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Is a State Court Receiver-Initiated Chapter 11 Proceeding an End Run around § 303?

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The commencement of a bankruptcy proceeding can be an effective tool in a variety of circumstances, whether your client is a debtor, creditor or principal of the distressed entity. Generally, little thought is given to the right/authority to commence a voluntary proceeding because it is the debtor—either individually or as an entity through its authorized officer(s)—who commences the proceeding.


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In the context of an involuntary proceeding, it is generally recognized that the petitioning creditors must satisfy certain statutory requirements and burdens, and that the failure to do so carries certain economic risks and penalties. This article will explore the implications and ramifications of a state court receiver filing a voluntary chapter 11 on behalf of a debtor entity, including whether such an action constitutes an end run around the requirements and consequences of § 303 of the Bankruptcy Code. For purposes of illustration, this article presents the following factual hypothetical.

LECNA is a limited liability company (LLC) with two members (Member A and Member B). The organizational


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document provides that the company is member managed. Furthermore, the organizational documents are silent regarding the members' voting rights and make no reference with respect to


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and distributed the remaining assets to employees and those who loaned money to the company. In order to minimize his guaranty exposure, Member A wanted to control the liquidation of the company in a chapter 11 proceeding. However, Member B refused to cooperate in any manner and would not authorize the filing of a voluntary chapter 11 petition.

Based on the foregoing hypothetical, what strategies are available for Member A to commence a chapter 11 proceeding for LECNA? A proceeding under chapter 7 or 11 can be commenced by the filing of a voluntary proceeding pursuant

On the Edge

a member's authority to file a voluntary bankruptcy petition. Member A has provided operating capital by guarantees of secured debt and is not involved in the daily operations of the business. Member B, on the other hand, has provided a small amount of operating capital but his primary contribution is managing the daily operation of the business and his industry contacts.

Following the commencement of the business, sales did not meet expectations and available capital dwindled. Member B turned to employees and friends for additional capital. A subsequent dispute arose between Member A and Member B. Shortly thereafter, operating capital completely disappeared and Member B closed the business without any discussions with Member A, surrendered all collateral to secured creditors,

to § 301 of the Code by an entity that is authorized to be a debtor.[1] The commencement of a proceeding by an entity must be based on the appropriate entity authority that is controlled by state law.[2]

For example, an LLC's authority to make the decision to file a bankruptcy proceeding is governed by the LLC statute of its state of organization. Generally, each member's consent is required to authorize an act of an LLC, which is not in the ordinary course of business unless the company's operating agreement provides otherwise.[3] In the foregoing hypothetical, Member A does not have the ability to obtain the appropriate entity

1 11 U.S.C. § 301.
2 *Price v. Gurney*, 324 U.S. 100, 106-7 (1945); *In re DB Capital Holdings LLC*, Case No. CO-10-23242, 2010 WL 4925811 *2 (10th Cir. B.A.P. Dec. 6, 2010).
3 *See, e.g., id.*

authority to commence a voluntary bankruptcy proceeding.

An involuntary proceeding under chapter 7 or 11 can be commenced by a minimum of three creditors, each of which holds a claim against the debtor that is not contingent as to liability or subject to a *bona fide* dispute as to liability or amount. The aggregate amount of these claims must exceed the value of any lien on property securing such claims by at least $14,425.[4] If there are fewer than 12 creditors, excluding insiders, employees and transferees of voidable claims, one or more of such holders of claims, in the aggregate of at least $14,425, may file an involuntary proceeding.[5]

In addition to the requirements of who can properly commence an involuntary proceeding, the petitioning creditors shoulder the burden of establishing at a trial in the bankruptcy court that the debtor is generally not paying its debts as they become due,[6] or within 120 days prior to the date of filing the petition a trustee, receiver or agent was appointed to take charge or took possession of less than substantially all of the property of the debtor for the purposes of enforcing a lien.[7]

In the event that the petitioning creditors do not sustain their burden and the court dismisses the involuntary petition, the court may grant a judgment against the petitioning creditors and in favor of the debtor for costs and reasonable attorney fees.[8] If the court determines that any petitioning creditor commenced the involuntary proceeding in bad faith, it can award damages proximately caused by the filing or punitive damages.[9]

The filing of an involuntary proceeding by Member A is not a viable alternative for a number of reasons. First, Member A's claim arises as a result of a guaranty and is therefore contingent, making her ineligible to be one of the petitioning creditors. In addition, because of Member A's status as an insider, she is not eligible to commence the proceeding as a single creditor or a group of less then 12.[10] Finally, there is the risk associated with the failure to sustain the burden of proof as a petitioning creditor. However, in this scenario, there is an additional alternative to consider: utilizing the statutory dissolution and enforcement provisions of the state within which the limited liability company is chartered to obtain the appointment of a receiver and having that receiver file a chapter 11 proceeding.

Pursuant to § 701(a)(5)(B) of the Revised Uniform Limited Liability Company Act (the "Uniform Act"), a member of a LLC may apply for an order of dissolution with the appropriate state court in which the LLC is organized. Under § 701(a)(5)(B), the petitioning member must show that the managers or members who control the company have acted in a manner that is oppressive and was, is or will be directly harmful to the petitioning member. The factual hypothetical set forth above meets the criteria for relief under § 701(a)(5)(B) of the Uniform Act.

Once the dissolution of the LLC has been ordered, the court, upon application, may appoint a receiver over the LLC pursuant to § 701(b) of the Uniform Act, which provides that "[i]n a proceeding brought under [§ 701(a)(5) of the Uniform Act], the court may order a remedy other than dissolution." Under this alternative, Member A files a complaint in state court alleging that LECNA is insolvent and seeks the dissolution of the company with broad authority to implement the orderly dissolution of the company, including express authority to commence a chapter 11 proceeding.[11] So long as state law does not specifically prohibit a receiver from filing a bankruptcy petition, bankruptcy courts have allowed state court receiver-initiated bankruptcy proceedings to proceed.[12]

Upon the filing, the receiver's role changes somewhat. LECNA's receiver has two roles: essentially to be a custodian of LECNA's assets and to manage the windup of LECNA's affairs and liquidate its assets. With the filing of the bankruptcy, the receiver's role as custodian effectively terminates.[13] However, the receiver's role as *de facto* management continues,[14] and as management, the receiver becomes a debtor in possession (DIP) and can continue to direct the actions of LECNA.[15]

Has Member A accomplished all of her goals? Not necessarily, as there are several obstacles that may arise. One obstacle is whether allowing a receiver to act as DIP amounts to a creditor appointing a trustee, which is the sole province of the U.S. Trustee. The U.S. Trustee took this position and lost in *In re Bayou Group LLC*.[16] There, however, the bankruptcy court took note that this result created a "bankruptcy loophole"[17] but that the circumstances present before it—corrupt management, inevitable bankruptcy and a highly motivated group of creditors desiring one person to manage a debtor—would not often arise.[18] The issue arose again in *In re Petters Co.*[19] but was ultimately resolved when the U.S. Trustee appointed the receiver as trustee. Here, there is no alleged mismanagement, nor was bankruptcy inevitable as opposed to a dissolution under state law. Would a bankruptcy court follow *In re Bayou LLC* and its progeny, or would it find that a trustee had to be appointed?

A more troubling and possibly fatal obstacle is whether a bankruptcy court would exercise its rights under § 305 of the Code and either dismiss the bankruptcy proceeding or suspend all proceedings under the bankruptcy proceeding.[20] A bankruptcy court is afforded significant discretion when deciding whether to exercise or withhold jurisdiction over a bankruptcy proceeding.[21] Would the bankruptcy court dismiss the LECNA bankruptcy on the basis that it violated Congress' intent and the spirit of the Bankruptcy Code by allowing a single putative creditor to effectively accomplish through a receiver what she was prohibited from doing under §§ 301 and 303 of the Code? Alternatively, would the bankruptcy court dismiss the LECNA bankruptcy or suspend the chapter 11 proceeding on the basis that the state court receivership proceeding was the better vehicle for liquidating the assets of LECNA and winding up its affairs? Assuming that the only difference between the state court receivership and the chapter 11 proceeding is the ability to pursue avoidance actions, would the bankruptcy court find that pur-

4 11 U.S.C. § 303(b)(1).
5 11 U.S.C. § 303(a)-(b)(2).
6 Excluding debts subject to *bona fide* disputes as to amount or liability.
7 11 U.S.C. § 303(h)(1)-(2).
8 11 U.S.C. § 303(i)(1)(A)-(B).
9 11 U.S.C. § 303(i)(2)(A)-(B).
10 *See* 11 U.S.C. § 303(b)(2) (if debtor has less than 12 creditors, only single petitioning creditor is needed).
11 Depending on the company's jurisdiction, there may be a statutory right for the appointment of a receiver over the insolvent company.
12 *See In re Marina Int'l Props. Ltd.*, 57 F.3d 1077 (9th Cir. 1996) (table decision); *Chitex Comm'n Inc. v. Kramer*, 168 B.R. 587, 589-90 (S.D. Tex. 1994); *In re The 12 Percent Fund I LLC*, Bankr. Nos. 07-BK-6481-SCC, 07-BK-6484-GBN, Adversary No. 07-AP-257-SSC, 2010 WL 94239 (Bankr. D. Ariz. Jan. 6, 2010); *In re Louis J. Pearlman Enterprises Inc.*, 398 B.R. 59 (Bankr. M.D. Fla. 2008); *In re Statepark Building Group Ltd.*, 316 B.R. 466, 471-72 (Bankr. N.D. Tex. 2004); *In re Monterey Equities-Hillside*, 73 B.R. 749, 752 (Bankr. N.D. Cal. 1987).
13 11 U.S.C. § 543; *In re Bayou Group LLC*, 363 B.R. 674, 684 (S.D.N.Y. 2007).
14 *In re Bayou Group LLC*, 363 B.R. at 685.
15 11 U.S.C. §§ 1101(a), 1107(a) and 1108; *Securities and Exchange Commission v. Byers*, 609 F.3d 87, 93 (2d Cir. 2010); *In re Bayou Group LLC*, 363 B.R. at 686-87.
16 363 B.R. at 689-90, *aff'd, In re Bayou Group LLC*, 574 F.3d 541 (2d Cir. 2009).
17 *In re Bayou Group LLC*, 363 B.R. at 685.
18 *Id.* at 690.
19 401 B.R. 391 (Bankr. D. Minn. 2009).
20 "The court, after notice and a hearing, may dismiss a case under this title or may suspend all proceedings in a case under this title, at any time if...the interests of creditors and the debtor would be better served by such dismissal or suspension[.]" 11 U.S.C. § 305(a)(1).
21 *In re Starlight Houseboats Inc.*, 426 B.R. 375, 386 (Bankr. D. Kan. 2010).

suing such actions was in the best interests of creditors (many of whom would be sued), or would it find that the pursuit of such actions only benefited Member A and dismiss the LECNA bankruptcy?

Conclusion

It is possible that the initiation of a bankruptcy proceeding through a state court receivership could be a useful tool in dealing with the limitations of §§ 301 and 303, but as a practical matter, the implementation of such a strategy is difficult. First, the client would have to prevail in a state court receivership proceeding. Second, the client would have to have some input as to who is actually appointed as receiver in order to obtain a "friendly" receiver. Third, state law must permit the receiver both to manage the company and file a bankruptcy proceeding. Fourth, the client may have to litigate with the U.S. Trustee on whether the receiver could operate as a DIP or a third party should be appointed as a trustee. Fifth, the client would have to hope that the bankruptcy court would not dismiss or suspend the bankruptcy proceeding under § 305. ■

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