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Involuntary Exposure – Do a Petitioning Creditor's Losses End in the Bankruptcy Court?

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Title 11 U.S.C. § 303 provides a powerful and unique tool for creditors. Under certain circumstances, creditors are empowered to force an individual or entity into bankruptcy. If an order for relief is entered and an alleged debtor becomes bound to a fate of court-supervised reorganization or liquidation, creditors may benefit from an involuntary petition. But what happens if the involuntary petition is dismissed?

Under § 303(i), the consequences of a failed involuntary bankruptcy case can be costly, if not punitive. Section 303(i) separates misdemeanors from felonies. For a petition dismissed where bad faith is not found, attorney's fees and costs may be awarded. § 303(i)(1). A petition dismissed with a finding of bad faith, however, can result in compensatory and punitive damages in addition to attorney's fees and costs. § 303(i)(2). The bridge to compensatory and punitive damages is narrow; a bad faith finding must be made by the bankruptcy court.

An involuntary petition is presumed to be filed in good faith. *In re Mi La Sul, 2007 BL 151747, 380 B.R. 546, 557 (Bankr. C.D. Cal. 2007); In re Molen Drilling Co., 68 B.R. 840, 843 (Bankr. D. Mont. 1987)*. To rebut the presumption of good faith, the debtor must demonstrate the existence of bad faith through an objective test (i.e., what a reasonable person would believe). *C & C Jewelry Mfg. v. Laxmi Jewel Inc. (In re C & C Jewelry Mfg.)*, 2010 BL 79818, 373 Fed. Appx. 775, 777 (9th Cir. 2010); citing *Jaffe v. Wavelength, Inc. (In re Wavelength, Inc.)*, 61 B.R. 614, 620 (9th Cir. B.A.P. 1986). Unless a debtor can rebut the presumption of good faith, the only recourse is attorney's fees and costs. Given the significant impact a bankruptcy filing has on the operations and finances of a debtor, a petitioning creditor who does not prevail on its involuntary petition may escape a failed involuntary bankruptcy for a relatively small price if it does not act in bad faith.

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But does potential liability for a failed involuntary bankruptcy petition end with the remedies set forth under § 303(i)? In the Ninth Circuit, the answer is ''yes.'' *Miles v. Okun (In re Miles)*, 430 F.3d 1083 (9th Cir. 2005). In the Third Circuit, however, the answer recently became ''no.'' *Rosenberg v. DVI Receivables XVII, LLC*, 2016 BL 280654, 835 F.3d 414 (3d Cir. Pa. Aug. 29, 2016.

In *Miles*, the U.S. Court of Appeals for the Ninth Circuit held § 303(i) provides the ''exclusive basis for awarding damages predicated upon the filing of an involuntary petition'' (otherwise known as ''complete preemption''). *Miles* at 1089. In effect, Section 303(i) preempts any non-bankruptcy law causes of action for harm caused by the filing of a bankruptcy petition. *Id.* at 1091. And even though non-alleged debtors lacked standing to pursue remedies under § 303(i), the Ninth Circuit finds ''it could not have gone unrecognized'' by Congress that third parties could be harmed by an involuntary bankruptcy petition. *Id.* at 1091. The Ninth Circuit concludes that Congress omitted a non-alleged debtors' right to seek damages under § 303(i) and that omission was intentional. *Id.* at 1091.

In *Rosenberg*, the U.S. Court of Appeals for the Third Circuit held § 303(i) does not preempt state law causes of action of non-debtors against petitioning creditors. *Rosenberg* at 9. Noting that there is a "presumption against preemption," the Third Circuit explains that field preemption (which is different from the complete preemption standard applied in *Miles*), requires "congressional intent that is clear and manifest." *Id.* at 11. The Third Circuit examined the text, structure and purpose of § 303(i) and found Congress was "silent" on any intent to preempt state law rights of aggrieved non-debtors harmed by the filing of an involuntary petition. *Id.* at 9. Quoting the Supreme Court in *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238, 251, 104 S. Ct. 615 (1984) the Third Circuit reiterates the importance of evidence of Congressional intent in the context of a preemption analysis: "[i]t is difficult to believe that Congress would, without comment, remove all means of judicial recourse for those injured by illegal conduct." *Id.* at 9. Unlike the *Miles* court, the *Rosenberg* court notes that when Congress passed § 303(i), it either "did not intend to disturb the existing framework of state law remedies for non-debtors or (more likely) was not thinking about non-debtor remedies. *Id.* at 9. This is where the dispute lies: did Congress intend to preempt state law when it enacted § 303(i) thereby eliminating rights of third parties to seek damages for a dismissed involuntary bankruptcy petition?

First, the issue of preemption. The Supreme Court has held that: "Congress did not intend for the Bankruptcy Code to pre-empt all state laws." *Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Prot.*, 474 U.S. 494, 505 (1986). In *Miles*, Ninth Circuit recognizes that the Bankruptcy Code does not provide field preemption over every matter that concerns a proceeding in bankruptcy. *Miles* at 1092. Field preemption occurs when a "field is reserved for federal regulation, leaving no room for state regulation" and "congressional intent to supersede state laws [is] clear and manifest." *Elassaad v. Indep. Air, Inc.*, 2010 BL 152491, 613 F.3d 119, 126 (3rd Cir. 2010), quoting *Holk v. Snapple Beverage Corp.*, 2009 BL 175208, 575 F.3d 329, 336 (3rd Cir. 2009). Complete preemption, on the other hand, confers original federal subject matter jurisdiction over a claim even where no federal cause of action is asserted. *In re U.S. Healthcare, Inc.*, 193 F.3d 151, 160 (3rd Cir. 1999). Complete preemption has only been found in three contexts: § 301 of the Labor Management Relations Act, § 502(a) of ERISA, and § § 85 and 86 of the National Bank Act. *New Jersey Carpenters & the Trustees Thereof*, 760 F.3d 297, 302 (3rd Cir. 2014).

Although there are differences between field preemption and complete preemption, one common thread exists: congressional intent. *See Rosenberg* at 11 and *U.S. Healthcare, Inc.* at 160. If the presumption is against preemption, the lack of intent to preempt state law rights suggests the Third Circuit is correct and state law causes of action are not preempted by § 303(i). Again, the Bankruptcy Code was not intended to preempt all state laws and there's no evidence of any Congressional intent to deprive non-debtor third parties of a right to pursue damages. In fact, even the *Miles* court admits the "Bankruptcy Code and its legislative history are silent on whether Congress intended 11 U.S.C. § 303(i) to provide the exclusive basis for awarding damages predicated upon the filing of an involuntary petition." *Miles* at 1089. If clear and manifest intent to supersede state law rights is not present, the presumption against preemption should apply. Otherwise, Congress removed any recourse for third parties harmed by conduct that may be negligent, intentional or outrageous and did so without comment. That seems unlikely. Should the Supreme Court be asked to decide the issue, it may side with the Third Circuit.

If *Miles* is overturned, an arsenal of remedies may be available in the Ninth Circuit for non-debtors damaged by an involuntary petition. In California, a corporation generally has standing to pursue harms against it. *See Nelson v. Anderson* (1999), 72 Cal. App. 4th 111, 126. If a corporation fails to seek relief for injury sustained by the corporation, the shareholders of the corporation may be able to pursue wrongs to a corporation in a derivative action. *Vega v. Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 297, 17 CR3d 26, 37. It is unclear if a failure of a debtor to pursue remedies under § 303(i) bars shareholders' claims in a derivative action. It is clear, however, only the debtor has standing to pursue remedies under § 303(i). Because only a debtor corporation may proceed under § 303(i), a shareholder derivative action is not necessarily preempted by § 303(i) based upon the *Rosenberg* decision.

Compensatory damages could be awarded to shareholders in a derivative action for harm suffered by a corporation as part of an involuntary bankruptcy case. For example, intentional interference with a contractual relationship is compensable. *Pacific Gas & Electric Co. v. Bear Stearns & Co.* (1990) 50 Cal.3d 1118, 1126 [270 Cal.Rptr. 1, 791 P.2d 587]. But unlike the arduous task of demonstrating bad faith under § 303(i), a shareholder need only prove the petitioning creditors knew that the interference with a contractual relationship was certain or substantially certain to occur as a result of their action. *Quelimane Co. v. Stewart Title Guaranty Co.* (1998) 19 Cal.4th 26, 56 [77 Cal. Rptr. 2d 709, 960 P.2d 513]. A similar standard applies for an award of damages for negligent interference with prospective business advantage. And neither of these causes of action requires a showing of bad faith. *Settimo Associates v. Environ Systems, Inc.* (1993) 14 Cal.App.4th 842, 845 [17 Cal.Rptr.2d 757].

What does a petitioning creditor expect to happen if a Chapter 7 involuntary petition is filed? It can be nothing less than liquidation of the debtor's assets and the closing of the corporation. Clearly a petitioning creditor knows, or should know, the filing of a Chapter 7 involuntary petition will interfere with existing contracts of the debtor and severe any prospective business relationships. If an involuntary Chapter 7 petition is dismissed, liability is fairly likely.

In the case of a Chapter 11 involuntary petition, the prospects of imminent loss of contracts and prospective business is not nearly as certain as is the case in a Chapter 7 involuntary bankruptcy. But a debtor still bears the brunt of additional costs to defend a Chapter 11 involuntary petition and must quell the jitters of vendors and customers concerned by the grim specter of insolvency. In most cases, business relationships will be irreparably tarnished or lost. Should the corporation not pursue remedies under § 303(i), a derivative action against the petitioning creditors could be pursued.

The spectrum of potential liability for a failed involuntary petition of an individual may be even broader. For instance, the plaintiffs in *Miles* sought damages for negligence, defamation, false light, abuse of process, intentional and negligent infliction of emotion distress, and negligent misrepresentation. *Miles* at 1086. None of

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these causes of action require a showing of bad faith (although several require a showing of intent). *See* California Civil Code § 1714(a), *Smith v. Maldonado* (1999) 72 Cal.App.4th 637, 645 [85 Cal.Rptr.2d 397]; *Hughes v. Pair* (2009) 46 Cal.4th 1035, 1050—1051 [95 Cal.Rptr.3d 636, 209 P.3d 963]; *Marlene F. v. Affýliated Psychiatric Medical Clinic, Inc.* (1989) 48 Cal.3d 583, 588 [257 Cal.Rptr. 98, 770 P.2d 278]; *Bily v. Arthur Young & Co.* (1992) 3 Cal.4th 370, 407—408 [11 Cal.Rptr.2d 51, 834 P.2d 745]. And there could be more causes of action that exist beyond those alleged by the *Miles* plaintiffs.

In the Ninth Circuit, creditors need only fear the debtor should an involuntary petition be dismissed. Should an involuntary petition be dismissed, a debtor is relegated to a recovery of attorney's fees and costs unless a showing of bad faith is made. If, however, *Rosenberg* is adopted by the Supreme Court, the door to an array of potential liability will open. The opening of that door could lead to the opening of a second door – a bankruptcy petition for the defeated petitioning creditor.