright Prods., Inc. (*In re* Walden), 781 F.2d 1121 (5th Cir. 1986).

[145] *See, e.g., In re* Eberhart Moving & Storage, Ltd., 120 B.R. 121 (Bankr. D.N.D. 1990); Jaffe v. Wavelength, Inc. (*In re* Wavelength, Inc.), 61 B.R. 614 (Bankr. 9th Cir. 1986); *In re* Godroy Wholesale Co., Inc. 37 B.R. at 500; *In re* Grecian Heights Owners' Ass'n, 27 B.R. 172, 173 (Bankr. D. Or. 1982); *In re* Ramsden, 17 B.R. 59, 60 (Bankr. N.D. Ga. 1981); *In re* SBA Factors of Miami, Inc., 13 B.R. 99 (Bankr. S.D. Fla. 1981).

[146] *See, e.g., In re* Fox Island Square Partnership, 106 B.R. 962, 967-69 (Bankr. N.D. Ill. 1989); *In re* Caucus Distribs., Inc., 106 B.R. 890, 923-24 (Bankr. E.D. Va. 1989); *In re* Better Care Ltd., 97 B.R. 405, 409-13 (Bankr. N.D. Ill. 1989); *In re* Exchange Network Corp., 85 B.R. 128, 132 (Bankr. D. Colo. 1988); *In re* Turner, 80 B.R. 618, 623 (Bankr. D. Mass. 1987); *In re* McDonald Trucking Co., Inc., 74 B.R. 474, *reconsid. denied*, 76 B.R. 513 (Bankr. W.D. Pa. 1987); *In re* Molen Drilling Co., Inc., 68 B.R. 840, 843-45 (Bankr. D. Mont. 1987); *In re* Elsub Corp., 66 B.R. 189 (Bankr. D.N.J. 1986); U.S. Fidelity & Guar. Co. v. DJF Realty & Suppliers, Inc., 58 B.R. 1008 (Bankr. N.D.N.Y. 1986); *In re* Alta Title Co., 55 B.R. 133 (Bankr. D. Utah 1985). *Compare* FED. R. CIV. P. 11 (combined objective/subjective standard of good faith as applied to attorney misconduct) *with* U.C.C. § 1-201(9) (adopting subjective standard for buyer in ordinary course) *and id.* § 2-103(1)(b) (adopting combined subjective and objective definition of good faith as applied to merchants).

[147] *See, e.g.*, Basin Elec. Power Coop. v. Midwest Processing Corp., 769 F.2d 483, 486-87 (8th Cir. 1985); *In re* Omega Trust, 110 B.R. 665 (Bankr. S.D.N.Y. 1990); Camelot Inc. v. Hayden (*In re* Camelot), 30 B.R. 409, 411 (Bankr. E.D. Tenn. 1983).

been brought in bad faith, just as courts have found the inherent power to dismiss voluntary petitions filed in bad faith.[148]

Courts have not defined "bad faith" in the context of the dismissal of an involuntary petition in a manner consistent with the definition applied for purposes of an award of damages under section 303(i); accordingly, they have dismissed these petitions based on a number of different factual allegations. Most commonly, involuntary petitions have been dismissed as filed in bad faith when brought by a single creditor despite knowledge that more than twelve creditors hold claims against the debtor.

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[148] Although the Code does not expressly provide for the dismissal of a voluntary chapter 11 petition filed in bad faith, courts have regularly presumed this inherent power. Courts of appeal appear to disagree as to the precise definition of bad faith, however. Some apply a factor approach that seeks to identify sufficient debtor misconduct to warrant the dismissal of a voluntary case. *See, e.g.*, Phoenix Picadilly v. Life Ins. Co. of Va. (*In re* Pheonix Picadilly, Ltd.), 849 F.2d 1393 (11th Cir. 1988) (chapter 11 petition dismissed as filed in bad faith, notwithstanding potential for successful reorganization, after consideration of factors that evidenced either intent to abuse judicial process and purposes of reorganization provisions, or intent to delay or frustrate legitimate efforts to enforce lien); Heisley v. U.I.P. Engineered Prods. Corp. (*In re* U.I.P. Engineered Prods. Corp.), 831 F.2d 54 (4th Cir. 1987) (same standard; motion to dismiss chapter 11 case as filed in bad faith denied); Natural Land Corp. v. Baker Farms, Inc., (*In re* Natural Land Corp.), 825 F.2d 296 (11th Cir. 1987) (same standard; chapter 11 petition dismissed due to bad faith filing); *In re* Winshall Settlor's Trust, 758 F.2d 1136 (6th Cir. 1985) (same). *See also, e.g.*, Little Creek Dev. Co. v. Commonwealth Mortgage Corp. (*In re* Little Creek Dev. Co.), 779 F.2d 1068 (5th Cir. 1986) (debtor's bad faith filing would constitute cause for relief from automatic stay; same standard as above; bad faith not found). *See also In re* East-West Assocs., 106 B.R. 767, 772 (S.D.N.Y. 1989) (in declining to dismiss *involuntary* case as commenced in bad faith, court stated that: "The possibility of an effective reorganization is not dispositive of the question of good faith . . . however, we believe that it does reflect favorably on the Petitioning Creditors' efforts and motives.") (citation omitted).

Other courts have stated that a voluntary chapter 11 petition will not be dismissed as filed in bad faith unless the movants also can show that there exists no realistic prospect of an effective reorganization of the debtor. *See, e.g.*, Carolin Corp. v. Miller, 886 F.2d 693 (4th Cir. 1989) (to warrant dismissal of voluntary chapter 11 petition for lack of good faith filing party in interest must show both objective futility of reorganization effort and debtor's subjective bad faith in invoking court's jurisdiction); Albany Partners, Ltd. v. Westbrook (*In re* Albany Partners, Ltd.), 749 F.2d 670 (11th Cir. 1984) (chapter 11 petition dismissed for bad faith filing upon showing that there existed no realistic prospect of effective reorganization for debtor and that debtor sought reorganization relief to delay or frustrate efforts of secured creditors to enforce their rights). *See also, e.g.*, First Nat'l Bank of Sioux City v. Kerr (*In re* Kerr), 908 F.2d 400 (8th Cir. 1990) (expressly declining to rule whether proof of debtor's inability to reorganize required dismissal for bad faith filing); Fruehauf Corp. v. Jartran, Inc. (*In re* Jartran, Inc.), 886 F.2d 859 (7th Cir. 1989) (without articulating standard, court declined to dismiss second chapter 11 petition as filed in bad faith). *See generally* 2 COLLIER ON BANKRUPTCY, *supra* note 23, ¶ 301.05[1].

Although the Bankruptcy Rules generally permit creditors to join in an involuntary petition after it has been filed,[149] when a single creditor files only on the hope that two of the debtor's other creditors will later join in the petition after the fact, courts dismiss the petition as having been filed in bad faith.[150] Others more generally contend that, as courts of equity, they are entitled to inquire into the good faith of petitioning creditors and to dismiss petitions filed by creditors acting in bad faith.[151]

Congress also sought to encourage negotiation among a debtor and its creditors. Section 305 empowers a bankruptcy court to abstain from a liquidation or reorganization case in "the interests of creditors and [if] the debtor would be better served by such dismissal."[152] Legislative history explains that absten-

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[149] *See* FED. R. BANKR. P. 1003(b).

[150] *See, e.g.*, Basin Elec. Power Coop. v. Midwest Processing Co., 769 F.2d at 486; *In re* Caucus Distribs. Inc., 106 B.R. 890 (Bankr. E.D. Va. 1989); *In re* Godroy Wholesale Co., Inc., 37 B.R. 496 (Bankr. D. Mass. 1984). *See also In re* LaRoche, 131 B.R. 253 (D.R.I. 1991) (where involuntary petition initially filed by three creditors in good faith but one petitioner ruled ineligible due to debtor's successful bona fide dispute of claim, joinder of additional petitioning creditor was permitted); *In re* Centennial Ins. Assocs., Inc., 119 B.R. 543 (Bankr. W.D. Mich. 1990) (where involuntary petition initially filed in bad faith by three creditors, one of which was later held to hold debt subject to debtor's bona fide dispute, joinder of additional petitioning creditor was denied); *In re* Molen Drilling Co., Inc., 68 B.R. 840 (Bankr. D. Mont. 1987) (debtor's motion to dismiss involuntary petition filed by single creditor dismissed, among other reasons, because petitioner in good faith relied on public filings which indicated that debtor had fewer than twelve creditors). This case law derives from Act § 59b (codified at 11 U.S.C. § 95(b) (repealed 1978)), and former Bankruptcy Rule 104(e). *See also In re* Crown Sportswear, Inc., 575 F.2d 991 (1st Cir. 1978) (Act); Speed Equip. Worlds of Am., Inc. v. Hunt (*In re* Hunt), 496 F.2d 882 (5th Cir. 1974) (same).

[151] *See, e.g.*, *In re* Wedgewood Golf Assocs., Ltd., 86 B.R. 711 (Bankr. M.D. Fla. 1988) (involuntary chapter 11 petition filed by fewer than all general partners of partnership dismissed when deadlock among partners would have precluded confirmation of plan of reorganization); *In re* Vincent J. Fasano, Inc., 55 B.R. 409 (Bankr. N.D.N.Y. 1985) (lead petitioning creditor misrepresented facts to obtain joinder of others in involuntary petition; petition dismissed as filed in bad faith); *In re* Quality Trading Co., Inc., 36 B.R. 265 (Bankr. D. Haw. 1984) (petitioner's collusive attempt to create claim against debtor sufficient cause for dismissal of involuntary petition); *In re* G-2 Realty Trust, 6 B.R. 549 (Bankr. D. Mass. 1980) (collusion between unsecured creditors and debtor cause for dismissal of involuntary petition when petition was filed on eve of foreclosure sale of debtor's primary asset, and debtor had changed from nominee trust to business trust just prior to filing in order to become eligible for bankruptcy relief). *See also, e.g.*, *In re* Trina Assocs., 128 B.R. 858 (Bankr. E.D.N.Y. 1991) (in dicta referring to inherent power to dismiss involuntary petition filed in bad faith; bad faith not found); Carteret Sav. Bank, F.A. v. Natasi-White, Inc. (*In re* East-West Assocs.), 106 B.R. 767 (S.D.N.Y. 1989) (same).

[152] 11 U.S.C. § 305.

tion would be appropriate under this section,

> for example, if an arrangement is being worked out by creditors and the debtor out of court, there is no prejudice to the results of creditors in that arrangement, and an involuntary case has been commenced by a few recalcitrant creditors to provide a basis for future threats to extract full payment. The less expensive out-of-court work-out may better serve the interests in the case.[153]

Thus, although the Code permits as few as three (and sometimes only one) petitioning creditors to file an involuntary petition, a bankruptcy court can abstain from an involuntary case if it determines that the bulk of the debtor's creditors prefer their nonbankruptcy collection remedies and pursuit of these collection methods is not prejudicial to the creditors as a whole. Courts have dismissed involuntary cases under section 305 where pending negotiations or state court remedies promoted more economic and efficient means of distributing the debtor's estate.[154] The mere fact that negotiations or state court proceedings are currently pending is not dispositive of a motion under section 305, however.[155]

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[153] H.R. REP. No. 595, *supra* note 44, at 325; S. REP. No. 989, *supra* note 44, at 36.

[154] *See, e.g., In re* Trina Assocs., 128 B.R. 858 (Bankr. E.D.N.Y. 1991) (bankruptcy court abstained from involuntary case to serve best interests of debtor partnerships and their secured creditors where settlement agreement had been reached in context of state foreclosure action); *In re* Williamsburg Suites, Ltd., 117 B.R. 216 (Bankr. E.D. Va. 1990) (bankruptcy court abstained from involuntary case where state partnership law better able to resolve termination of partnership); *In re* Kass, 114 B.R. 308 (Bankr. S.D. Fla. 1990) (court abstained from involuntary petition where adequate state law remedies existed in that disputes all involved pending divorce proceeding); *In re* Fales, 73 B.R. 44 (Bankr. S.D. Ohio 1987) (bankruptcy court granted motion to abstain from case where state court fraudulent transfer action would serve creditors' interests less expensively than pending involuntary bankruptcy case); *In re* Deacon Plastics Mach., Inc., 49 B.R. 982 (Bankr. D. Mass. 1985) (involuntary case dismissed where involuntary debtor had transferred all its assets to secured creditor during gap period in satisfaction of lien; since transfer was proper, and there was nothing left to distribute to creditors, court held abstention was warranted); *In re* Michael S. Starbuck, Inc., 14 B.R. 134 (Bankr. S.D.N.Y. 1981) (involuntary case dismissed when pending SEC equity receivership was providing means for efficient and equitable distributions to creditors); *In re* Evans, 8 B.R. 568 (Bankr. M.D. Fla. 1981) (involuntary case dismissed since the action was nothing more than bitter rehash of contested divorce proceeding); *In re* Luftek, 6 B.R. 539 (Bankr. E.D.N.Y. 1980) (involuntary case dismissed when petition filed by few recalcitrant creditors and majority of debtor's creditors more likely to be repaid outside of bankruptcy due to pending loan commitment); *In re* Sun World Broadcasters, Inc., 5 B.R. 719 (Bankr. M.D. Fla. 1980) (involuntary case dismissed in favor of state court receivership that had been pending for four years before bankruptcy case commenced).

[155] *See, e.g., In re* Barth, 109 B.R. 570 (Bankr. D. Conn. 1990) (involuntary case not

II. CREDITORS' DISINCENTIVES TO COMMENCE AN INVOLUNTARY BANKRUPTCY CASE

When Congress abolished "acts of bankruptcy" as the standard for commencement of an involuntary bankruptcy case, it did so for two different but related reasons. First, it recognized that petitioning creditors had difficulty establishing their debtor's insolvency, which often was an element under the "acts of bankruptcy."[156] More than just to simplify proof of the standard for commencement of an involuntary bankruptcy case, however, Congress also recognized that "a major factor explaining the smallness of distributions in business bankruptcies is the delay in the institution of proceedings for liquidation until assets are largely depleted."[157] Hence by abolishing the acts of bankruptcy, Congress also intended "to encourage and facilitate earlier resort to [bankruptcy] relief" and, as a result, to increase dividends to creditors.[158] More than just reform the standard for commencement of an involuntary case, with its enactment of the present Code Congress also made alterations to other aspects of the statutes governing involuntary filings.[159] With these other reforms, Congress intended to temper the negotiating leverage

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dismissed where trustee in bankruptcy and single creditor opposed debtor's motion and debtor had failed to provide trustee with list of creditors); *In re* Sky Group Int'l, Inc., 108 B.R. 86 (Bankr. W.D. Pa. 1989) (court declined to abstain from involuntary bankruptcy case, despite creditor's state foreclosure action, when dismissal would permit foreclosing creditor to gain possession of debtor's sole asset worth $8 million in satisfaction of $5 million debt thus depriving debtor's other creditors of $3 million equity); *In re* Monterrey Equities-Hillside, 73 B.R. 749 (Bankr. N.D. Cal. 1987) (involuntary case not dismissed, despite pending foreclosure action); *In re* Ross, 63 B.R. 951 (Bankr. S.D.N.Y. 1986) (involuntary case retained despite debtor's offer of security to petitioning creditors in settlement of their claims); *In re* Paolino, 49 B.R. 834 (Bankr. E.D. Pa. 1985) (despite pendency of state court receivership, motion to dismiss involuntary case denied due to lack of proof of duplication of effort); *In re* Zoomaire, Inc., 47 B.R. 628 (Bankr. S.D. Ohio 1985) (motion to abstain from involuntary case denied, despite pendency of state dissolution action and despite jurisdictional problems trustee in bankruptcy likely to face in pursuing debtor's indemnitor); *In re* Midwest Processing Co., 41 B.R. 90 (Bankr. D.N.D. 1984) (motion to dismiss involuntary case dismissed on grounds that success of debtor's out-of-court workout was speculative); *In re* Kenval Mktg. Corp., 40 B.R. 445 (Bankr. E.D. Pa. 1984) (court denied motion of assignee for benefit of creditors to abstain, after comparing powers of assignee and trustee in bankruptcy to avoid allegedly preferential transfers).

[156] COMMISSION REPORT, *supra* note 4, at 14, 188.

[157] *Id.* at 14.

[158] *See id.* at 14-15, 188-91, 192-93.

[159] *See* text accompanying notes 124-38 *supra*.

that the liberalized standard might have otherwise created, by discouraging bad faith filings and encouraging creditors to pursue less expensive and more expeditious nonbankruptcy solutions to a debtor's financial crisis.

There is no empirical evidence to show that this statutory reform has had any impact on distributions to creditors.[160] Nor are there statistics to determine whether creditors now file involuntary petitions at an earlier stage in their debtor's financial troubles than they did under the former Act. Statistics do show, however, that the number of involuntary petitions has increased very little, if at all, since enactment of the "general failure to pay" standard.[161] Whether the consistently small numbers of involuntary filings mean that Congress's reform of the standard for commencement of an involuntary case was unsuccessful depends upon which of Congress's purposes is considered.

When its goal of easing creditors' difficulties in proving the standard for commencement of an involuntary case is considered, clearly Congress did not succeed. Creditors continue to have difficulties obtaining access to the information necessary to commence a bankruptcy case against a debtor's will. But this failure is fairly easily remedied by further reform to the standard.[162] When its intent to increase dividends to creditors, by inviting earlier or more frequent involuntary petitions, is considered, Congress's failure is less easily remedied but perhaps less troublesome. It is harder to get creditors to file sooner or more often, not because the standard requires tinkering, but because creditors prefer nonjudicial resolution of payment disputes for many reasons, including creditors' and debtors' interests in preserving their viable long-standing relationships. Congress's invitation to creditors' petitions was inconsistent, not merely competitive, with its intent to encourage creditors to pursue these nonbankruptcy solutions to debtor/creditor problems. Thus Congress succeeded in its goal to encourage creditors to pursue nonbankruptcy options for resolution of a debtor's difficulties, although this success is moderated by Congress's failure to get

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[160] The Administrative Office has not published statistics on distributions to creditors from bankruptcy estates since enactment of the current Bankruptcy Code in 1978. *Compare* BANKRUPTCY STATISTICAL TABLES (1976-77) *supra* note 6 (Tables F5-F11) *with id.* (1979-89).

[161] *See* note 6 *supra.*

[162] *See* text accompanying notes 230-70 *infra.*

creditors to file petitions earlier and more often.

A. *Informational Disadvantages*

The "general failure to pay" standard is not an easy one for creditors to satisfy. To commence an involuntary case, petitioning creditors must be able to show that the debtor generally is not paying its debts as they come due, without regard to those debts as to which the debtor can raise a bona fide dispute.[163] Proof of this requires not only general information about the debtor's cash disbursements, but also about the due dates of its obligations, whether the debtor's nonpayment of a past due obligation is the result of an inability or an unwillingness to pay, and, if the latter, whether the debtor's dispute involves a substantial issue of fact or law.[164] While a debtor's general default may be easier to prove than its insolvency, clearly the public nature of this event has been overstated.[165] Creditors often do not have ready access to information[166] from which to determine whether the debtor is generally unable to pay its debts as they come due.[167]

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[163] 11 U.S.C. § 303(h)(1).

[164] Debtors, of course, are in the best position to determine their own general default, but not even a debtor can be assured whether it can satisfy the "general failure to pay" standard when it disputes a significant portion of its obligations, because the determination as to whether a debtor's disputes are bona fide is governed by an objective standard and not by what the debtor represents to be its state of mind.

[165] *See, e.g.*, B.D. Int'l Discount Corp. v. Chase Manhattan Bank, N.A (*In re* B.D. Int'l Discount Corp.), 701 F.2d 1071, 1075 (2d Cir. 1983) (noting that Congress had failed in its effort to streamline proof of standard for commencement of involuntary case by enacting a standard "woefully lacking in clarity").

[166] For a general discussion of the relationship between information, communication and collection remedies, see Arthur A. Leff, *Injury, Ignorance and Spite — The Dynamics of Coercive Collection*, 80 YALE L.J. 1, 26-46 (1970); William C. Whitford, *A Critique of the Consumer Credit Collection System*, 1979 WIS. L. REV. 1047, 1106-07.

[167] Creditors do not face a similar disadvantage when they seek to coerce repayment through their individual collection remedies. All that a creditor must plead and prove in order to obtain a judgment is that the debtor owes a certain amount on a claim, that the amount is due, and that the debtor has refused to pay its obligation—information easily available to a creditor. A creditor may also want information about whether the debtor has non-exempt assets subject to execution, but a creditor generally can compel a debtor to provide it with access to this sort of information under state law. CAL. CIV. PROC. CODE § 704.720-.850 (West 1987 & Supp. 1991); N.Y. CIV. PRAC. L. & R. 5206 (McKinney 1978 & Supp. 1991). Whitford argues that these post-judgment discovery measures are largely ineffective and involve "purposeless technicalities" because they generally require proof that a writ of execution has been returned nulla bona. Whitford, *supra* note 166, at 1096-97.

Until the news spreads by word of mouth,[168] a creditor may be unaware of a debtor's general default,[169] unless the debtor informs the public of the occurrence of this event either because it is a public company[170] and is obligated to file quarterly financial

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[168] With some debtors, word of mouth can be extremely effective. With public figures, like Donald Trump, word of financial difficulty is front page news. *See, e.g.*, Judi Bevan, *Depression, Divorce and 'The Donald'*, DAILY TELEGRAPH, Sept. 23, 1990, at 24; Richard D. Hylton, *$1.1 Million Loan Payment Missed by Trump on Shuttle*, N.Y. TIMES, Sept. 21, 1990, at D1; James Kim, *Trump's Luck Runs Bad*, USA Today, Sept. 21, 1990, at 1B (Money); James Kim, *Trump Loan for Shuttle in Default*, USA TODAY, Sept. 20, 1990, at 1B (Money); Allan Sloan, *Trump's Bankers Hold All the Cards in the Fate of the Taj Mahal Casino*, WASH. POST, Sept. 18, 1990, at F3. Most debtors aren't as renowned as Donald Trump however, with their general default newsworthy only to the few creditors stung by the nonpayment.

[169] *Cf.* LoPucki, *supra* note 10, at 329:

> The determination of viability is costly and at best highly subjective. In attempting to compare going-concern value with liquidation value, the creditor will have difficulty with both sides of the equation. The creditor must guess at the value of assets he has no right to inspect, sold under procedures not designed to obtain the best price. Predictions as to the future earning capacity of the business, uncertain in any circumstances, are particularly uncertain here. Usually little information is available to work from other than the debtor's chaotic accounting and his unwaveringly rosy future outlook.

[170] Moreover, finance theorists have developed models to predict the likelihood of bankruptcy, but these models apply only to public companies. *See, e.g.*, Edward I. Altman, *Why Businesses Fail*, 3 J. BUS. STRATEGY 15 (1983); Edward I. Altman et. al., *Zeta Analysis: A New Model to Identify Bankruptcy Risk of Corporations*, 1 J. BANKING & FIN. 29 (1977); Edward I. Altman, *Predicting Railroad Bankruptcies in America*, 4 BELL J. ECON. & MGMT. SCI. 184 (1973); Edward I. Altman, *Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy*, 23 J. FIN., Sept. 1968, at 589; Beaver, *Alternative Accounting Measures As Predictors of Failure*, ACCT. REV. 113 (1968); Beaver, *Financial Ratios as Predictive of Failure*, *in* EMPIRICAL RESEARCH IN ACCOUNTING: SELECTED STUDIES, 4 J. ACCT. RES. 71 (Supp. 1966); Blum, *Failing Company Discriminant Analysis*, J. ACCT. RES., Spring 1974, at 1; Deakin, *A Discriminant Analysis of Predictors of Business Failure*, J. ACCT. RES., Spring 1972, at 167; Edminster, *An Empirical Test of Financial Ratio Analysis for Small Business Failure Prediction*, J. FIN. & QUANT. ANAL., Mar. 1972, at 1477; Michael J. Gombola et. al., *Cash Flow in Bankruptcy Prediction*, FIN. MGMT, Winter 1987, at 55; James A. Largay & Clyde P. Stickney, *Cash Flows, Ratio Analysis and the W.T. Grant-Company Bankruptcy*, 36 FIN. ANALYSIS J., July/Aug. 1980, at 51; Paul A. Meyer & Howard W. Pifer, *Prediction of Bank Failures*, 25 J. FIN., Sept. 1970, at 853; Curtis L. Norton & Ralph E. Smith, *A Comparison of General Price Level and Historical Cost Financial Statements in the Prediction of Bankruptcy*, 54 ACCT. REV., Jan. 1979, at 72; Ohlson, *Financial Ratios and the Probabilistic Prediction of Bankruptcy*, J. ACCT. RES., Spring 1980, at 109; Gerald V. Post & Soo-Young Moon, *A Pooled Cross-Section Time-Series Approach to Business Failures in 18 U.S. Cities*, 40 J. ECON. & BUS. 45 (1988); Rose et. al., *Predicting Business Failure: A Macroeconomic Perspective*, 6 J. ACCT. AUDITING & FIN. 20 (1982); Subhash Sharma & Vijay Mahajan, *Early Warning Indicators of Business Failure*, 44 J. MKTG 80 (1980); Joseph F. Sinkey, Jr., *A Multivariate Statistical Analysis of the Characteristics of Problem Banks*, 30 J. FIN., Mar. 1975, at 21; Christine V. Zavgren & George E. Friedman, *Are*

reports under the Securities and Exchange Act of 1934[171] or for some other reason.[172] Credit reporting agencies may provide, for a fee, historical and anecdotal information about a debtor's defaults,[173] but knowing that the debtor has defaulted on occasion in the past is not proof that the debtor is generally not paying its debts as they come due.[174] In addition, creditors will have a difficult time assessing which of the debtor's unpaid debts are disputed and whether a dispute is bona fide. If litigation is involved, there may exist a public record of the dispute. But a dispute need not involve pending litigation to qualify as bona fide. Nor is the mere pendency of a lawsuit decisive of the bona fides of the debtor's dispute. Moreover, creditors cannot be confident of their ability to establish the illegitimacy of the debtor's disputes because the determination of whether the debtor's disputes are bona fide is a legal one for the bankruptcy court to resolve.

Even if creditors theoretically have access to information about the occurrence, regularity and nature of a debtor's de-

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Bankruptcy Prediction Models Worthwhile? An Application in Securities Analysis, 28 MGMT. INT'L REV. 34 (1988). For a general survey of this literature, see Christine V. Zavgren, *The Prediction of Corporate Failure: The State of the Art*, J. ACCT. LIT., Spring 1983, at 1.

[171] Section 13(a) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78m(a) (1988). At the risk of oversimplifying a rich and complex area of the law, there would appear to be no duty for a public company to inform the public of changes in its financial condition more frequently than on a quarterly basis (except in the narrow case of material changes to the financial condition of an issuer under a shelf registration).

[172] If the debtor seeks to resolve its financial troubles through an exchange offer of its public debt for newly issued securities, the Trust Indenture Act requires that the debtor issuer publicly file a report which discloses material information concerning the securities. See 15 U.S.C. §§ 77eee, 77j and Securities and Exchange Commission regulations promulgated thereunder. In these public filings, debtors often inform their public debt holders that the exchange offer is necessary due to the debtor's financial difficulties and that a failure of debt holders in the requisite percentage to accept the offer may require the debtor to file a voluntary bankruptcy petition to accomplish a coerced restructuring of its public and other debt.

[173] For example, Dun & Bradstreet Credit Services provides what it refers to as "Payment Analysis Services" to its subscribers. These *Payment Analysis Reports* compare a debtor's payment performance in relation to similar-size companies in the same industry.

[174] Certainly stories about the debtor's prior defaults are informative to creditors in making decisions about whether to extend, or continue to extend, credit to the debtor, and may even be predictive of the debtor's financial or business failure. But their value in making credit decisions is distinct from their value as evidence of a debtor's general default.

faults and disputes, the cost of acquiring this information may be so great as to deter creditors from making the effort. Because access to information may be costly, creditors with small claims—especially small claims that arise out of a single, discrete transaction—will have little incentive to acquire information about the debtor's financial condition.[175] They may choose to rely on other creditors or the debtor to commence a bankruptcy case, even though the benefits of a collective proceeding may outweigh the costs associated with making an informed decision about the need for bankruptcy.[176]

That creditors are disadvantaged in their access to the debtor's financial information need not necessarily discourage them from initiating an involuntary case. Plaintiffs often act on a hunch in bringing a suit, hoping to build a case after the complaint is filed and discovery is available. Within bounds,[177] that sort of behavior is not only tolerated by the law, but encouraged. Moreover, once the debtor is subject to the jurisdiction of the

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[175] *See* David G. Carlson, *Bankruptcy Philosophy*, 85 MICH. L. REV. 1341, 1356 n.43 (1987) ("The race of diligent creditors promotes the interest of those vested with power over and information in the debtor, because knowledgeable or influential creditors are more likely to win the race."); LoPucki, *supra* note 10, at 329-330 ("Where the debt is relatively small it is impractical for a single creditor to attempt to make the determination [as to the debtor's viability]."); Elizabeth Warren, *Bankruptcy Policy*, 54 CHI. L. REV. 775, 794 (1987) ("Creditors with small claims may reasonably conclude that the costs of an involuntary filing are too great to make bankruptcy an attractive alternative."). The notion that creditors with small claims have little financial incentive to participate actively in a bankruptcy case justifies the creation of an official committee to represent the interests of all of a debtor's general creditors. 11 U.S.C. §§ 705, 1102-1103. Similarly, courts of appeal have permitted the filing of class proofs of claim in bankruptcy cases, despite ambiguity in the Code and Bankruptcy Rules, among other reasons, because they provide a cost-effective means for numerous small claims to be asserted against a debtor. *See* The Certified Class in the Charter Sec. Litig. v. The Charter Co., (*In re* The Charter Co.), 876 F.2d 866 (11th Cir. 1989), *cert. dismissed*, 110 S. Ct. 3232 (1990); *In re* American Reserve Corp., 840 F.2d 487 (7th Cir. 1988).

[176] *See* Warren, *supra* note 175, at 794:

> In effect, these creditors often depend either on the debtor or on creditors with larger claims to make the filing decision—even when the small-claim creditors would gain from a bankruptcy resolution. Some other creditors may have enough at stake to make it worthwhile for them to institute an involuntary filing, but they will not file if they lack the information to make a rational decision. They too may rely on the filing either of the debtor or of other creditors with superior information. The rub, of course, is that small or uninformed creditors must rely on parties who may be able to profit more (legally or otherwise) outside bankruptcy and who are disinclined to lead the debtor into bankruptcy.

[177] *See* FED. R. CIV. P. 11.

bankruptcy court,[178] creditors will have access to virtually all information about the debtor's financial affairs, both through the examination process[179] and through the trustee in bankruptcy who is appointed in all liquidation cases[180] (and who, for cause, may be appointed in a reorganization case)[181] in order, among other things, to investigate the debtor's financial affairs.[182]

But the informational disadvantages that creditors face before a bankruptcy case has been commenced clearly outweigh the advantages they enjoy after the case is brought.[183] Congress sought to encourage creditors to bring involuntary cases, but it also feared the unwarranted filing of involuntary petitions. To prevent the filing of an involuntary petition against financially sound debtors, the Bankruptcy Code permits courts to require creditors to compensate debtors for all out-of-pocket expenses incurred in successfully defending an involuntary petition, as well as additional damages if they can show that the petitioning creditors acted in bad faith.[184] The threat of a sanction that creditors are certain to face if an involuntary petition is dismissed for any reason, and the possibility of actual and punitive

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[178] Even before an order for relief is entered, petitioning creditors have access to information about an involuntary debtor's financial affairs. Fed. R. Bankr. P. 1003 requires a debtor who contests an involuntary petition on the grounds that too few creditors have joined in the petition because it owes twelve or more creditors to "file with the answer a list of all creditors with their addresses, a brief statement of the nature of their claims, and the amounts thereof." Moreover, Fed. R. Bankr. P. 1018 generally applies the federal rules of discovery to proceedings related to a contested involuntary petition. *See* Rubin v. Belo Broadcasting Corp., (*In re* Rubin), 769 F.2d 611 (9th Cir. 1985) (due to lower court's failure to use less drastic measures, court of appeals reversed bankruptcy court's entry of order for relief as sanction for involuntary debtor's failure to cooperate with petitioning creditors' discovery requests, but generally upheld bankruptcy court's jurisdiction to impose discovery sanctions against involuntary debtor during gap period between filing of petition and entry of order of relief). Until the Bankruptcy Rules were amended in 1983, the applicability of normal pretrial discovery to contested involuntary petitions was unclear. *See* 1 HARVEY R. MILLER & MICHAEL L. COOK, A PRACTICAL GUIDE TO THE BANKRUPTCY REFORM ACT 81-82 (1984 Supp.).

[179] *See* 11 U.S.C. § 341; FED. R. BANKR. P. 2004.

[180] 11 U.S.C. §§ 701, 702.

[181] *Id.* § 1104.

[182] *Id.* §§ 704, 1106.

[183] *See, e.g.*, 2 COLLIER ON BANKRUPTCY, *supra* note 23, ¶ 303.30 ("Discovery may be conducted before trial of the involuntary case by any of the parties in the case . . . . Nevertheless, considering that petitioning creditors risk a damage claim by the debtor pursuant to section 303(i), creditors will generally avoid filing involuntary cases without having sufficient information to state a cause of action in the petition.").

[184] 11 U.S.C. § 303(i). *See* text accompanying notes 131-38 *supra*.

damages should the court question their motives in filing, undoubtedly chills creditors from filing involuntary petitions based upon even well-founded suspicion.[185]

By contrast, creditors are able to establish the second standard for commencement of an involuntary case—the appointment of a custodian or the custodian's possession of the debtor's property—by referring to publicly available information, since the appointment of an assignee for the benefit of creditors or an equitable receiver generally is a matter of public record. Moreover, the appointment is good circumstantial evidence that the debtor is unable to pay its debts as they come due. By virtue of the applicable standards, commencement of an assignment for the benefit of creditors[186] or receivership,[187] often is indicative of the debtor's inability to pay debts as they come due. Moreover, in either event, the custodian is likely to freeze payments to creditors pending resolution of the equitable basis for the appointment, and may have been appointed to supervise the liquidation of all or some of the debtor's assets. Indeed, Congress implicitly recognized this justification when it explained, in legislative history, that creditors who wait more than 120 days past such an appointment should have little difficulty in establishing a debtor's general default from proof that a custodian has been in possession for more than 120 days.[188]

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[185] *See e.g.*, MILLER & COOK, *supra* note 178, at 83 (advising counsel for petitioning creditors to "insist upon reliable factual information before filing petition"); LoPucki, *supra* note 10, at 353 (same); Warren, *supra* note 175, at 795 ("But the Code also exacerbates the inaccessibility of bankruptcy by imposing stiff penalties for wrongful involuntary filings, thus discouraging creditors from filing unless they are very certain that their choice to file will be upheld in court.").

[186] *See, e.g.*, ARIZ. REV. STAT. ANN. § 44-1031 (1989); FLA. STAT. ANN. § 727.104 (West 1990). *But see, e.g.*, ARK. CODE ANN. §§ 16-117-401 to -407 (Michie 1987) (no mention of requirement of allegation of balance sheet or equitable insolvency as prerequisite to assignment for benefit of creditors); CAL. CIV. PROC. CODE § 493-010 (West 1979 & Supp. 1991) (same); D.C. CODE ANN. § 28-2101 (1991) (same); GA. CODE ANN. §§ 28-301 to -320 (Harrison 1980 & Supp. 1988) (same); MO. ANN. STAT. §§ 426.010 to .410 (Vernon 1952 & Supp. 1991) (same); N.J. STAT. ANN. §§ 2A: 19-1 to -50 (West 1987 & Supp. 1991) (same).

[187] *See* MacLachlan, *Aspects of the Chandler Bill*, *supra* note 58, at 367 nn.82-83:

> A creditor praying for a receivership must show that he will probably suffer irreparable injury if the relief is not granted . . . . Insolvency is neither per se ground for receivership nor is it an indispensable circumstance . . . . But where a debtor is unable to pay his debts as they mature, a court of equity will in a proper case assume control of his property.

[188] H.R. REP. No. 595, *supra* note 44, at 324; S. REP. No. 989, *supra* note 44, at 34.

A peculiar thing about this second ground is that Congress did not include other types of external evidence of a debtor's financial difficulties as alternate grounds for the commencement of an involuntary case. Why shouldn't creditors be able to assert a corporate or partnership debtor's commencement of dissolution proceedings, or a business debtor's cessation of operations with debts unpaid,[189] or an individual debtor's unexplained disappearance,[190] as grounds for commencement of an involuntary bankruptcy case? Why shouldn't creditors be able to force a debtor into bankruptcy if the debtor has admitted its inability to pay debts as they come due?[191]

The standard is also strangely limited to the 120 days after appointment of a custodian. Why shouldn't creditors be able to assert the appointment of an equitable receivership as the basis for an involuntary bankruptcy case, even if the appointment occurred 121, rather than 120, days before the filing of the petition?[192] Congress's remark in legislative history that creditors should easily be able to prove a debtor's general failure to pay debts as they come due[193] is unpersuasive, since the burden of proving a debtor's general default is much greater than proving the appointment of a custodian. By setting this arbitrary deadline, Congress may have presumed that appointments which persist in excess of 120 days are in the best interests of the debtor

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See note 123 *supra.*

[189] MacLachlan referred to this as "stoppage of payments" and recommended that a "stoppage of payments" constitute a rebuttable presumption of a debtor's inability to pay debts as they accrue. MACLACHLAN, *supra* note 24, § 68, at 59-60.

[190] MacLachlan described a debtor's "unexplained disappearance" as "absconding" and recommended that absconding constitute a rebuttable presumption of the debtor's inability to pay debts as they come due. *Id.*

[191] Under the former Bankruptcy Act, the debtor's admission in writing of its inability to pay debts as they came due and its willingness to be adjudicated a bankrupt constituted an act of bankruptcy. *See* text accompanying note 42 *supra.* MacLachlan recommended the retention of this act of bankruptcy, although he generally disfavored the acts of bankruptcy as the standard for bringing an involuntary case. *See* MACLACHLAN, *supra* note 24, § 67, at 58-59.

[192] Some have argued that the 120 day limitation reflects a federal deference, on comity grounds, to the state law remedies of equitable receivership and assignment for the benefit of creditors. *See, e.g.*, BAIRD & JACKSON, *supra* note 40, at 1298-1301. But the Act had provided that the appointment of an equitable receiver or an assignee for the benefit of creditors constituted an act of bankruptcy, without reference to the time between the appointment and the filing of the involuntary petition. *See* text accompanying notes 40-41 *supra.*

[193] *See* note 188 and accompanying text *supra.*

and its creditors, and that the debtor should accordingly be insulated from an involuntary petition. This blanket presumption seems an unwarranted shifting of the burden of proof, however, since a party requesting abstention from an involuntary case under section 305 otherwise would bear the burden of proving that the case contradicts the group's best interests.[194]

B. *Preferences for Non-Judicial Resolutions*

Creditors may decide not to force their debtor into bankruptcy for reasons other than that they are unable to gain access to the information necessary to establish that their debtor "generally is not paying [its] debts as [they] come due."[195] Creditors may decide not to file an involuntary petition because, for one reason or another, they prefer not to seek the aid of the courts in collecting the debtor's unpaid debt. General creditors need not, and often do not, seek the aid of the courts and their officers to coerce repayment of delinquent debts. Debtors may be persuaded to pay simply by force of moral suasion or use of the forceful negotiating leverage creditors can marshall.

Creditors may prefer not to pursue their coercive collection remedies because they stand to gain little from litigation with the debtor. Because all coercive remedies involve repayment from the proceeds of the forced sale of unencumbered, nonexempt property, creditors may determine that coercion would be fruitless because their debtor's assets are mostly exempt or subject to liens.[196]

Even when creditors are able to identify nonexempt, unencumbered assets, they may be reluctant to rely on repayment from the receipts of a forced sale of these assets. Repayment from the proceeds of a forced sale will be a less efficient and effective collection device than a method that relies on repayment out of liquid funds, because forced sales of assets generally result in a loss of value.[197] There generally is no ready market

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[194] 11 U.S.C. § 305. *See* text accompanying notes 152-55 *supra*.

[195] 11 U.S.C. § 303(h)(1).

[196] While only individual debtors enjoy the benefit of state and federal exemption laws, *Id.* § 522(b)(2)(A), even a nonindividual debtor may grant a blanket lien against the bulk of its assets. *See, e.g.*, U.C.C. §§ 9-110, -111, -203.

[197] Whitford, *supra* note 166, at 1060, 1097.

for used goods, especially consumer goods.[198] Even if a market were to exist, debtors lose value in a forced sale of their assets since it often is more expensive for a debtor to replace used goods than to continue to use them.[199] And forced sales never compensate an individual debtor for lost sentimental value, or a business debtor for lost idiosyncratic value, that may be associated with an asset.[200] In addition, forced sales generally bring lower prices than voluntary sales.[201] Because the debtor has no choice but to sell, bidders can make lowball offers knowing that the debtor cannot take the goods out of the market and wait for a higher bid. Nor can the debtor counteract this effect by ensuring that there exists competition among the bidders since a debtor generally has no control over the terms or conditions of the execution sale. Indeed, execution sales nearly always cause a loss of the going concern value of a debtor's assets[202] because levying sheriffs generally are required either to take physical possession of the debtor's property, or to render it unusable, thus ensuring the cessation of a debtor's business.[203] All of these factors mean that creditors generally should prefer voluntary repayment to a coerced collection action unless the coercive remedy is against liquid assets, such as often is the case in the state

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[198] *Id.* at 1060.

[199] Leff, *supra* note 166, at 12-14; Whitford, *supra* note 166, at 1060, 1097.

[200] Leff, *supra* note 166, at 12-14; Whitford, *supra* note 166, at 1060, 1097.

[201] Whitford, *supra* note 166, at 1060, 1097.

[202] Going concern value is simply the value that a collection of assets would have if sold together as a group, rather than one at a time. A collection of assets often is more valuable if sold together than if sold piecemeal. Of course, the existence of going concern value isn't limited to business debtors. An individual debtor's assets may be more valuable if sold together than one at a time if the debtor is a collector, for example. Moreover, not all business debtors have going concern value to preserve. For example, a business debtor's assets may be more valuable if sold one at a time, rather than as a whole, if there is little or no goodwill value to be added to the aggregate of the assets.

[203] *See, e.g.*, CAL. CIV. PROC. CODE § 700.030 (West 1987) ("[T]o levy upon tangible personal property in the possession or under the control of the judgment debtor, the levying officer shall take the property into custody."); N.J. STAT. ANN. § 2A:26-12 (West 1987) ("Personal property of a defendant attached as provided by this chapter shall remain in the safekeeping of the attaching officer to answer and abide the judgment of the court."); N.Y. CIV. PRAC. L. & R. 5232(b) (McKinney 1978 & Supp. 1991) ("The sheriff shall levy upon any interest of the judgment debtor in personal property capable of delivery by taking the property into his custody . . . ."). *See also* Knapp v. McFarland, 462 F.2d 935 (2d Cir. 1972) (stating generally that, when judgment debtor's property is capable of delivery, sheriff ordinarily is obligated to levy by taking property into custody). *See generally* LoPucki, *supra* note 10, at 317.

collection remedy of garnishment.[204]

Moreover, creditors of an individual debtor rarely have anything to gain from the commencement of an involuntary bankruptcy case because the filing of a petition is a particularly ineffective means of coercing repayment of an individual debtor's obligations.[205] As under state law, only the proceeds from the forced sale of unencumbered, nonexempt assets are available for distribution from a bankruptcy estate.[206] Because most individuals own few nonexempt assets, creditors are most likely to be repaid from an individual debtor's wages. But the filing of an involuntary petition forecloses repayment from an individual debtor's earnings, since an individual debtor's post-petition wages are not included among the "property of the estate" distributed to general creditors.[207] In addition, most individuals receive a discharge from any indebtedness that remains unpaid after the close of the bankruptcy case.[208] The discharge acts as a

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[204] *See* Leff, *supra* note 166, at 14; Whitford, *supra* note 166, at 1054.

[205] *See* Leff, *supra* note 166, at 5-18; Whitford, *supra* note 166, at 1049-71, 1100-05. Nonetheless, creditors might determine to file an involuntary petition against an individual debtor whom they suspected of engaging in fraudulent activities or other misconduct. A trustee is automatically appointed upon the commencement of a liquidation case, and trustees in bankruptcy are well-equipped to investigate and remedy a debtor's fraudulent conduct. 11 U.S.C. §§ 548, 704. Moreover, creditors may succeed in objecting to the debtor's discharge, or excepting their debts from the debtor's general discharge. *See* 11 U.S.C. §§ 523, 727.

[206] 11 U.S.C. §§ 541, 726.

[207] *Id.* § 541(a)(6).

[208] *Id.* § 524. *But see id.* §§ 523, 727. Although only individual debtors receive a discharge in a chapter 7 liquidation case, *id.* § 727(a)(1), even corporate and partnership debtors-in- possession receive a discharge upon confirmation of most sorts of chapter 11 reorganization plans. *Compare id.* § 727(a)(1) *with id.* § 1141(d). Only when a chapter 11 debtor-in-possession (i) liquidates all or substantially all of its property pursuant to a plan of reorganization, (ii) does not engage in business after consummation of the plan, and (iii) would be denied a discharge in a chapter 7 liquidation case (which would be true in the case of every debtor that is not an individual) will confirmation of a chapter 11 plan *not* result in discharge. *Id.* § 1141(d)(3). Moreover, although a discharge generally only applies to debts owed by the debtor, *id.* § 524(e), the principals of a business debtor may be able to structure the plan of reorganization so that they will be discharged from their secondary liability on the company's liability. *Compare, e.g.*, Republic Supply Co. v. Shoaf, 815 F.2d 1046 (5th Cir. 1987) *with, e.g.*, Underhill v. Royal, 769 F.2d 1426 (9th Cir. 1985), *rev'd on other grounds by*, 58 U.S.L.W. 4210 (1991); Union Carbide v. Newboles, 686 F.2d 593 (7th Cir. 1982). In other proper circumstances, the bankruptcy court may enjoin creditors from proceeding against certain nondebtor entities. *See, e.g.*, American Hardwoods, Inc. v. Deutsche Credit Corp., (*In re* American Hardwoods, Inc.), 885 F.2d 621 (9th Cir. 1989); Menard-Sanford v. Mabey (*In re* A.H. Robins, Inc.), 880 F.2d 694 (4th Cir.), *cert. denied*, 110 S. Ct. 376 (1989); MacArthur Co. v. Johns-Manville

further injunction against collection on pre-petition claims.[209]

Creditors' preference for extralegal solutions to the debtor's nonpayment also follows from the simple fact that there often is little to lose from pursuit of nonjudicial collection efforts. It is cheaper and easier to collect a debt by dunning the debtor with telephone calls and letters than to sue the debtor in court.[210] And, in some cases, creditors may write off the bad debt as a loss and take the tax deduction rather than litigate the claim in the hope of collecting a small portion of its entirety.[211]

Moreover, the threat of coercive collection remedies can be far more effective than implementation of the remedies themselves. All litigation involves the risk that the defendant will be successful in defending the suit.[212] Litigation against a debtor with financial difficulties is almost certain to net less-than-full recovery. This uncertainty provides creditors with a forceful incentive to encourage a debtor's repayment of unpaid debts without resorting to court-sanctioned collection remedies, and to settle any law suits that are brought.

Perhaps more than the creditors who pursue their individual collection remedies, debtors also suffer from the loss of value that inevitably results from pursuit of the state law remedies of attachment, levy and garnishment.[213] Attachment can close down a debtor's business or render an individual virtually penniless. Creditors know this and often threaten to pursue these remedies solely to intimidate the debtor into payment.[214]

This reliance on strong-arm negotiation tactics[215] will in-

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Corp. (*In re* Johns-Manville Corp.), 837 F.2d 89 (2d Cir.), *cert. denied*, 488 U.S. 868 (1988).

[209] 11 U.S.C. § 524(a)(2).

[210] *See* Leff, *supra* note 166, at 8; Whitford, *supra* note 166, at 1053, 1097.

[211] *See* I.R.C. § 166 (1988).

[212] *See, e.g.*, Leff, *supra* note 166, at 9, 10-11; Whitford, *supra* note 166, at 1055.

[213] *See* Leff, *supra* note 166, at 14-18; Whitford, *supra* note 166, at 1054, 1058-60, 1096-99.

[214] *See* Leff, *supra* note 166, at 17-18; LoPucki, *supra* note 10, at 355; Whitford, *supra* note 166, at 1098-99.

[215] Not all negotiated resolutions of a debtor's financial distress involve "strong-arm" tactics. Debtors frequently request, and their lenders often acquiesce, in an amicable resolution of such difficulties. *See, e.g.*, Greenfield, *supra* note 40, at 138-40; Daniel M. Morris, *Eight Steps to a Successful Workout*, BUS. CREDIT, Mar. 1988, at 20. Moreover, professional credit counselors and workout specialists exist to help the parties reach a negotiated repayment plan. Creditors may request or insist on the participation of a credit counsellor or workout specialist. *See, e.g.*, Gary J. Sbona & William R.

crease if the debtor's assets are protected from the reach of unsecured creditors. If an individual debtor's most valuable assets are exempt or held as entireties property, or if either an individual or business debtor has granted a blanket lien against its most valuable assets, a general unsecured creditor will have little to gain from court-sanctioned methods of collection, including the filing of an involuntary bankruptcy petition.[216] Threats are all that it has to coerce repayment.[217]

In addition, forceful requests may be all that a creditor needs to persuade the debtor to repay. Studies show that a common cause for the delinquency of an individual debtor is a temporary interruption in disposable income, either as a result of the loss of a job or the occurrence of an unusual major expense.[218] Although there is no single empirical explanation for

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Krehbiel, *Creditor-Supported Workouts*, BUS. CREDIT, Mar. 1988, at 48. In the case of individual debtors, however, some state legislatures view creditor involvement with credit counselors as potentially subject to abuse and collusion and have regulated the area. *See* Ferguson v. Skrupa, 372 U.S. 726, 727 (1963) (upholding constitutionality of Kansas statute making it a misdemeanor for any person to engage "in the business of debt adjusting" except as an incident to "the lawful practice of law in this state" and reviewing other states' prohibition and regulation of credit counselling or debt-pooling). *See generally* KING & COOK, *supra* note 40, at 591-99.

[216] *See* text accompanying note 196 *supra*.

[217] Aware of the frequency with which creditors rely on informal methods to force repayment of delinquent obligations, Congress and other federal administrative agencies restrict these practices. *See* 11 U.S.C. § 522(f)(2) (permitting individual debtors to avoid nonpossessory nonpurchase money liens against certain exempt property; 15 U.S.C. §§ 1692-1692o (1988) (Fair Debt Collection Practices Act); 16 C.F.R. § 444.2(a)(4) (1991) (taking of nonpossessory nonpurchase money liens against "household goods" is unfair trade practice under Federal Trade Commission Act).

[218] *See, e.g.*, DAVID CAPLOVITZ & ERIC SINGLE, CONSUMERS IN TROUBLE: A STUDY OF DEBTORS IN DEFAULT 49-55, 57-64 (1974); COMPTROLLER GENERAL OF THE UNITED STATES, BANKRUPTCY REFORM ACT OF 1978: A BEFORE AND AFTER LOOK, REPORT TO THE CHAIRMAN, COMMITTEE ON THE JUDICIARY, HOUSE OF REPRESENTATIVES (1984); V THE NATIONAL COMMISSION ON CONSUMER FINANCE, TECHNICAL STUDIES 6-9 (1973); DAVID T. STANLEY & MARJORIE GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM 47-49 (1971); SULLIVAN ET AL., *supra* note 7, at 98-104. Of course, there a number of other variables that may foreshadow personal bankruptcy. *See, e.g.*, Vincent P. Apilado et al., *Personal Bankruptcies*, 7 J. LEG. STUD. 371 (1978); Ramona K.Z. Heck, *An Econometric Analysis of Interstate Differences in Non-Business Bankruptcy and Chapter Thirteen Rates*, 15 J. CONSUMER AFF. 13 (1981); Peterson & Aoki, *Bankruptcy Filings Before and After Implementation of the Bankruptcy Reform Law*, 36 J. ECON. & BUS. 95 (1984); Lawrence Shepard, *Accounting for the Rise in Consumer Bankruptcy Rates in the United States: A Preliminary Analysis of Aggregate Data (1945 -1981)*, 18 J. CONSUMER AFF. 213 (1984); Lawrence Shepard, *Personal Failures and the Bankruptcy Reform Act of 1978*, 27 J.L. & ECON. 419 (1984); Aiden F. Shiers & Daniel P. Williamson, *Nonbusiness Bankruptcies and the Law: Some Empirical Results*, 21 J. CONSUMER AFF. 277 (1987); Sullivan, Per-

business failures,[219] seasonal cash flow problems presumably account for a fair percentage of business debtors' financial difficulties. If only some of a debtor's creditors press for payment, the debtor is likely to pay those few creditors who squawk until finances improve and all creditors can be paid in full on time. If all of the debtor's creditors are made aware that a short-term financial problem has caused the debtor's general delinquency, a sensible course of action for these creditors may simply be to negotiate a schedule for repayment and wait for the short-term difficulty to pass.

C. *Interest in Preservation of Long-Term Relationships*

Creditors' preferences for extrajudicial resolution of their payment disputes also may be explained by the relationships between debtors and creditors.[220] When a creditor and debtor enjoy a complex, uncertain or long-standing relationship,[221] the

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sonal Failures: Causes, Costs and Benefits (Monograph No. 24) (Credit Research Center, Purdue Univ. 1982).

[219] *See* note 170 *supra* (finance theorists' bankruptcy models involve multitude of predictive factors).

[220] My reference to the "relationships" between debtors and creditors as influential upon creditors' decisions to file an involuntary petition must be credited to the use of this and similar terms coined by Ian Macneil, Stewart Macaulay and other relational contracts theorists. *See generally* Stewart Macaulay: *An Empirical View of Contract*, 1985 WIS. L. REV. 465; *The Standardized Contracts of United States Automobile Manufacturers, in* 7 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW ch. 3-21, at 18-34 (1974); *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963). *See generally* IAN R. MACNEIL: THE NEW SOCIAL CONTRACT (1980); *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483; *Values in Contract: Internal and External*, 78 NW. U. L. REV. 340 (1983); *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947 (1982); *Economic Analysis of Contractual Relations: Its Shortfalls and The Need for a "Rich Classificatory Apparatus,"* 75 NW. U. L. REV. 1018 (1981); *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law*, 72 NW. U. L. REV. 854 (1978); *Elegant Models, Empirical Pictures, and the Complexities of Contract*, 11 LAW & SOC'Y REV. 507 (1977); *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691 (1974); *Restatement (Second) of Contracts and Presentiation*, 60 VA. L. REV. 589 (1974). *See also* William C. Whitford, *Ian Macneil's Contribution to Contracts Scholarship*, 1985 WIS. L. REV. 545, 546, 550 (reducing relational contract theory to two basic points: (i) that contracting takes place not at a single point in time but rather "emerges over time in the context of ongoing relationships"; and (ii) that parties to relational contract "frequently temper wealth maximization goals with other objectives.").

[221] *See* Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1091, 1092, 1099-1111 (1981):

> A contract is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such defini-

parties will tend to resolve their disputes through negotiation, mediation or some other informal dispute resolution mechanism, rather than through litigation.[222]

This preference for informal resolution of disputes involving relational contracts[223] should be just as strong, if not stronger, in the context of coerced repayment of delinquent obligations.[224] All collection remedies are likely to harm the profitability of the debtor's firm[225] and (except in involuntarily commenced chapter

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tive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance . . . . [L]ong-term contracts are more likely than short-term agreements to fit this conceptualization, but temporal extension per se is not the defining characteristic.

[222] *See, e.g.*, Macaulay, *An Empirical View of Contract*, *supra* note 220, at 467-68:

> Contract planning and contract law, at best, stand at the margin of important long-term continuing business relations. Business people often do not plan, exhibit great care in drafting contracts, pay much attention to those that lawyers carefully draft, or honor a legal approach to business relationships. There are business cultures defining the risks assumed in bargains, and what should be done when things go wrong. People perform disadvantageous contracts today because often this gains credit that they can draw on in the future. People often renegotiate deals that have turned out badly for one or both sides. They recognize a range of excuses much broader than those accepted in most legal systems.

See also, e.g., Whitford, *supra* note 220, at 550:

> Humans are social animals and their identities (that is, self-concepts relating to their character and place in society) are partly constituted by their relationships. Not all relationships are enjoyable, and at times the parties will prefer separation to a continued relationship. But if the relationship is an important one, termination will inevitably entail a partial change in identity . . . . [A]nd therefore is an event often carrying emotional costs well beyond the wealth costs of establishing a new career.

See also, e.g., Gidon Gottlieb, *Relationism: Legal Theory for a Relational Society*, 50 U. CHI. L. REV. 567, 568. 598-99, 603-05, 607, 611 (1983). *See generally* MACNEIL, THE NEW SOCIAL CONTRACT, *supra* note 220, at 71-117; Macneil, *Contracts: Adjustment*, *supra* note 220, at 886-901; Macneil, *Efficient Breach of Contract*, *supra* note 220, at 957-69.

[223] *See* note 221 and accompanying text *supra*.

[224] *See, e.g.*, Addison Mueller, *Contract Remedies: Business Fact and Legal Fantasy*, 1967 WIS. L. REV. 833, 836:

> You will search the cases in vain for many suits involving institutionalized relationships; when you do find them, they are apt to have arisen in bankruptcy. The cases that are to be found generally involve 'one shot' deals — situations where the breaching party did not fear loss of goodwill and, in addition, the settlement offer was too small to be tolerated or feelings were too aroused to permit settlement on any basis.

[225] *See, e.g.*, Sutton & Callahan, *The Stigma of Bankruptcy: Spoiled Organizational Image and Its Management*, 30 ACAD. MGMT. J. 405 (1987).

11 cases) often result, at least by the conclusion of the proceeding, in the cessation of the business.[226] Moreover, these remedies are likely to impact upon an individual's earning capacity. Thus a creditor with a long-term, or otherwise important, relationship with the debtor, contractual or otherwise, is less likely to coerce repayment through a collective rather than an individual remedy, and is less likely to coerce repayment through a court-sanctioned collection remedy than through negotiation.

While creditor inhibitions may disappear as the creditor determines that the debtor's earning capacity is no longer viable, the relationship between a creditor and debtor may cause the creditor to delay bringing a collective proceeding until the debtor's financial failure is certain, rather than feared. Moreover, if a relational contract extends not only between the creditor and a failing debtor, but also among the creditor and other entities related financially to the failing debtor, the creditor may decide that avoiding the harmful effect that the collective action could have on its relationship with the related entities is more important than collection of its obligation.

Finally, if a relational creditor[227] determines that the debtor should file a reorganization petition in order to preserve its business or financial affairs, the relational creditor may be in a position to prevail upon the debtor to initiate its own reorganization case, rather than force the debtor into reorganization by filing an involuntary petition. To compound this preference for out-of-court workouts, not only may the relational creditor be reluctant to disrupt the relationship by commencing a collection remedy, but also the debtor may be motivated to preserve important relationships by preventing the default in the first place and "working out" any default or dispute that does arise with the relational creditor.[228] "Working things out" can mean preferen-

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[226] *See* text accompanying notes 202-03 *supra*. Macaulay makes a similar point with regard to contract law generally when he notes that: "There are relatively few contracts cases litigated, and . . . . [w]hen final judgments are won, often they cannot be executed because of insolvency." Macaulay, *An Empirical View of Contract*, *supra* note 220, at 468.

[227] By "relational creditor" I mean a creditor who is a party to a relational contract. *See* note 221 *supra*.

[228] *See, e.g.*, Macaulay, *An Empirical View of Contract*, *supra* note 220, at 469 ("Power, exploitation, and dependence also are significant. Continuing relationships are not necessarily nice. The value of arrangements locks some people into dependent positions . . . . Seemingly independent actors may have little real freedom and discretion in

tially paying the creditor, granting additional encumbrances to the creditor's favor, or providing it with nonpecuniary insolvency protections, such as a long-term contract that the debtor can assume in the event a bankruptcy filing occurs.[229]

III. Some Proposed Reforms

Congress intended for petitioning creditors to be able to prove the standard for commencement of an involuntary case with the sorts of evidence available to the general public, to discourage creditors from filing involuntary petitions in bad faith, and to promote a negotiated resolution of a debtor's financial difficulties. The current standard falls short of realizing these goals and could be improved. First, the 1984 amendment to section 303(h) should be repealed, although the companion amendment to section 303(b) should be retained. In addition, creditors' grounds for commencement of an involuntary case should be expanded to include external indicators of the debtor's financial distress other than a debtor's general default and the appointment of a custodian for the debtor's property.[230]

A. *Repeal of the 1984 Amendment to Section 303(h)*

The current standard for commencement of an involuntary case excludes disputed debts from the calculation of whether the debtor is in general default if the debtor shows that its dispute involves either a genuine issue of material fact or a substantial question of law. Moreover, if the debtor can establish a bona fide dispute as to the claims of any of its petitioning creditors, those creditors will not have standing to file a petition and, unless sufficient additional creditors with standing can be convinced to join in the petition, an order for relief will not be entered. By requiring petitioning creditors to show both that their own claims are not subject to bona fide disputes raised by the debtor

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light of the costs of offending dominant parties.").

[229] *See, e.g.*, LoPucki, *supra* note 10, at 333-35.

[230] The proposed changes are intended neither to encourage creditors to file more involuntary petitions nor discourage creditors from forcing a debtor into bankruptcy. Instead, they recognize that the standard for commencement is only one factor considered by creditors when deciding how best to coerce repayment of an unpaid obligation, and that many creditors successfully collect delinquent debts without resort to the bankruptcy court or any other court.

and that the debtor has not raised bona fide disputes as to other creditors' claims (or at least as to enough other claims so that calculation of whether the debtor generally has failed to pay its debts as they come due is affected), Congress asks petitioning creditors to prove a standard that, in part, is based on information to which they generally will not have access.

The bona fide dispute part of the "general failure to pay" standard was added with the 1984 amendments to the Code to quell suspicions that creditors were filing involuntary petitions against their debtors solely to gain negotiating leverage in settlement discussions.[231] But this concern could be addressed simply with an initial inquiry into the bona fides of disputed obligations held by the petitioning creditors. In this way, the court would not be required to consider the merits, even in a summary fashion, of all the debtor's obligations, but only those three (or fewer) disputed liabilities claimed by creditors that join in an involuntary petition. Moreover, since petitioning creditors would only be required to prove that their own claims were not subject to the debtor's bona fide dispute, they are likely to have access to the information they need.

The standard for commencement of an involuntary bankruptcy case should minimize undue negotiating leverage. Under the current "bona fide dispute" standard financially distressed debtors may feel it is in their best interest to litigate disputed claims, rather than reach a negotiated resolution of the dispute, in order to support their claim that the dispute is bona fide should an involuntary petition later be commenced because courts are more likely to find that a bona fide dispute exists if litigation is pending.[232] In addition, the current standard may compel debtors to "pay off" all creditors whose claims they only partially dispute[233] because courts have tended not to find that a bona fide dispute exists for purposes of this standard when a debtor merely disputes the amount of debt rather than the fact of liability.[234] If courts were to scrutinize only the bona fides of a debtor's dispute of petitioners' claims, debtors would be less apt to rush to litigate or pay disputed claims because the tactical

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[231] 130 CONG. REC. 17,151 (1984) (statement of Sen. Baucus).

[232] *See* note 110 and accompanying text *supra*.

[233] Credit for this point is due to Professor Barry Zaretsky of Brooklyn Law School.

[234] *See* note 111 and accompanying text *supra*.

advantage of litigating the claim in a subsequent contest over an involuntary petition would be reduced.

B. *Adding To the Grounds for Involuntary Bankruptcy*

The standard for commencement of an involuntary bankruptcy case should be expanded. Creditors may have difficulty proving the "general failure to pay" standard because proof may require information to which creditors do not have access. Expanding upon the external indications of a debtor's financial distress is one easy solution to creditors' problems of proof. Thus, the 120 day limitation should be removed from section 303(h)(2). Unpaid debts that remain following (i) a corporate or partnership debtor's dissolution under state law, (ii) a business debtor's cessation of business, or (iii) an individual debtor's unexplained disappearance, should be added as rebuttable grounds for involuntary relief. In addition, a debtor's admitted inability to pay its debts as they come due should be rebuttable grounds for the commencement of an involuntary case.[235] Petitioning creditors' allegations of these external events could be rebutted by the involuntary debtor's proof that it is paying its debts as they come due.

Creditors' problems of proof also could be resolved by adding insolvency as a rebuttable grounds for bringing an involuntary bankruptcy case, providing insolvency is defined in a way that permits proof with reference to publicly available facts. As with the other proposed grounds for relief, petitioning creditors' proof of insolvency should be rebuttable by the debtor's proof of its general payment of debts as they come due.[236]

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[235] The former Bankruptcy Act permitted the commencement of an involuntary bankruptcy case based on a debtor's written admission of its inability to pay its debts as they came due and willingness to be adjudicated a bankrupt. *See* text accompanying note 42 *supra*. The requirement of a written admission seems unduly restrictive of a court's prerogative as a fact finder. The requirement that the debtor not only admit its inability to pay debts as they come due, but also waive in writing prior to the filing its right to contest a creditors' petition, seems only to provide a means for debtors with public filing requirements to fulfill their need to disclose material financial information (i.e., their inability to pay debts as they come due) without providing creditors the ammunition for an involuntary petition.

[236] Insolvency should constitute only rebuttable grounds for the commencement of an involuntary case. When an insolvent debtor is able to repay its obligations out of current earnings, creditors' interests are satisfied, without the need for involuntary bankruptcy, because these interests are triggered only after a debtor's default. Although the

The suggestion that other external indications of a debtor's financial difficulties be included among the criteria for commencement of an involuntary case is not a novel one. Treiman and MacLachlan made similar proposals long before enactment of the Code.[237] The foreign laws from which they drew support similarly permit the commencement of an involuntary bankruptcy case based upon proof of these sorts of events.[238]

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debtor is balance sheet insolvent, this insolvency does not present the need for any sort of collection remedy, whether individual or collective, because the debtor has not defaulted on its obligations. *See* LoPucki, *supra* note 10, at 325:

> [T]he desirability of continued operation does not depend upon the business being profitable or able to pay its debts as they become due; nor does it depend in any degree upon the amount of debt the business owes or the relationship between the amount of debt and the value of assets. Under some circumstances, it may be desireable to permit and encourage the continued operation of an insolvent, unprofitable business.

But see THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 200 (1986) (criticizing current "general failure to pay" standard because it does not permit commencement of bankruptcy case against insolvent debtor able to pay debts as they come due, and using Johns-Manville as example of insolvent debtor that was appropriate candidate for bankruptcy, although able to pay debts as they came due). Admittedly, adding insolvency as a rebuttable grounds for bringing an involuntary bankruptcy case merely shifts the burden of proving general default from creditors to the debtor. But the shift is appropriate, because debtors have access to the financial records necessary to establish their general payment whereas creditors often do not. *See* text accompanying notes 163-85 *supra*.

[237] MACLACHLAN, *supra* note 24, at 58-60 (recommending retention of general assignment for benefit of creditors, and admission of inability to pay debts coupled with declaration of willingness to be adjudged bankrupt, as conclusive grounds for commencement of involuntary case; recommending proof of absconding or general stoppage of payments as rebuttable grounds for commencement of involuntary case); Treiman, *supra* note 45, at 211-15 (recommending retention of assignment for benefit of creditors, unsatisfied liens obtained through legal proceedings, receiverships, recent admissions of inability to pay debts as they come due, and other conduct and events as presumptive of debtor's inability to pay debts as they come due).

[238] *See, e.g.*, Canadian Bankruptcy Act, R.S.C. §§ 24, 25 (permitting one or more creditors to file involuntary bankruptcy petition if (i) debt owed petitioner is $1,000 or more and (ii) if debtor has committed one of ten possible acts of bankruptcy within 6 months before filing; acts of bankruptcy defined as (1) assignment of property to trustee for benefit of creditors generally; (2) fraudulent conveyance; (3) fraudulent preference; (4) departure from, or remainder outside, boundaries of Canada, with intent to defeat or delay creditors; (5) "keeping to house" with intent to defeat or delay creditors; (6) assignment, removal, secretion or disposal of assets, with intent to defeat or delay creditors; (7) permitting execution under which property is seized to remain unsatisfied until within 4 days before date fixed for sale, or for 14 days after seizure by sheriff, or permitting sheriff to sell goods is satisfaction of judgment lien; (8) written admission of inability to pay debts as they come due; (9) notice to creditors of suspension of payments; (10) failure to meet liabilities generally as they come due) (current version at R.S.C. §§ 42, 43 (1985)).

On the other hand, the notion that insolvency should be among the standards for commencement of involuntary cases will undoubtedly be viewed, at first blush, as a jurisprudential step backward, since, in 1978, Congress abolished the "acts of bankruptcy" expressly because the "acts" often required elusive proof of a debtor's insolvency.[239] Nonetheless, insolvency should be added to the grounds for thrusting a debtor into bankruptcy because, if properly defined, in some cases it may actually be easier for creditors to prove a debtor's insolvency than its general default.

Generally speaking, balance sheet insolvency describes a debtor's internal financial condition that requires extensive examination and valuation to diagnose. A debtor's general failure to pay describes both an internal financial condition and its external manifestations.[240] Because a debtor's general failure to pay its debts as they come due is an external event, it should be easier for creditors to prove than the internal financial situation of insolvency it manifests. But creditors may be unable to gain access to information that would show by a preponderance of the evidence that a debtor has generally failed to pay its debts as they come due.[241] Moreover, a debtor's general cessation of payment is not the only way in which a debtor's financial distress manifests itself.[242] Thus the involuntary bankruptcy standard should permit creditors to commence a case upon proof of *any* external manifestation of the internal financial condition of insolvency.

This suggestion that insolvency be added to the grounds for commencement of an involuntary bankruptcy case depends upon being able to propose a definition of insolvency that is consistent with creditors' goals for involuntary bankruptcy. In addition, insolvency should be easy for creditors to establish on the basis of information that is publicly available or otherwise easily accessible.

Historically, balance sheet insolvency has been criticized as difficult to prove. Commentators criticized ambiguities in the statutory definition of the term under the former Bankruptcy

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[239] COMMISSION REPORT, *supra* note 4, at 14, 187-88.

[240] Treiman, *supra* note 45, at 211-15.

[241] *See* text accompanying notes 163-85 *supra*.

[242] *See* text accompanying notes 189-91 *supra*.

Act and the Uniform Fraudulent Conveyance Act:[243] What assets and liabilities were to be included in creating this hypothetical balance sheet comparison?[244] What assumptions were to be made about the conditions surrounding the hypothetical liquidation of the debtor's assets and payment of the debtor's liabilities?[245] Others generally criticized the difficulty of proving an internal financial condition based on creditors' limited access to financial records.[246]

With its enactment of the Code, Congress refined the definition of "insolvency" to clarify the types of assets and liabilities includible in the determination of whether a debtor's assets are sufficient to repay its liabilities.[247] Presently the Code defines "insolvent" as the financial condition that exists when "the sum of [the debtor's] debts is greater than all of [the debtor's] property, at fair valuation," excluding fraudulently transferred and exempt property.[248]

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[243] *See* text accompanying notes 50-55 *supra*.

[244] *See* text accompanying notes 49-55 *supra*.

[245] *See* text accompanying notes 49-55 *supra*.

[246] *See* text accompanying notes 49-55 *supra*.

[247] The Code still does not resolve the assumptions a court is to make in valuing a debtor's assets and liabilities. The Code states only that a debtor's assets are to be measured "at a fair valuation," 11 U.S.C. § 101(31), the same standard as under the former Act. *See* text accompanying notes 51-52 *supra*. The Code provides a single definition of insolvency applicable to several very different circumstances—to determine when the debtor's payment of antecedent debts is preferential, *see* 11 U.S.C. § 547(b)(3), (f), when transfers by the debtor are constructively fraudulent to its creditors, *see id.* § 548(a)(2)(B)(i), and when the absolute priority rule should be enforced in a reorganization case because the debtor's equity interests are valueless, *see id.* § 1129(b)(2)(C). *See also* Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979). As a result, the Code's definition of insolvency still is difficult to apply because it does not tell the court how to measure the value of the debtor's assets and liabilities. Some methods of measuring the value of the debtor's assets and liabilities are more appropriate for certain circumstances than others, and if the Code were to prescribe a single measure for valuation, it could not provide a single definition of insolvency applicable throughout the Code. For example, a going concern valuation of the debtor's assets may be more appropriate when the court is seeking to determine whether the debtor's common stock should be deemed valueless in a reorganization plan due to the debtor's insolvency, *see* 11 U.S.C. § 1129(b)(2)(C), whereas a liquidation value may be more appropriate in determining whether a transfer by the debtor should be deemed constructively fraudulent either because it depleted the debtor's insolvent estate, or caused the solvent debtor to become insolvent, *see id.* § 548(a)(2)(B)(i).

[248] *Id.* § 101(31). When the debtor is a partnership, "insolvency" instead is defined as the financial condition that exists when "the sum of such partnership's debts is greater than the aggregate of . . . all of such partnership's property, exclusive of [fraudu-

The Uniform Fraudulent Transfer Act (UFTA)[249] improves somewhat on the Code's definition of insolvency.[250] Reminiscent of the Code,[251] the UFTA defines "insolvency" in terms of the financial condition of a debtor and provides that "[a] debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets."[252] The UFTA is, however, more specific than the Code about the types of assets and liabilities that should be counted on each side of a debtor/transferee's balance sheet. Like the Code, the UFTA excludes exempt[253] and fraudulently transferred assets.[254] The UFTA goes even further than the Code and excludes "property held in tenancy by the entireties to the extent it is not subject to process by a creditor holding a claim against only one tenant,"[255] and encumbered property,[256] from inclusion on the asset side of balance sheet insolvency.

In addition, the UFTA attempts to resolve creditors' evidentiary problems associated with proving a debtor's insolvency in ways that the Code does not. First, the UFTA provides that

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lently transferred property], and the sum of the excess of the value of each general partner's non-partnership property, exclusive of . . . [exempt and fraudulently transferred property], over such partner's non-partnership debts." *Id.* § 101(31)(B). When the debtor is a municipality, another definition of insolvency applies. *See id.* § 101(31)(C). And when an individual debtor resides in a state that recognizes community property rights, the definition of the asset side of the balance sheet, for purposes of determining the debtor's insolvency, will differ somewhat. *See id.* § 541(a)(2).

[249] 7A U.L.A. 639 (1985). *See generally* Michael L. Cook & Richard E. Mendales, *The Uniform Fraudulent Transfer Act: An Introductory Critique*, 62 AM. BANKR. L.J. 87 (1988); Frank R. Kennedy, *The Uniform Fraudulent Transfer Act*, 18 U.C.C. L.J. 195 (1986).

[250] Unlike the Code definition, the UFTA definition of insolvency relates only to the question of whether a transfer by the debtor should be deemed constructively fraudulent because it depleted an insolvent debtor's insolvent estate, or because it rendered a solvent debtor insolvent. UFTA § 5. Nonetheless, UFTA is no clearer than the Code in its standard of valuation. Like the Code, UFTA specifies only that a debtor's insolvency is to be calculated by comparing the debtor's debts to its assets "at a fair valuation." *Id.* § 2(a).

[251] 11 U.S.C. § 101(31)(A).

[252] UFTA § 2(a). *See also id.* § 2(b) (definition of insolvency as applied to partnership debtor).

[253] *Id.* § 1(2)(ii).

[254] *Id.* § 2(d).

[255] *Id.* § 1(2)(iii).

[256] *Id.* § 1(2)(i). UFTA broadly defines property as encumbered by a "lien" if subject, not only to consensual security interests, but also to involuntary liens such as judgment liens, execution liens and mechanics' liens. *Id.* § 1(8).

"[a] debtor who is generally not paying his [or her] debts as they become due is presumed to be insolvent."[257] It also effectively incorporates a presumption of insolvency upon proof that a debtor's assets are fully encumbered by excluding both encumbered assets[258] and secured liabilities[259] from the calculation of insolvency.

How should "insolvency" be defined under the Code if it were to be added to the grounds for commencement of an involuntary bankruptcy case? The current balance sheet definition of insolvency should be retained under the Code, with some refinements, including the improvements made to the definition under the UFTA. Specifically, all of the debtor's property that is subject to the state law remedy of execution should be included on the asset side of this balance sheet. Thus, exempt assets should be excluded,[260] as well as assets held by the debtor as a tenant by the entireties unless the debtor's interest in such property is subject to process by an individual, as distinct from a joint, creditor of the debtor under applicable nonbankruptcy law.[261] Assets fraudulently transferred to the debtor also should not be counted among the debtor's assets.[262] Similarly, assets that are subject to a valid lien[263] should also be excluded from this balance sheet[264] because general unsecured creditors can levy against only the debtor's equity in encumbered property.

To be fair, secured indebtedness,[265] indebtedness protected

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[257] *Id.* § 2(b).

[258] *Id.* § 1(2)(i).

[259] *Id.* § 2(e).

[260] *See* 11 U.S.C. § 101(31)(A)(ii) (exempt assets excluded from asset side of insolvency balance sheet); UFTA § 1(2)(ii) (definition of "asset" excludes exempt property). *See also id.* § 2 cmt. 1.

[261] *See id.* § 1(2)(iii) (definition of asset excludes "an interest in property held in tenancy by the entireties to the extent it is not subject to process by a creditor holding a claim against only one tenant"). *See also id.* § 2 cmt. 1.

[262] 11 U.S.C. § 101(31)(A)(i); UFTA § 2(d).

[263] The standard would also incorporate the UFTA's broad definition of "lien." *See id.* § 1(8). *See also* note 256 *supra*. As such, the proposed standard is reminiscent of the former third act of bankruptcy, which permitted commencement of an involuntary bankruptcy case upon proof that the debtor had allowed a judicial lien to remain unsatisfied for a period of time. *See* text accompanying note 39 *supra*. *See also* MACLACHLAN, *supra* note 24, at 60-62 (recommending that debtor's failure to satisfy judicial liens be retained as prima facie evidence of its general inability to pay debts as they come due).

[264] *See* UFTA § 1(2)(i) (definition of asset excludes property encumbered by valid lien). *See also id.* § 2 cmt. 1.

[265] "Secured indebtedness" should be as broadly defined as the term "lien." Thus it

by a valid waiver of exemption, and obligations jointly incurred by an individual debtor and his or her spouse should be excluded from the liability side of this balance sheet.[266] Contingent and unliquidated liabilities should be assigned liquidated present values based on reasonable predictions of the debtor's actual liability. Assets should be assigned a "fair valuation" by reference to an estimate of the proceeds that would be received in a hypothetical actual liquidation of the property.

This definition of insolvency addresses creditors' problem of proof because insolvency is defined in a way to permit creditors to establish their debtor's insolvency based upon readily available information. In practical result, the definition raises a rebuttable presumption of insolvency upon proof that all or substantially all of a debtor's assets are beyond the reach of its general unsecured creditors, either because the assets are subject to a blanket lien, held as a tenant by the entireties, or otherwise exempt, and that the debtor has unsecured liabilities.[267] Creditors should enjoy easy access to this information by reference to applicable laws relevant to exemptions and entireties property and by searching public filings.

One trouble with this definition is that it may make the standard for commencement of an involuntary case too easy to establish since many debtors have few nonexempt or unencumbered assets, but the proposed standard would protect against abusive petitions in two ways. First, the proposed standard provides only presumptive grounds for entry of an order for relief. Debtors would be able to rebut the showing of insolvency with proof of their general payment of debts as they come due, and should have easy access to this proof. Second, petitioning creditors would still be subject to the overarching requirement that they act in good faith when filing an involuntary petition.[268] Creditors who join in an involuntary petition grounded on a debtor's insolvency should in good faith believe that the debtor has failed to pay its current obligations as they mature, or suffer

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should include indebtedness secured both by voluntary and involuntary liens. *See* note 256 *supra*.

[266] *See* UFTA § 2(e); *id.* § 2 cmt. 5.

[267] Although such a presumption is not made explicit by the UFTA, its exclusion of exempt property, collateral and property held as a tenant by the entireties accomplishes the same result. *See id.* § 1(2).

[268] *See* notes 131-51 and accompanying text *supra*.

the sanctions that can follow from the filing of an involuntary petition in bad faith.[269] Finally, courts should strive to ensure that debtors who are successful in procuring a dismissal of an involuntary petition grounded on insolvency are compensated both for the costs incurred by them in fighting the petition and the losses caused by the filing.[270]

CONCLUSION

From July 1, 1987 to June 30, 1988, creditors filed 1,409 involuntary bankruptcy petitions against their debtors.[271] Whether this number is viewed as too small depends upon which of Congress's purposes in amending the statute governing involuntary bankruptcy is considered. The number might have been greater had Congress succeeded in its effort to make proof of the standard for commencement of an involuntary case dependent solely upon publicly available information. In addition, more creditors might have filed involuntary petitions had Congress sought to encourage creditors to file earlier in a debtor's financial crisis through a more effective means than liberalization of the standard for commencement, such as through a bounty system that rewards petitioning creditors for successfully obtaining the entry of an order for relief against their debtor.[272] By contrast, the number can be viewed as about right when considered in light of Congress's goal to encourage creditors to resolve a debtor's financial difficulties outside of bankruptcy when a nonbankruptcy solution can be accomplished more quickly, less expensively and with less disruption than would have occurred in an involuntary case.

The difficulty in assessing whether creditors file too few involuntary petitions is that two of these three goals are inconsistent. It is possible to streamline proof of the standard for com-

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[269] The possibility that an involuntary filing grounded on the debtor's insolvency would be filed in bad faith is strongest in the case of an individual debtor. However, absent fraud or the like, creditors have little rational reason to thrust an individual debtor into bankruptcy due to the Bankruptcy Code's policy to provide individuals with a "fresh start." *See* text accompanying notes 205-09 *supra*. Thus the presumption of a debtor's inability to pay debts as they mature from proof of insolvency perhaps should be applied only to nonindividual debtors.

[270] 11 U.S.C. § 303(i).

[271] *See* note 14 *supra*.

[272] *See* LoPucki, *supra* note 10, at 365.

mencement of an involuntary case and encourage creditors to file petitions earlier in a debtor's financial troubles, but realization of these goals is inconsistent with the notion that nonbankruptcy options should be exhausted before an involuntary petition is filed. It is possible to improve the standard for commencement and encourage creditors to reach a consensus about the debtor's difficulties, but accomplishing these goals may preclude efforts to encourage creditors to file earlier and more often in the face of a debtor's insolvency or default.

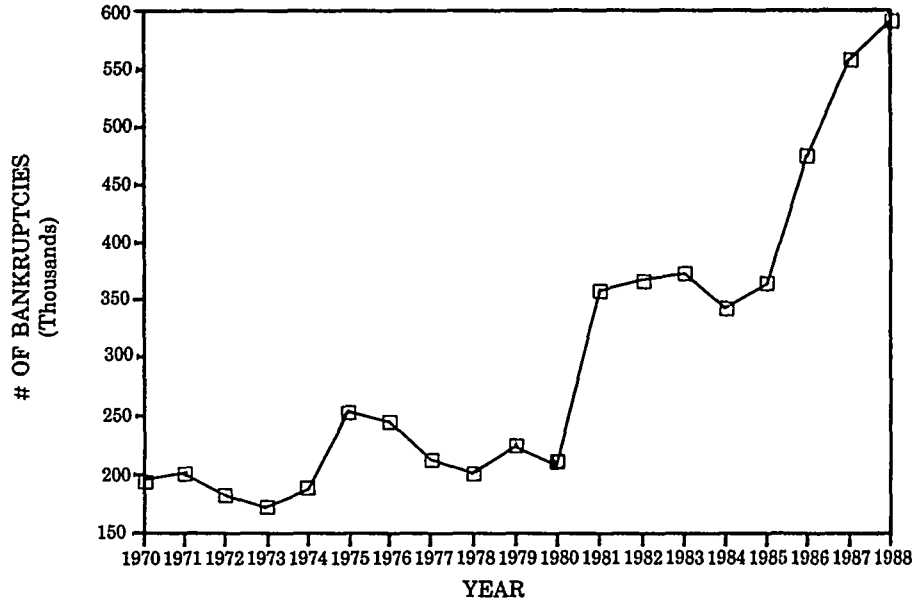
Creditors' preferences for resolution of their debtor's financial troubles without litigation are both strong and appropriate. As a result, it would be undesireable to change the statute governing commencement of an involuntary bankruptcy case to encourage creditors to shortcut these consensual efforts. Congress should seek to increase dividends to creditors from bankruptcy estates in some other way.

APPENDIX A

BANKRUPTCY STATISTICS TABLE 1970-88

Year	Total	Total Invol.	% Total	Chap. 7 Invol.	% Invol.	Chap. X, XI or 11 Invol.	% Invol.
1970	194399	1099	0.57%	1085	98.73%	13	1.18%
1971	201352	1234	0.61%	1215	98.46%	19	1.54%
1972	182869	1117	0.61%	1094	97.94%	23	2.06%
1973	173197	997	0.58%	985	98.80%	12	1.20%
1974	189513	1020	0.54%	1009	98.92%	11	1.08%
1975	254484	1286	0.51%	1266	98.44%	20	1.56%
1976	246549	1166	0.47%	1141	97.86%	25	2.14%
1977	214399	1142	0.53%	1132	99.12%	10	0.88%
1978	202951	1007	0.50%	995	98.81%	12	1.19%
Average	206634.78	1118.67		1102.44		16.11	
1979	226476	927	0.41%	915	98.71%	12	1.29%
1980	210364	936	0.44%	812	86.75%	121	12.93%
1981	360329	1331	0.37%	1169	87.83%	160	12.02%
1982	367866	1535	0.42%	1328	86.51%	207	13.49%
1983	374734	1670	0.45%	1400	83.83%	270	16.17%
1984	344275	1447	0.42%	1174	81.13%	272	18.80%
1985	364536	1597	0.44%	1285	80.46%	311	19.47%
1986	477856	1642	0.34%	1266	77.10%	376	22.90%
1987	561278	1620	0.29%	1283	79.20%	335	20.68%
1988	594567	1409	0.24%	1149	81.55%	260	18.45%
Average	388228.10	1411.40		1178.10		232.40	

TOTAL BANKRUPTCIES PER YEAR



INVOLUNTARY BANKRUPTCIES PER YEAR