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2016 Guide to INVESTIGATIVE SERVICES

EARN MCLE CREDIT

BRAND PROTECTION
page 26

INVOLUNTARY BANKRUPTCY
page 32

On Direct: Ralph M. Terrazas
page 8

Surrogacy for Same-Sex Couples
page 12

PLUS

PATIENT DUMPING
page 20

Renewing our Mission

Los Angeles lawyer Margaret P. Stevens is the 2016-17 president of the Los Angeles County Bar Association
page 7

BY ASA S. HAMI

FORCING THE ISSUE

Section 303 of the Bankruptcy Code determines who may be subject to an involuntary bankruptcy

FILING bankruptcy is always an option for a financially distressed company. A wide array of reasons for seeking bankruptcy protection exists, including to stop an aggressive creditor from grabbing valuable assets, stay contentious litigation draining a company's finances, avoid an impending adverse judgment, or simply restructure crippling debt. Whatever the impetus for filing bankruptcy, it is a decision the distressed company usually makes voluntarily. However, the Bankruptcy Code also grants creditors the ability to commence a bankruptcy against a company through the filing of an involuntary bankruptcy petition under certain circumstances.[1] It is a powerful tool creditors may wield, albeit one that should be used sparingly.

Commencing an involuntary bankruptcy case is simple. Creditors file with the bankruptcy court a form that identifies the name of the entity against which the involuntary petition is being filed, the names of the parties filing the petition, the amount of the petitioners' claims against the entity, and the chapter under which they are filing the case—chapter 7 or 11 are the only two available for an involuntary case. The period between the date the petition is filed and the date the bankruptcy court enters an order for relief—an adjudication that the involuntary bankruptcy filing was appropriate—is known as the gap period.

Threshold Considerations

Parties contemplating an involuntary petition should consider two threshold issues before taking the step to file the petition: 1) whether the alleged debtor is eligible to be an involuntary debtor and 2) whether the petitioners

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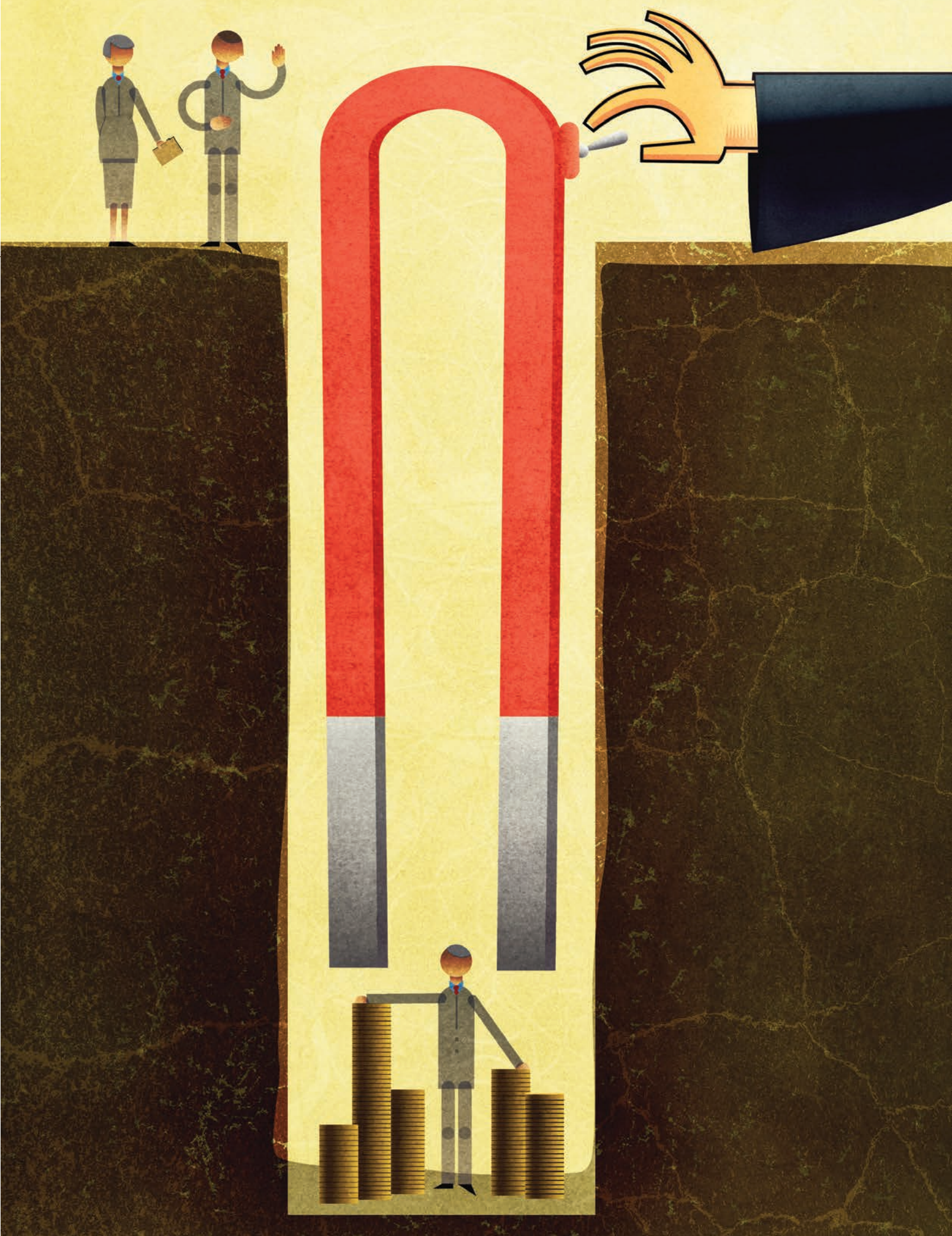


are eligible to file the petition. These issues will play a role in the bankruptcy court's determination whether to enter an order for relief or dismiss the case.[2]

Section 303(a) of the Bankruptcy Code governs the first threshold issue.[3] The universe of parties against whom an involuntary petition may be filed is narrower than those that may file a voluntary petition, but the class of potential involuntary debtors is still broad. With limited exception, an involuntary petition may be filed "against a person."[4] The code defines "person" expansively to include an "individual, partnership, and corporation."[5] Aside from farmers, the only "person" placed beyond the reach of an involuntary petition is "a corporation that is not a moneyed, business, or commercial corporation."[6] Courts construe this phrase to include eleemosynary or other nonprofit organizations.[7] Other exceptions not explicit in the code include: 1) a dissolved corporation (unless it still exists under state law for purposes of winding up its affairs)[8] and 2) individuals barred from filing bankruptcy based on the dismissal of a prior bankruptcy case.[9]

Section 303(b) governs the second threshold issue.[10] Who may be a petitioner varies from debtor to debtor. If the petition is filed against a corporation or individual, it could be filed by creditors holding noncontingent unsecured claims in the aggregate of $15,775[11] that are not subject to "bona fide" dispute.[12] If the entity has 12 or more creditors, the petition must be signed by at least three such creditors; if fewer than 12 creditors, the petition must be signed by at least one such creditor.[13] If the petition is filed against a partnership, it could be commenced by fewer than all of the general partners, or if all of the general partners are in bankruptcy, by a general partner, the trustee of the general partner, or a holder of a claim against the partnership.[14]

Prosecuting The Petition

Once the petition is filed, the case runs much like a conventional lawsuit during the gap period in the petitioners' pursuit of an order for relief. A summons is issued to, and served on, the alleged debtor together with the involuntary petition, and the debtor must file a response within 21 days after the summons is served (plus three additional days if the summons was served by mail). Its response could come in one of the following forms: 1) an answer to the petition that denies or admits the allegations in the petition and asserts affirmative defenses, 2) a motion under Rule 12(b) of the Federal Rules of Civil Procedure, or 3) the filing of a voluntary bankruptcy or motion to convert the case to a voluntary case (essentially consenting to the involuntary petition).

If the involuntary petition is not timely controverted, the bankruptcy court must enter an order for relief.[15] However, if the petition is opposed the court conducts an evidentiary hearing to determine whether an order for relief should be entered.[16] The court evaluates a number of issues in considering the petition. First, the court determines whether the "petitioning creditor" requirements are satisfied, to wit: whether the petitioners hold the amount and type of claims required under Section 303(b). Second, the court determines whether the alleged debtor should be in bankruptcy and particularly whether 1) "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 as to liability or amount," or 2) "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 purposes of enforcing a lien against such property, was appointed or took possession."[17] If the court finds in favor of the petitioners, the order for relief is entered, and the case progresses as would any voluntary bankruptcy case; if not, the bankruptcy case is dismissed.

Petitioners who prosecute an involuntary petition that results in the entry of an order for relief may seek a priority claim for attorney's fees and costs incurred commencing and prosecuting the involuntary petition.[18] The petitioners will need to establish that their efforts made a substantial contribution to the bankruptcy estate.[19] However, the petitioners' claim that qualified them to file the involuntary petition in the first place remains a general unsecured claim—with a lower payment priority—despite successful prosecution of the petition. On the flipside, petitioners could be held liable for the alleged debtor's fees and costs, or other damages, if the petition is dismissed.

Various types of pretrial remedies could be pursued during the gap period before the court adjudicates the petition. The alleged debtor could seek to compel the petitioners to post a bond pending entry of an order for relief.[20] The bond would serve to indemnify the alleged debtor for the potential damages the court may later award to it against the petitioners under Section 303(i) if the case ultimately is dismissed.[21]

The petitioners, in turn, could seek the appointment of an interim trustee during the gap period.[22] If the need is grave, such as when serious mismanagement of the debtor is ongoing or an imminent threat of harm to valuable assets is present, a motion to appoint an interim trustee could be filed concurrently with the involuntary petition. The ability to move for such relief is potent. Appointment of a trustee would transfer control over the alleged debtor's assets and operations to the trustee who essentially displaces current management. This relief is available whether the involuntary case is filed under chapter 7 or chapter 11, although the standards for appointment differ slightly between the two chapters.

Section 303(g) provides that, in a chapter 7 case, the court may appoint an interim trustee "if necessary to preserve the property of the estate or to prevent loss to the estate."[23] This includes, for example, scenarios in which "assets are missing or are in danger of being dissipated," "the debtor's assets are perishable," interpreted "broadly to include 'not only that which may deteriorate physically but that which is liable to deteriorate in price and value,'" or "the debtor or insiders have resisted examination into the debtor's affairs."[24] In the final analysis, "the appointment of an interim trustee lies within the sound discretion of the bankruptcy court, guided in large part by the best interests of the creditors."[25] Separate from any bond the court may order on motion by the alleged debtor, the petitioners' posting of a bond sufficient to indemnify the debtor for costs, attorney's fees, expenses, and damages "allowable under § 303(i)" is an express condition to the appointment of an interim trustee.[26]

The Bankruptcy Code does not expressly permit the appointment of an interim trustee in an involuntary bankruptcy case filed under chapter 11. In fact, the code's explicit allowance of the appointment of an interim trustee in a chapter 7 case could be construed as an implicit prohibition against such an appointment in a chapter 11 case. Nevertheless, relying on the language in Section 1104 generally addressing the appointment of a trustee in all chapter 11 cases, courts permit appointment of an interim trustee in an involuntary chapter 11 case.[27] Courts, therefore, apply the standard for appointment of a trustee in a voluntary chapter 11 case, which generally requires a showing of some form of gross mismanagement or serious misconduct on the part of the person controlling the debtor.[28]

Risks

Filing an involuntary petition carries risks and benefits, and the pros and cons should be vetted thoroughly before taking the plunge. The most notable risk is the exposure to liability based on an unsuccessful petition. In particular, if the case is dismissed (other than through the consent of the petitioners and the debtor), Section 303(i) authorizes the bankruptcy court to award costs, reasonable attorney's fees, any damages proximately caused by the filing of the involuntary petition, or punitive damages against the petitioners.[29]

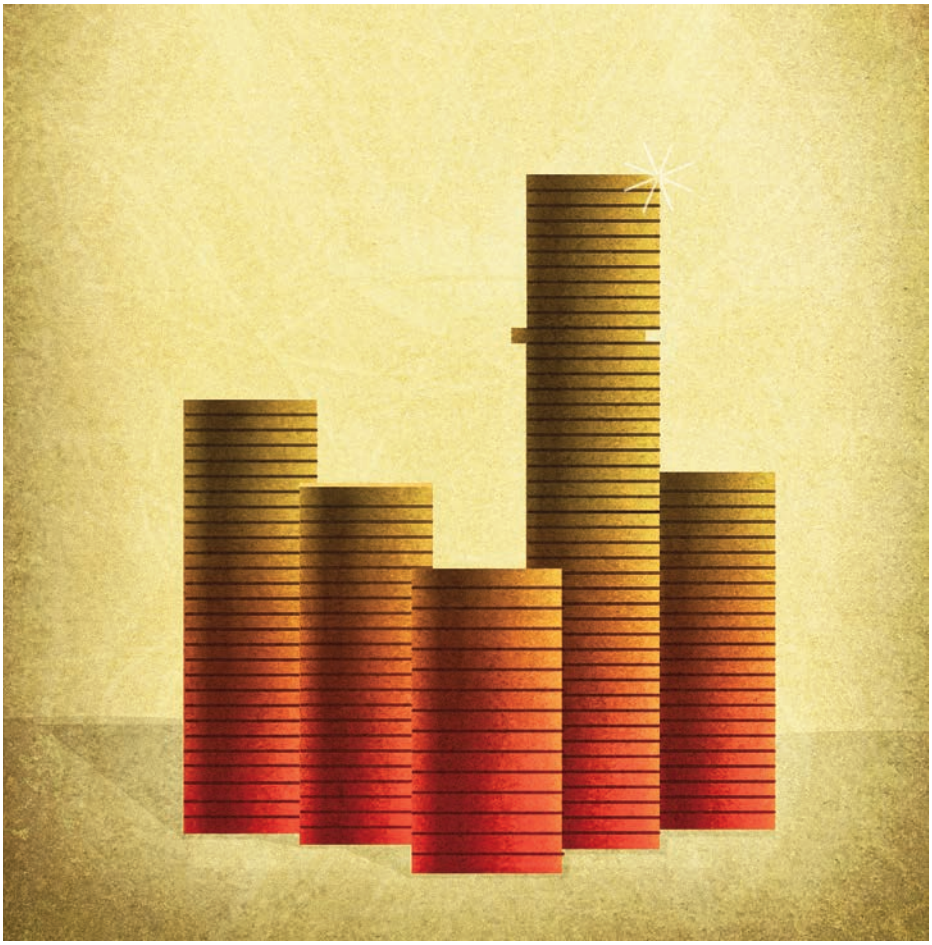
With respect to an award of attorney's fees and costs, the Ninth Circuit Court of Appeals views Section 303(i)(1) as a "fee-shifting" statute, not one imposing sanctions.[30] As a result, courts faced with a request for attorney's fees and costs under this section must consider the litigation as a whole, not whether the specific filing was well founded. This requires consideration of the "totality of the circumstances," including "1) 'the merits of the involuntary petition,' 2) 'the role of any improper conduct on the part of the alleged debtor,' 3) 'the reasonableness of the actions taken by the petitioning creditors,' and 4) 'the motivation and objectives behind filing the petition.'"[31]

There are only two prerequisites to awarding fees and costs: 1) the court must have dismissed the petition on some ground other than consent of all parties and 2) the debtor must not have waived its right to recovery under this section.[32] Bad faith is not a prerequisite.[33] Although the bankruptcy court is infused with wide discretion in determining whether or not to make the award,[34] the petitioners' risk of being hit with the judgment is high. Indeed, the Ninth Circuit has gone so far as to conclude that the Bankruptcy Code "creates a presumption in favor of an award of attorney's fees"[35] and "any petitioning creditor in an involuntary case… should expect to pay the debtor's attorney's fees and costs if the petition is dismissed."[36] Therefore, it behooves any creditor considering an involuntary petition to assess the propriety of the petition before filing.[37]

With respect to an award of damages under Section 303(i)(2), bad faith is a prerequisite.[38] However, the mere finding of bad faith does not guarantee an award of punitive damages; discretion still lies with the court. Bad faith is measured by an objective test that probes what a reasonable person would have believed.[39] Some courts permit an award of damages against a petitioner's counsel.[40]

Aside from liability stemming directly from an unsuccessful petition, even successful petitioners who obtain an order for relief are exposed to the general risks, dangers, or hindrances that accompany every bankruptcy case. Four are of note. First, the mere filing of the involuntary petition triggers the automatic stay under Section 362(a).[41] Therefore, the petitioners will no longer be permitted to engage in any collection activities to pursue their debt outside the bankruptcy case. A violation of the automatic stay is subject to the court's contempt power and exposes the violator to damages.[42]

Second, petitioners must understand that a bankruptcy is a collective proceeding, not an individual debt-collection device.[43] This means that by successfully placing a company into bankruptcy, the petitioners have limited any recovery on their claim to receipt of only a pro rata share of the generally limited funds available to pay all creditors pursuant to the Bankruptcy Code's priority scheme. This could result in no payment at all to a petitioner on account of its claim. Indeed, more often than not, insufficient funds are present to pay all creditors in full. This is especially true regarding payment of claims of general unsecured creditors—in which class the petitioners' claims necessarily fall—given that such claims rank low on the hierarchy of claims.[44] And, absent a judgment from the bankruptcy court adjudicating a claim nondischargeable, the creditor will be unable to pursue collection of its claim after the bankruptcy case concludes.



Third, and compounding the risk of not receiving payment on the prebankruptcy claim that served as the impetus for filing the petition in the first instance, petitioners will incur attorney's fees and costs preparing and prosecuting the involuntary petition above and beyond their outstanding prebankruptcy claim. Although they may seek to recoup those fees through a higher priority claim, the bankruptcy court may deny this request—or allow it at a significantly reduced amount or, even if allowed in full, insufficient funds may prevent payment of even this higher priority claim. In other words, in addition to receiving no payment on the claim that prompted commencement of the petition in the first place, the petitioner now has incurred additional fees and expenses it may be unable to recoup.

Finally, by filing the involuntary petition, the petitioners open the door to being hit with "preference" liability to the extent they received any payments from the debtor within 90 days before the petition was filed. The code empowers a trustee to avoid and recover as a preferential transfer any payments made to a creditor within 90 days of the filing of the petition under certain circumstances.[45] As a result, in addition to risking nonpayment on its claim, a petitioner may now be compelled to disgorge payment it previously received on its claim. Creditors contemplating an involuntary petition, however, have some ability to mitigate this risk by delaying any filing to a date outside the 90-day preference period if possible.

Benefits

Among others, some benefits to filing an involuntary case under the right circumstances to countervail the risks include:

Preserving Assets. An involuntary petition could be used to avoid the loss of, and preserve, a valuable asset that could be monetized

to pay creditors. For example, filing an involuntary petition would stop an impending foreclosure on real property or a landlord's anticipated termination of a valuable commercial lease following a tenant's default. Commencing the petition before the foreclosure or lease termination is absolutely necessary to preserve the asset.

Maximizing Value of Assets. An involuntary bankruptcy also could force the sale of property at maximum value for the benefit of creditors. A debtor may own an asset with significant equity that it refuses to sell to pay claims. Filing a petition will permit the appointment of a trustee with the power to market and auction the property to generate funds to pay claims.[46]

Replacing Existing Management. At times, a company's management is incompetent, dishonest, or otherwise mismanaging the company to the detriment of creditors. Under such circumstances, an involuntary petition could be filed to displace existing management with an independent trustee to stabilize operations or proceed with an orderly liquidation.

The ability to put a company into bankruptcy could serve as an effective tool in a creditor's attempt to recover on an outstanding debt. Given the potential liability stemming from a failed involuntary petition, however, creditors should proceed with extreme caution and only after careful deliberation and balancing of the risks and benefits. ■

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[1] *See* 11 U.S.C. §303.

[2] A third threshold requirement determines whether the alleged debtor is eligible to be a debtor under the particular chapter selected. *See* 11 U.S.C. §109. This requirement applies in voluntary cases and is not limited to involuntary cases. This is different from the first threshold identified above, which more broadly considers whether the entity subject to the involuntary petition may be an involuntary debtor under any chapter of the Bankruptcy Code.

[3] *See* 11 U.S.C. §303(a).

[4] *Id.*

[5] 11 U.S.C. §101(41).

[6] 11 U.S.C. §303(a).

[7] *See* In re Center For Mgmt. & Tech., Inc., 2007 Bankr. LEXIS 3734 (Bankr. D. Md. Oct. 26, 2007); In re MAEDC Mesa Ridge, LLC, 334 B.R. 197, 200 (Bankr. N.D. Tex. 2005); In re Caucus Distribs., Inc., 83 B.R. 921, 930 (Bankr. E.D. Va. 1988). Some courts sweep all nonprofit organizations into this exception, whereas others apply a two-pronged test: 1) whether the debtor is considered an eleemosynary organization under state law and 2) whether the debtor actually conducts itself as an eleemosynary organization. *See* Center For Mgmt., 2007 Bankr. LEXIS at *10-11; MAEDC, 334 B.R. at 200; Caucus Distribs., 83 B.R. at 930. An alleged debtor must plead that it is not a "moneyed, business, or commercial corporation" as an affirmative defense in response to an involuntary petition. *See* Center For Mgmt., 2007 Bankr. LEXIS 3734.

[8] *See* In re Anderson, 94 B.R. 153, 157 (Bankr. W.D. Mo. 1988).

[9] *See* 11 U.S.C. §109(g).

[10] 11 U.S.C. §303(b).

[11] As adjusted effective April 1, 2016, and subject to readjustment on April 1, 2019. *See* 11 U.S.C. §§104 (a), 303(b). *See also* Revisions of Certain Dollar Amounts in the Bankruptcy Code, Fed. Reg. Notice, dated February 22, 2016, *available at* https://www.federalregister.gov.

[12] *See* 11 U.S.C. §303(b)(1), (2).

[13] *See id.*

[14] *See* 11 U.S.C. §303(b)(3).

[15] *See* 11 U.S.C. §303(h).

[16] *See id.*

[17] 11 U.S.C. §303(h)(1), (2).

[18] *See* 11 U.S.C. §503(b)(3)(A), (b)(4). *See also* North Sports, Inc. v. Knupper (In re Wind N' Wave), 509 F. 3d 938, 941-42 (9th Cir. 2007); In re Hovdebray Enters., 499 B.R. 333, 336-37 (Bankr. D. Minn. 2013); In re Key Auto Liquidation Ctr., Inc., 384 B.R. 599, 605-06 (Bankr. N.D. Fla. 2008).

[19] 11 U.S.C. §§503(b)(3)(A), (b)(4).

[20] *See* 11 U.S.C. §303(e).

[21] *See id. See also* 11 U.S.C. §303(i).

[22] *See* 11 U.S.C. §303(g). The appointment is interim because it stretches only through the gap period.

[23] 11 U.S.C. §303(g); Fed. R. Bankr. P. 2001(a).

[24] 9-2001 COLLIER ON BANKR. ¶2001.02[2] (16th ed. 2015) [hereinafter COLLIER] (citing Hill v. Douglass, 78 F. 2d 851, 854 (9th Cir. 1935)). *See also* In re James Plaza Joint Venture, 62 B.R. 959, 961 (Bankr. S.D. Tex. 1986); In re Tradex Swiss AG, 2007 Bankr. LEXIS 4246 (Bankr. D. Mass. Dec. 12, 2007).

[25] COLLIER, *supra* note 24.

[26] Fed. R. Bankr. P. 2001(b). *See also*, 11 U.S.C. §303(i).

[27] *See* 2 COLLIER, *supra* note 24, at ¶303.29; In re Prof'l Accountants Referral Servs., Inc., 142 B.R. 424, 429 (Bankr. D. Colo. 1992).

[28] *See* 11 U.S.C. §1104(a)(1).

[29] *See* 11 U.S.C. §303(i)(1), (2). *See also* Orange Blossom Ltd. P'Ship v. S. Cal. Sunbelt Developers, Inc. (In re S. Cal. Sunbelt Developers, Inc.), 608 F. 3d 456, 461-62 (9th Cir. 2010).

[30] Orange Blossom, 608 F. 3d at 462.

[31] Higgins v. Vortex Fishing Systems, Inc. (In re Vortex Fishing Sys.), 379 F. 3d 701, 707 (9th Cir. 2004) (quoting In re Scrap Metal Buyers of Tampa, Inc., 233 B.R. 162, 166 (Bankr. M.D. Fla.1999)).

[32] *See* 11 U.S.C. §303(i); Higgins, 379 F. 3d at 705-06.

[33] *See* Higgins, 379 F. 3d at 707.

[34] *See* Sofris v. Maple-Whitworth, Inc. (In re Maple-Whitworth, Inc.), 556 F. 3d 742, 745-46 (9th Cir. 2009).

[35] Orange Blossom, 608 F. 3d at 462.

[36] Higgins, 379 F. 3d at 707.

[37] In one recent case, the bankruptcy court dismissed an involuntary petition after scolding the petitioner for filing the case solely to settle a "two-party dispute" between the petitioner and the debtor, explaining that "the bankruptcy court is not a collection agency" and "bankruptcy is not a judgment enforcement device." In re Murray, 543 B.R. 484, 486, 494 (Bankr. S.D. N.Y. Jan. 13, 2016).

[38] *See* 11 U.S.C. §303(i)(2); Higgins, 379 F. 3d at 706.

[39] *See* In re Reynolds, 2014 Bankr. LEXIS 4421, *10 (Bankr. C.D. Cal. Oct. 20, 2014) (citing Wechsler v. Macke Int'l Trade, Inc. (In re Macke Int'l Trade, Inc.), 370 B.R. 236, 256 (B.A.P. 9th Cir. 2007)) *and* Jaffe v. Wavelength, Inc. (In re Wavelength, Inc.), 61 B.R. 614, 621 (B.A.P. 9th Cir. 1986)).

[40] *See, e.g.*, In re Walden, 781 F. 2d 1121 (5th Cir. 1986); Strange v. Columbia Nat'l Bank, 1998 U.S. Dist. LEXIS 16628 (N.D. Ill. Oct. 13, 1998).

[41] *See* 11 U.S.C. §362(a).

[42] *See* 11 U.S.C. §362(k).

[43] *See* In re Murray, 543 B.R. at 496.

[44] *See* 11 U.S.C. §§507(a), 726.

[45] *See* 11 U.S.C. §§547(b), 550(a).

[46] *See* 11 U.S.C. §363.