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In re: KIDS.COM LLC, Debtor.	UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF NEW JERSEY HON. NOVALYN L. WINFIELD CASE NO. 04-45797 (NLW) Chapter 7 (Involuntary) **HEARING DATE: DECEMBER 9, 2004**

BRIEF OF PETITIONING CREDITORS (i) IN OPPOSITION TO DEBTOR'S MOTION TO DISMISS INVOLUNTARY PETITION AND FOR OTHER RELIEF, AND (ii) IN SUPPORT OF PETITIONING CREDITORS' CROSS-MOTION FOR SUMMARY JUDGMENT ON INVOLUNTARY PETITION

On the Brief:

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PRELIMINARY STATEMENT

This Brief is submitted on behalf of National Talent Associates, Inc. ("NTA), A & S Holding Co. ("A & S"), David Laurino ("Laurino"), and Classic Coffee Systems Ltd. ("Classic Coffee") (collectively, the "Petitioning Creditors") (i) in opposition to the motion of KIDS.COM LLC ("KIDS.COM" or the "Debtor") to dismiss the Involuntary Chapter 7 Petition ("Petition") filed by the Petitioning Creditors ("Motion"), and (ii) in support of the Petitioning Creditors' cross-motion for summary judgment on the Involuntary Petition ("Cross-Motion").

Approximately one (1) month before the Involuntary Petition was filed, the Debtor commenced proceedings in the Superior Court of New Jersey, Essex County, pursuant to a Deed of Assignment For the Benefit of Creditors ("Assignment Case"). In the Assignment Case, the Debtor sought to sell all of its assets to its affiliate, KIDMODELS, LLC, for the sum of $25,000.00 and the assumption of a $69,500.00 secured debt that, upon information and belief, is personally guaranteed by the Debtor's principal, Alfred Bagwell (the "KIDMODELS Sale"). The KIDMODELS Sale, if approved, would have effectuated the transfer of all of the Debtor's assets to an entity owned and controlled by the Bagwell family, while allowing the company to continue doing business and relieve itself of the Petitioning Creditors' substantial debts.

Before the hearing on the KIDMODELS Sale, NTA and A & S, through a review of the Debtor's books and records, discovered numerous improprieties in the conduct of the Debtor's business. Among other things, it was learned that the Debtor loaned KIDMODELS $170,632.00 in 2001 and 2002, but never obtained repayment of the debt, opting instead to write off a majority of the debt and transfer the remaining balance to

Alfred Bagwell's "personal loan account" with the Debtor, which itself has a balance due and owing to the Debtor in the amount of $29,357.66. Neither this receivable, nor the $39,097.89 in other "Loans to Employees" that is owed to the Debtor by unnamed employees according to the Debtor's general ledger, were identified as assets in the Deed of Assignment.

NTA and A & S also discovered that the Debtor expended an average of $106,054.00 in annual automobile expenses for the years 2001-2003, as well as an average of $66,077.67 in unexplained miscellaneous expenses for those years. These excessive costs help to explain why the Debtor, despite generating an average annual gross income of $3,328,905.30 for the years 2001-2003, showed average net income of only $81,847.00 during those years.

NTA and A & S also learned that the Debtor, after commencing the Deed of Assignment Case, continued to pay many of its existing debts, although it continued to refuse to pay the valid and undisputed debts of NTA and A & S. These circumstances, taken together with the above issues, led NTA and A & S to conclude that the Assignment Case and the KIDMODELS Sale were simply a vehicle for the Bagwell family to retain the value of the Debtor's business as a going concern, while shielding the company from a proper investigation into its affairs that a bankruptcy filing would have resulted in. Accordingly, NTA and A & S, joined by Laurino and Classic Coffee, filed the Involuntary Petition.

The Debtor, in an obvious attempt to prevent an inquiry into the conduct of its business, and preserve the company for the Bagwell family at all costs, is seeking to dismiss the Involuntary Petition, claiming that it was filed in bad faith. Nothing could be

further from the truth. The Debtor's claim of bad faith by the Petitioning Creditors is completely disingenuous, given the Bagwells' attempt to simply repurchase KIDS.COM's business through the KIDMODELS Sale, without addressing the company's largest debts, as well as the various transgressions that are reflected in the Debtor's own records.

Entering an Order for relief and appointing a Chapter 7 Trustee will permit a comprehensive forensic investigation into the Debtor's business practices and enhance the possibility that creditors will obtain a recovery from the Debtor's assets. A Chapter 7 Trustee, equipped with broad discovery and avoidance powers under the Bankruptcy Code and Rules, is best suited to pursue recovery of potential preferential, fraudulent, and unauthorized post-petition transfers, and otherwise determine the proper method for maximizing the value of the Debtor's assets. Accordingly, the Court should deny the Debtor's Motion and grant the Petitioning Creditors' Cross-Motion.

STATEMENT OF FACTS

The relevant facts are set forth in the Certifications of Jerome Ashfield ("Ashfield Cert."), David Laurino ("Laurino Cert."), and Charles Chiarello ("Chiarello Cert."), submitted herewith. For the sake of brevity, those facts will not be repeated below, but are hereby incorporated by reference. Unless otherwise noted, the capitalized, defined terms herein shall have the same definitions ascribed to them in the Certifications.

LEGAL ARGUMENT

THE COURT SHOULD DENY THE DEBTOR'S MOTION TO DISMISS THE INVOLUNTARY PETITION AND FOR OTHER RELIEF, AND GRANT THE PETITIONING CREDITORS SUMMARY JUDGMENT ON THE INVOLUNTARY PETITION.

I. BECAUSE EACH OF THE PETITIONING CREDITORS HOLDS A VALID CLAIM THAT IS NOT CONTINGENT AS TO LIABILITY OR THE SUBJECT OF A BONA FIDE DISPUTE, THEY EACH HAVE STANDING TO FILE THE INVOLUNTARY PETITION, AND THEREFORE, THE INVOLUNTARY PETITION SATISFIES THE REQUIREMENTS OF 11 U.S.C. § 303(b)(1).

An involuntary petition is valid where it is based on claims that are not the subject of a bona fide dispute. B.D.W. Associates, Inc. v. Busy Beaver Building Ctrs, Inc., 865 F.2d 65, 66 (3d Cir. 1989). The term "bona fide dispute" is not specifically defined within the Bankruptcy Code. In re Byrd, 357 F.3d 433, 437 (4th Cir. 2004). Many bankruptcy courts, however, have considered the question of what constitutes a bona fide dispute. See e.g. In re Garland Coal & Mining Company, 67 B.R. 514 (Bankr. W.D.Ark. 1986); Atlas Mach. & Iron Works, Inc. v. Bethlehem Steel Corp., 986 F.2d 709 (4th Cir. 1993); Matter of Busick, 831 F.2d 745 (7th Cir. 1987). Some courts have done little more than "recognize that the term 'clearly entails some sort of meritorious, existing conflict.'" Byrd, 357 F.3d at 437. Other courts, however, have been more specific in their analysis. The court in In re Johnston Hawks, Ltd., 49 B.R. 823 (Bankr. D.Hawaii 1985) held as follows:

> [a] bona fide dispute is a conflict in which an assertion of a claim or right made in good faith and without fraud or deceit on one side is met by contrary claims or allegations made in good faith and without fraud or deceit on the other side.

Johnston Hawks, 49 B.R. at 830. To determine whether the claim at issue was the subject of a bona fide dispute, the Johnston Hawks court considered the following:

> (1) the nature of the dispute; (2) the nature and the extent of the evidence and allegations presented in support of the creditor's claim and in support of the debtor's contrary claims; (3) whether the creditor's claim and the debtor's contrary claims are made in good faith and without fraud or deceit; (4) whether on balance the interests of the creditor outweigh those of the debtor.

Garland, 67 B.R. at 520-21 (citing Johnston Hawks, 49 B.R. at 831).

Another court, in the case of In re Lough, 57 B.R. 993 (Bankr. E.D.Mich. 1986), determined that a "bona fide dispute" exists "wherever there is any legitimate basis for the debtor not paying the debt, whether that basis is factual or legal." Garland, 67 B.R. at 521 (citing Lough, 57 B.R. at 997) (emphasis added). Where, however, a creditor has "no legitimate basis…to decline to pay" the debt underlying the petitioning creditor's claim, that claim is not the subject of a bona fide dispute. Id. (citing Lads Trucking Co. v. Board of Trustees, 777 F.2d 1371 (9th Cir. 1985)).

In sum, a court must determine "whether there is an objective basis for either a factual or legal dispute as to the validity of a debt." Busick, 831 F.2d at 750; see also Byrd, 357 F.3d at 437. Where there is no bona fide dispute as to either the law or facts underlying the claim of the petitioning creditor(s), an involuntary petition is valid.

Here, the Debtor, in a desperate attempt to stave off an involuntary Chapter 7 proceeding (which is necessary to ensure that its creditors are treated fairly and equitably, and to prevent the Assignment Case from being used as a tool by the Bagwell family to cleanse the company of select debts and repurchase it for a grossly insufficient sum), attempts to raise disputes regarding each of the Petitioning Creditors' claims. None of these disputes, however, are "bona fide," or have any merit.

A. NTA's Claim Is Not Contingent As To Liability Or The Subject Of A Bona Fide Dispute.

As described in the Ashfield Certification, the Debtor's debt to NTA arises from the sale of NTA's business to KIDS.COM in July 1999. The Purchase Price of $350,000.00 was to be paid through a $20,000.00 deposit and a Note for $330,000.00, which was not paid in full. The Debtor's default under the Note resulted in a debt to NTA in the amount of $191,556. Tellingly, this is the same amount that NTA sought to recover in the Collection Action, in which the Debtor never filed an answer or otherwise disputed NTA's claim, and the same amount that the Debtor listed in its schedule of liabilities in the Deed of Assignment. (Ashfield Cert. at ¶ 14.)

Despite acknowledging the amount and validity of its debt to NTA in its Deed of Assignment, the Debtor now attempts for the first time to dispute that debt through a series of tortured and false allegations concerning adjustments to the Note. Most importantly, the Note specifically prohibited any oral modifications, and only permitted modifications through a written instrument signed by the party to be charged with such modifications. (Ashfield Cert. at ¶ 9.) No written modifications signed by NTA were ever executed, and NTA never consented to any modifications. Moreover, the Debtor received all of the monies it was entitled to receive from NTA in connection with the Sale (Ashfield Cert. at ¶¶ 11-12), and any other claimed adjustments are simply baseless (Id. at ¶ 13). Thus, NTA's claim is not subject to a bona fide dispute as a matter of law.

B. A & S' Claim Is Not Contingent As To Liability Or The Subject Of A Bona Fide Dispute.

The Debtor argues that A & S has no claim because (i) A & S' claim for unpaid rent was subsumed within the Note and (ii) A & S and NTA should be treated as one and the same entity. This argument has no basis in law or fact. First, A & S never directed

the Debtor to pay a debt owed to A & S, to NTA instead. Moreover, because the Debtor did not occupy the Locations leased by A & S, and accrue rent obligations until after the Sale was completed, the "adjustment" claimed by the Debtor to be made at the time of closing could not possibly have occurred. (Ashfield Cert. at ¶ 16.) In addition, from the time each entity was formed, NTA and A & S have had separate tax identification numbers, filed separate tax returns and maintained separate books and records. (Ashfield Cert. at ¶ 17.) These companies have not commingled their assets with one another and have not engaged in any practice of paying each other's debts. Therefore, because A & S holds an undisputed claim against the Debtor in the amount of $40,467.82, it has standing to prosecute the Involuntary Petition.

C. Laurino's Claim Is Not Contingent As To Liability Or The Subject Of A Bona Fide Dispute.

David Laurino's ("Laurino") $570.00 claim against the Debtor is based on "overrides," or commissions he earned on account of contracts procured by employees in the Debtor's Chicago office while Laurino worked there as a manager/interviewer. (Laurino Cert. at ¶¶ 3-4.) The Debtor, in response to Laurino's Wage Claim Application filed with the Illinois Department of Labor, did not dispute the number of modeling contracts procured in the Chicago office during the period in question, or the amount of money Laurino was entitled to. Rather, the Debtor attempted to claim an offset against Laurino's debt by alleging that Laurino did not discharge his duties as required. (Laurino Cert. at ¶ 4.) The Administrative Law Judge in Laurino's case declined to exercise jurisdiction over the Wage Claim Application because the claim was based on "overrides" and services rendered by third parties, not Laurino. The Administrative Law Judge did not, however, reject the Wage Claim Application on its merits. Laurino's

$570.00 claim is supported by proper documentation and has never been disputed by the Debtor. Accordingly, it is a valid claim that confers standing on Laurino to file the Involuntary Petition.

D. Classic Coffee's Claim Is Not Contingent As To Liability Or The Subject Of A Bona Fide Dispute.

At the time the Involuntary Petition was filed, Classic Coffee believed the sum of $71.25 to be due and owing from the Debtor, based on invoices dated August 23, and September 1, 2004. Upon a further review of its books and records, Classic Coffee determined that that debt was actually paid on or about October 10, 2004. (Chiarello Cert. at ¶ 2.) There existed another debt owed by the Debtor to Classic Coffee as of the Petition Date, however, in the amount of $215.64, based on an invoice dated October 5, 2004. That debt was paid by the Debtor on November 12, 2004, two (2) days after the Petition Date. (Chiarello Cert. at ¶ 3.)

Payment of a debt post-petition does not affect a petitioning creditor's standing. In fact, "the fact that a debt has been paid post-petition is irrelevant." In re H.I.J.R. Properties Denver, 115 B.R. 275, 278 n. 2 (D. Colo. 1990). The "alleged debtor's debts must be examined at the time the petition was filed." In re Midwest Processing Company, 41 B.R. 90, 98 (Bankr. D.N.D. 1984). "While post-petition payments of delinquent accounts may be material in some circumstances to the issue of whether relief should be granted under § 303(h)(1), **post-petition payments ordinarily indicate a last ditch effort on the part of the alleged debtor to avoid bankruptcy proceedings**." In re Win-Sum Sports, Inc., 14 B.R. 389, 392 (Bankr. D.Conn. 1981) (citing In re All Media Properties, 5 B.R. 126, 144 (Bankr. S.D.Tex. 1980) (emphasis added)).

The payment of Classic Coffee's pre-petition debt during the involuntary "gap period" is a clear violation of the automatic stay. *See* In re Oxford Dev., Ltd. , 115 B.R. 216, 217 (Bankr. W.D. Mo. 1990) ("[T]he automatic stay is present in all involuntary cases, by definition, through the gap period and even if debtor is never adjudicated a bankrupt."); Collier on Bankruptcy, ¶ 303.12[1][a] (15th ed.) As the above case law demonstrates, it is also insufficient to deny Classic Coffee status as a Petitioning Creditor.

Because all of the Petitioning Creditors' claims are valid, and not the subject of a bona fide dispute, each of the Petitioning Creditors have standing to file Involuntary Petition. Accordingly, the Involuntary Petition satisfies the requirements of 11 U.S.C. § 303(b)(1).

II. EVEN IF FEWER THAN THREE (3) OF THE PETITIONING CREDITORS HAVE CLAIMS THAT ARE NOT CONTINGENT AS TO LIABILITY OR THE SUBJECT OF A BONA FIDE DISPUTE, THE "SPECIAL CIRCUMSTANCES" EXCEPTION TO 11 U.S.C. § 303(b)(1) WARRANTS THE ENTRY OF AN ORDER FOR RELIEF.

Courts have created an exception to the three (3) creditor requirement set forth in Section 303(b)(1), often referred to as the "special circumstances" exception. In re Moss, 249 B.R. 411, 424 (Bankr. N.D.Tex. 2000). The "special circumstances" exception provides an exception to the jurisdictional requirements of Section 303 where (i) a sole creditor "cannot possibly obtain adequate relief in the ordinary courts without resorting to the bankruptcy court," or (ii) where there is evidence of fraud, "scam, artifice or trick" on the part of the debtor. Matter of 7H Land & Cattle Co., 6 B.R. 29, 32-33 (Bankr. D.Nev. 1980)). Initially, this exception "developed in single creditor cases where the courts were analyzing whether the failure to pay a single creditor could constitute a failure to pay

debts generally." Id. (citing In re Concrete Pumping Service, Inc., 943 F.2d 627, 630 (6th Cir. 1991); 7H Land & Cattle Co., 6 B.R. at 33. Courts, however, have expanded this exception, applying it to the three-creditor requirement of Section 303(b)(1). Moss, 249 B.R. at 424 (where the Court found there was "no logical reason why [the special circumstances] exception should not be available to avoid dismissal of an involuntary petition…). As such, where "special circumstances" are shown, the three-creditor requirement may be waived. Id.

The case of Concrete Pumping involved facts similar to those here. In Concrete Pumping, the debtor had received numerous loans from its sole owner and president, secured by the debtor's assets. Concrete Pumping, 943 F.2d at 628-29. The debtor defaulted on these loans and, as such, turned over "almost all of its assets" to its sole owner. Id. While the debtor ceased operating, the sole owner began operating another company that "perform[ed] the same service as did Concrete Pumping, and [did] so using most of the same equipment. The sole owner proceeded to pay off all creditors of the debtor, with the exception of one creditor. Id. at 629. The sole remaining creditor filed an involuntary petition against the debtor. Id.

The Sixth Circuit applied the "special circumstances" exception to determine whether the petition filed by the sole remaining creditor should be dismissed. Id. at 630. The Court found that the exception applied, and stated as follows:

> [t]he facts in this case strongly suggest that Sykora [the sole owner] engaged in "fraud, artifice, or scam," or possibly even all three. Sykora, a insider, had "loaned" her company money, but she failed to keep any records of these loans. At the same time Concrete Pumping lost a judgment to King [the petitioning creditor], it executed a security agreement covering almost all of its assets. Sykora collects on her agreement, and then turns around and opens another

> business doing the same thing that Concrete Pumping used to do. This is, on its face, a very suspicious sequence of events. Accordingly, even under the doctrine, as it has grown up in the bankruptcy courts, there was no error in granting the [involuntary] petition.

Concrete Pumping, 943 F.2d at 630.

Similarly, in Moss, where an involuntary petition was filed by an insufficient number of petitioning creditors, the court considered whether the "special circumstances" exception would prevent dismissal of the petition on the grounds that the requirements of Section 303 had not been met. The court found that alleged fraudulent and preferential transfers made by the alleged debtor sufficiently constituted "fraud, trick, artifice, or scam" on the part of the alleged debtor, so as to permit the court to waive the three-creditor requirement set forth in Section 303 of the Bankruptcy Code. Moss, 249 B.R. at 424.

Here, the Debtor's conduct regarding the operation of its business in recent years, coupled with its attempt to cleanse the company of the business of its most substantial debts and repurchase it for nominal consideration, is nothing less than a sham for the benefit of the Bagwell family. Despite earning an average annual gross income of $3,328,905.30 million for the years 2001-2003, KIDS.COM generated an average net income of only $81,847.00 for those years. This sizable discrepancy can likely be explained, in part, by automobile and related expenses for those same years in an average amount of $106,054.00, and unexplained miscellaneous expenses in an average amount of $66,077.67. (Ashfield Cert. at ¶ 26.)

The Debtor's records also reflect that it loaned the sum of $170,632.00 to KIDMODELS, the proposed purchaser of the Debtor's assets in the Assignment Case, in 2001 and 2002. This substantial debt was never collected but, instead, was written off,

with a portion of the loan balance transferred to Alfred Bagwell's loan account with the company, which itself reflects a balance due and owing in the amount of $29,357.66 as of September 30, 2004. (Ashfield Cert. at ¶ 27.) Thus, the Debtor, by arguing against the entry of an Order for relief in these proceedings, would have this Court believe that it will be in the best interest of creditors to allow the Debtor to return to state court; process a sale of its assets to its affiliate, which owes the Debtor a $170,632.00 debt that is not being collected, for the cash price of $25,000 plus assumption of a secured debt that, upon information and belief, is personally guaranteed by Alfred Bagwell; and cleanse itself of its largest debts, while retaining the substantial value of the company for the Bagwell family. The actual result, however, would protect KIDS.COM from a proper forensic inquiry into the questionable activities it has undertaken in recent years and the inter-company transfers and loans that remain unpaid. Clearly, the best interests of creditors will be served by the appointment of a Chapter 7 Trustee. Therefore, because the "special circumstances" exception to Section 303(b)(1) applies here, even if fewer than three (3) of the Petitioning Creditors are deemed to have standing to file the Involuntary Petition, the Involuntary Petition is nevertheless proper.

III. TO THE EXTENT THE DEBTS LISTED IN THE DEED OF ASSIGNMENT, OTHER THAN THE PETITIONING CREDITORS' DEBTS, WERE PAID BEFORE THE FILING OF THE INVOLUNTARY PETITION, THE INVOLUNTARY PETITION WAS PROPERLY FILED PURSUANT TO 11 U.S.C. § 303(b)(2).

The requirements for obtaining an order for relief via involuntary petition under Chapter 7 or 11 of the Bankruptcy Code are set forth in 11 U.S.C. § 303. Garland, 67 B.R. at 519. The Court in Garland stated as follows:

> if there are twelve or more qualified creditors of the alleged debtor holding unsecured claims aggregating more than

> $5,000, the petition must be brought by three or more creditors…[i]f the alleged debtor has **fewer than twelve creditors** an involuntary petition may be brought by one creditor.

Id. (emphasis added). The number of creditors "is to be determined as of the date the petition is filed." Id. (citing Matter of Skye Marketing Corp., 11 B.R. 891 (Bankr. E.D.N.Y. 1981); In re Blaine Richards & Co., Inc., 10 B.R. 424 (Bankr. E.D.N.Y. 1981); Matter of International Teldata Corp., 12 B.R. 879 (Bankr. D.Nev. 1981)). More specifically, "those creditors **who were paid in full before the petition was filed** are not creditors on the day the petition was filed, and **none may be counted for purposes of the twelve creditor rule**." Garland, 67 B.R. at 519 (emphasis added) (where the bankruptcy court found that a single creditor could file an involuntary petition despite the fact that the putative debtor listed 66 creditors on its schedules, where some listed creditors had been paid in full and thus did not qualify, leaving fewer than twelve creditors eligible to be counted for purposes of twelve creditor rule).

According to its counsel, KIDS.COM has paid its debts, both post-Deed of Assignment filing and post-Involuntary Petition filing, "in the ordinary course of business." (Ashfield Cert. at ¶ 30.) While the latter represents an improper post-petition payment of pre-petition debts, in violation of the automatic stay, the former raises the distinct possibility that the Debtor had fewer than twelve (12) creditors as of the date the Involuntary Petition Date. If this is true, only one (1) Petitioning Creditor would be needed to properly commence these proceedings, pursuant to 11 U.S.C. § 303(b)(2), and the Debtor's otherwise spurious arguments regarding the validity of the debts of A & S, Laurino, and Classic Coffee would be irrelevant. To determine this issue, the Court

should require the Debtor to immediately file a schedule of debts that existed as of the Involuntary Petition Date, i.e., November 10, 2004.

IV. THE COURT SHOULD GRANT THE PETITIONING CREDITORS SUMMARY JUDGMENT ON THE INVOLUNTARY PETITION AND ENTER AN ORDER FOR RELIEF PURSUANT TO CHAPTER 7 OF THE BANKRUPTCY CODE.

Section 303(h) of the Bankruptcy Code provides two (2) alternative scenarios under which an order for relief may be entered, as follows:

> (h) If the petition is not timely controverted, the court shall order relief against the debtor in an involuntary case under the chapter under which the petition was filed. Otherwise, after trial, the court shall order relief against the debtor in an involuntary case under the chapter under which the petition was filed, only if–
>
> **(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; 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 the purpose of enforcing a lien against such property, was appointed or take possession.**

11 U.S.C. § 303(h).

As addressed further, the facts here justify the entry of an Order for relief, under both options provided for in Section 303(h).

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A. Because The Debtor, Pursuant To New Jersey Law, Assigned All Of Its Assets To The Assignee Approximately One (1) Month Before The Involuntary Petition Date, Relief Under Chapter 7 Is Warranted Pursuant To 11 U.S.C. § 303(h)(2).

The term "custodian," as it is used in Section 303(h)(2), is defined under the Bankruptcy Code to specifically include an "assignee under a general assignment for the benefit of the debtor's creditors…" 11 U.S.C. § 101(11). This definition is consistent with the legislative history of the statute, which indicates that Congress "intended the term 'custodian' to encompass a variety of prepetition agents who have taken charge of a debtor's assets." In re Quality Laser Works, 211 B.R. 936, 943 (9th Cir. BAP 1997).

Consistent with the definition of a custodian under Sections 101(11) and 303(h)(2), the powers accorded to an assignee under New Jersey law include the "full power and authority to dispose of all of the assignor's property, except as otherwise may be provided, as the assignor had at the time of the general assignment…." N.J.S.A. 2A:19-13. Here, the Deed of Assignment transferred all of the Debtor's assets, without qualification or limitation, to the Assignee on October 8, 2004. The Assignee then proposed to sell those same assets to KIDMODELS. There can be no valid argument that the Assignee is not a custodian within the meaning under Sections 101(11) and 303(h)(2) of the Bankruptcy Code. Accordingly, the Court should enter an Order for relief under Chapter 7 of the Bankruptcy Code pursuant to Section 303(h)(2).

B. Because The Debtor Is Generally Not Paying Its Debts As They Come Due, Relief Under Chapter 7 Is Warranted Pursuant To 11 U.S.C. § 303(h)(1).

To satisfy the statutory requirements of Section 303(h)(1), the Petitioning Creditors must demonstrate, "by a preponderance of the evidence that the [a]lleged

[d]ebtor is generally not paying its debts as such debts become due." In re Palace Oriental Rugs, Inc., 193 B.R. 126, 128 (Bankr. D. Conn. 1996). See also In re Knoth, 168 B.R. 311, 312 (Bankr. D.S.C. 1994) (citing Atlas Machine & Iron Works, 986 F.2d. at 716); West Side Community Hsp., 112 B.R. 243, 256 (Bankr. N.D.Ill. 1990). Congress "was not explicit regarding what factors should be considered" to determine whether a debtor is generally paying its debts as they become due. West Side Community Hsp., 112 B.R. at 256. This determination, as stated previously, is made regarding a debtor's financial state as of the date the petition is filed. Id. (citing Matter of Bishop, Baldwin, Rewald, Dillingham & Wong, Inc., 779 F.2d 471, 475 (9th Cir. 1985)). See also In re Laclede Cab Co., 76 B.R 687, 691 (Bankr. E.D.Mo. 1987); Win-Sum Sports, 14 B.R. at 391.

To determine whether an alleged debtor is generally paying its debts as they come due, courts "review a variety of factors including the nature and conduct of the alleged debtor's financial affairs." Garland, 67 B.R. at 521. A "purely mechanical test will not reveal whether a debtor is generally not paying its debts." Id. (citing In re Reed, 11 B.R. 755 (Bankr. S.D.W.Va. 1981)). Courts will often consider the following four factors:

> (1) the number of unpaid claims; (2) the amount of such claims; (3) the materiality of the non-payments; and (4) the debtor's overall conduct in [its] financial affairs.

Moss, 249 B.R. at 422 (citing In re Norris, 183 B.R. 437, 456-57 (Bankr. W.D.La. 1995)).

There is "substantial authority for the proposition that even though an alleged debtor may owe only one debt, or very few debts, an order for relief may be granted where such debt or debts are sufficiently substantial to establish the generality of the alleged debtor's default." In re Fischer, 202 B.R. 341, 350-51 (E.D.N.Y. 1996).

"Nonpayment of a few large debts has been held sufficient to warrant an order of relief." Garland, 67 B.R. at 522 (citing International Teldata Corp., 12 B.R. at 879; Matter of Bowers, 16 B.R. 298 (Bankr. D.Conn. 1981); Hill v. Cargill, 8 B.R. 779 (D.Minn. 1981)).

For example, in Garland, the bankruptcy court found that where a debtor "was paying most of its creditors in number [but] the total debt which it was not paying as the debts became due **was well over fifty percent of the outstanding liabilities**," the debtor was not paying its debts as they came due. Similarly, in Hill, the court entered an order for relief where a debtor was paying its small consumer creditors but maintained a substantial total amount of unpaid claims. Hill, 8 B.R. at 780-81. Likewise, in the Fischer case, the bankruptcy court determined that, as "the record fails to establish that Fischer [the alleged debtor] was paying, in terms of dollar amounts, anywhere close to 50% of his current liabilities," the alleged debtor was not generally paying his debts as they came due. Finally, in Moss, the bankruptcy court found that an alleged debtor was not paying her debts as they came due where she was only making payment to small, recurring obligations, owed a substantial sum to one petitioning creditor, and had not made payments to the remaining two petitioning creditors for over two years. Moss, 249 B.R. at 422-23.

Here, according to the Deed of Assignment, the Debtor's $191,556 debt to NTA, which has been outstanding since July 2004, represents approximately 58.7 percent of its unsecured liabilities. NTA's debt also dwarfs the Commerce Debt which, upon information and belief, is personally guaranteed by Alfred Bagwell. In addition, the Debtor owes A & S $40,467.82. In light of the proposed sale to KIDMODELS in the Assignment Case, it is clear that the Debtor has no intention of paying NTA's or A & S'

debts. Instead, the Debtor and the Bagwells are attempting to retain the value of the company while relieving it of its largest debts. In any event, the Debtor is clearly not paying its debts as they come due. Accordingly, an Order for relief pursuant to Chapter 7 is both appropriate and warranted.

V. THE DEBTOR IS NOT ENTITLED TO AN AWARD OF PUNITIVE DAMAGES, FEES OR COSTS BECAUSE THE INVOLUNTARY PETITION WAS FILED IN GOOD FAITH

Section 303(i) of the Bankruptcy Code provides as follows:

> If the court dismisses a petition under this section other than on consent of all petitioners and the debtor, and if the debtor does not waive the right to judgment under this subsection, the court may grant judgment–
>
> (1) against the petitioners and in favor of the debtor for–
>
> (A) costs; or
>
> (B) a reasonable attorney's fee; or
>
> (2) against any petitioner that filed the petition in bad faith, for–
>
> (A) any damages proximately caused by such filing; or
>
> (B) punitive damages.

11 U.S.C. § 303(i).

The Bankruptcy Code does not further define either bad faith or the circumstances under which an award of fees and costs is proper under section 303(i)(1). As a threshold matter, the Bankruptcy Court for the District of New Jersey has held that there exists a presumption that good faith has been exercised in the filing of an involuntary petition. Matter of Elsub Corp., 66 B.R. 172, 188 (Bankr. D.N.J. 1986). Therefore, the Debtor has the burden of proving bad faith. Id.

There is no mandatory list of criteria courts must consider to determine whether an involuntary petition was filed in bad faith. Generally, to determine whether an involuntary petition was filed in bad faith, courts "apply the standard for imposing sanctions pursuant to Bankruptcy Rule 9011." In re Kearney, 121 B.R. 642, 645 (Bankr. M.D.Fla. 1990) (citing In re Turner, 80 B.R. 618 (Bankr. D.Mass. 1987); In re Alta Title Co., 55 B.R. 133 (Bankr. D.Utah 1985)). In applying the standard set forth in Bankruptcy Rule 9011, courts consider the following:

> whether [petitioning creditors] made reasonable inquiry of relevant facts and pertinent law before initiating [the] involuntary bankruptcy case; whether the involuntary petition's allegations were well-grounded in fact; whether the request for involuntary bankruptcy relief was warranted by existing law or by a good faith argument for extension, modification or reversal of existing law; and whether the action was initiated for any improper purpose, such as harassment, delay or to increase costs.

In re K.P. Enterprise, 135 B.R. 174, 180 (Bankr. D.Maine 1992) (citing In re Fox Island Square Partnership, 106 B.R. 962, 968 (Bankr. N.D.Ill. 1989); In re Better Care, Ltd., 97 B.R. 405, 411-12 (Bankr. N.D.Ill. 1989); Turner, 80 B.R. at 263).

It is only where the petitioning creditors' "actions were not objectively reasonable, [where they] conducted insufficient inquiry into material facts…invoked bankruptcy procedures in circumstances where their application was inappropriate…and [where petitioning creditors were] largely motivated by an improper purpose…" that an involuntary petition has been filed in bad faith. K.P. Enterprise, 135 B.R. at 182. Further, it is important to note that contrary to the Debtor's assertions, even where the claims of one or more of the petitioning creditors are "subject to a bona fide dispute resulting in the dismissal of the petition, **dismissal alone does not per se establish any**

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bad faith on the part of the [c]reditors." In re Mundo Custom Homes, Inc., 179 B.R. 566, 571 (Bankr. N.D.Ill. 1995) (emphasis added).

A finding that an involuntary petition was filed in bad faith, and an award of punitive damages is appropriate only "in response to particularly egregious conduct or a purely frivolous filing." Id. That is clearly not the case here. The Petitioning Creditors filed the Involuntary Petition in an effort to have their valid debts paid. Where, as here, the Petitioning Creditors "acted on advice of counsel and **had factually and legally supportable good faith-based claims against the alleged Debtor**," the involuntary petition was not filed in bad faith, and any award of punitive damages is inappropriate. Mundo Custom Homes, 179 B.R. at 571 (emphasis added).

The Debtor also claims entitlement to an award of fees and costs under Section 303(i)(1) of the Bankruptcy Code. While Section 303(i)(1) does provide for such an award in favor of the Debtor where an involuntary petition is dismissed, "[i]t is generally recognized that an award of any damages, fees, and costs is entirely within the Court's discretion." Mundo Custom Homes, 179 B.R. at 569. In fact, most courts "hold that the award of costs and attorneys fees, even if the involuntary is dismissed, is not mandatory, but instead is within the discretion of the court." Kearney, 121 B.R. at 644-45 (citing In re Anderson, 95 B.R. 703 (Bankr. W.D.Mo. 1989). Courts addressing this issue have noted as follows:

> [e]ach request for an award of fees and costs invokes the court's discretion, informed by such factors as the reasonableness of petitioners' actions, their motivation and objectives, and the merits of their view that the petition was proper and sustainable.

K.P. Enterprise, 135 B.R. at 177 (citing In re Reid, 854 F.2d 156, 160 (7th Cir. 1988)).

Generally, "fees and costs are seldom awarded in the absence of bad faith." K.P. Enterprise, 135 B.R. at 177 (citing West Side Community Hsp., 112 B.R. at 257). Here, as set forth above, the actions, motivations and objectives of the Petitioning Creditors were entirely reasonable. The Involuntary Petition was proper, sustainable, and filed in good faith. As such, the Debtor is not entitled to any award for fees and costs.

VI. BECAUSE THE DEBTOR'S ESTATE WILL BE "BETTER SERVED" BY THE APPOINTMENT OF A CHAPTER 7 TRUSTEE, THE COURT SHOULD NOT ABSTAIN FROM HEARING THIS CASE PURSUANT TO 11 U.S.C. § 305.

The Debtor improperly seeks to dismiss the Involuntary Petition pursuant to Section 305 of the Bankruptcy Code, which provides, in relevant part, as follows:

> (a) The court, after notice and a hearing, may dismiss a case under this title . . .if -
>
> (1) the interests of creditors and the debtor would be better served by such dismissal . . .;

11 U.S.C. § 305 (emphasis supplied).

Courts have uniformly held that the application of Section 305(a) is an **extraordinary** remedy, In re Mazzocone, 200 B.R. 568, 575 (E.D. Pa. 1996); In re Wine & Spirits Specialties of Kansas City, 142 B.R. 345, 346 (Bankr. W. D. Mo. 1992), and that the burden of proof is **substantial** and rests on the movant. In re Sherwood Enters., Inc., 112 B.R 165, 167 (Bankr. S.D. Tex. 1989). *See also*, In re Marker, 133 B.R. 340, 344 (Bankr. W.D. Pa. 1991) (holding that relief under Section 305(a) "should be granted only in egregious circumstances").

As one leading commentator has observed, "Section 305(a) is applicable only in narrow circumstances. It requires that any dismissal or suspension be warranted because (i) it is in the interest of the creditors and the debtor or (ii) a foreign proceeding is

pending." 2 Collier on Bankruptcy ¶ 305.01[1] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. Rev. 2002). The Bankruptcy Appellate Panel for the Ninth Circuit clarified the proper Section 305(a)(1) analysis as follows:

> As the statutory language and legislative history demonstrate, the test under section 305(a) is not whether dismissal would give rise to a substantial prejudice to the debtor. Nor is the test whether a balancing process favors dismissal. Rather, the test is whether both the debtor and the creditors would be 'better served' by a dismissal.

Eastman v. Eastman, (In re Eastman), 188 B.R. 621 (B.A.P. 9th Cir. 1995).

Legislative history makes clear the prototypical basis for applying Section 305:

> The court may dismiss or suspend under the first paragraph, for example, if an arrangement is being worked out by creditors and the debtor out of court, there is no prejudice to the rights 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 protract full payment.

H. Rep. No. 595, 95th Cong., 1st Sess. 325 (1977), U.S. Code Cong. & Admin. News 1978, pp. 5787, 6281.

Without question, the Debtor's estate will be better served by the appointment of a Chapter 7 Trustee. Instead of being forced into a quick sale of a company that grosses more than $3 million on an annual basis for $25,000 cash, to an insider entity, for the sole benefit of the Bagwell family, a Chapter 7 Trustee can fully investigate the numerous suspicious items in the Debtor's books and records, including excessive automobile and other miscellaneous expenses and unpaid shareholder loans, before determining the proper vehicle for maximizing the value of the Debtor's assets. Allowing this dispute to return to state court will only aid the Bagwells in carrying out their plan, which is to retain the entire value of the business while "cleansing" it of the substantial debts owed to NTA and the other Petitioning Creditors.

The Court should also reject the Debtor's disingenuous argument that creditors will be better served by permitting the Assignment Case to proceed. Only a Chapter 7 Trustee, with broad investigative and avoidance powers pursuant to Bankruptcy Rule 2004 and Sections 544, 547, 548, 549, 550, and 704 of the Bankruptcy Code, and the ability to retain forensic accountants, will be able to properly unwind the suspicious transactions and conduct KIDS.COM has engaged in during the past few years, and recover what appear to be numerous preferential, fraudulent, and unauthorized post-petition transfers. Accordingly, the Court should deny the Debtor's motion for abstention pursuant to 11 U.S.C. § 305.

CONCLUSION

For the foregoing reasons, the Petitioning Creditors respectfully request that the Court enter an Order denying the Debtor's Motion to dismiss the Involuntary Petition and for other relief, granting the Petitioning Creditor's Cross-Motion for summary judgment on the Involuntary Petition, and for such other and further relief as the Court deems just and proper.

Respectfully submitted,

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