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Involuntary Petition Damages

The decision to force an entity into an involuntary bankruptcy proceeding must be carefully considered. The threat of attorneys' fees, compensatory damages and punitive damages, all of which may be awarded under § 303(i) of the Bankruptcy Code if an involuntary petition is dismissed, should give pause to any creditor contemplating the use of an involuntary filing against another party. If unsuccessful, a strategy to commence an involuntary bankruptcy case against an adversary could result in severe consequences to a petitioning creditor. As one court addressing § 303(i) colorfully noted, "The one who swats at the hornet had best kill it."¹

Understanding the issues related to the categories of damage awards that are potentially available to involuntary debtors is critical for petitioning creditors, for purposes of risk assessment, and to alleged debtors, to inform their trial strategy where they anticipate dismissal of the petition.



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Attorneys' Fees

The first category of damages available under § 303(i)(1) is costs and attorneys' fees. Assuming that the involuntary petition is dismissed (without the alleged debtor's consent or waiver of the right to seek damages under § 303(i)), the involuntary debtor may expect to recover its costs and reasonable attorneys' fees.

A finding of bad faith is not required for an award of costs and attorneys' fees under § 303(i)(1).² When a petition is dismissed, there is a presumption in favor of awarding attorneys' fees and costs to the alleged debtor.³ The burden of proof is on the petitioning creditors to demonstrate that attorneys' fees and costs should not be awarded.⁴

Understanding the breadth of recoverable attorneys' fees is important to petitioning creditors so that they can take into account the fact that an award of attorneys' fees might go beyond just fees incurred to seek dismissal of the involuntary petition. Fee awards under § 303(i)(1) might include fees incurred in all phases of a § 303(i) proceeding, including fees incurred seeking a recovery under § 303(i)(2) for compensatory and punitive damages.⁵

Courts have even awarded attorneys' fees incurred in connection with defending appeals of a dismissal order,⁶ and fees incurred by the involuntary debtor in seeking attorneys' fees.⁷ In awarding attorneys' fees and costs, courts consider the totality of the circumstances, including the following factors:

- (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 the filing of the petition.⁸

When exercising their discretion to determine the reasonableness of attorneys' fees, courts may use the "presumptively reasonable fee" standard.⁹ The lodestar calculation (a reasonable hourly rate multiplied by the reasonable number of hours required by the case) "creates a 'presumptively reasonable fee.'"¹⁰ In considering what evidence to present at trial to support an award of attorneys' fees, debtors will want to provide detailed time records of counsel to substantiate the legal services performed, and an explanation of the necessity of such services. For bankruptcy practitioners accustomed to fee applications, seeking an award of attorneys' fees in the § 303(i)(1) context should be familiar, as the process is similar to a fee application in a voluntary bankruptcy case, but without the watchful scrutiny of the Office of the U.S. Trustee.

Bad Faith

Section 303(i)(2) of the Bankruptcy Code permits the imposition of damages proximately caused by such involuntary filing and punitive damages upon a finding that a petitioning creditor filed a petition in bad faith. There is a presumption of good faith in the petitioning creditor's favor, and the alleged debtor has the burden of establishing that the petitioning creditor acted in bad faith.¹¹ The Second Circuit has described the four generally recognized approaches for determining "bad faith" for purposes of § 303(i)(2).¹²

A wide variety of conduct has been found to demonstrate that a petitioning creditor's filing of an involuntary petition was in bad faith. Bad faith

1 *In re Kidwell*, 158 B.R. 203, 213 (Bankr. E.D. Cal. 1993).

2 *Lubow Mach. Co. Inc. v. Bayshore Wire Prods. Corp.* (In re Bayshore Wire Prods. Corp.), 209 F.3d 100, 105 (2d Cir. 2000).

3 *Crest One Spa v. TPG Troy LLC* (In re TPG Troy LLC), 793 F.3d 228, 235 (2d Cir. 2015).

4 *In re Mountain Dairies Inc.*, 372 B.R. 623, 637 (Bankr. S.D.N.Y. 2007) (internal citations omitted).

5 *DVI Receivables XIV LLC v. Rosenberg* (In re Rosenberg), 779 F.3d 1254, 1267 (11th Cir. 2015); see also *Orange Blossom Ltd. P'ship v. S. Cal. Sunbelt Devs. Inc.* (In re S. Cal. Sunbelt Dev. Inc.), 608 F.3d 456, 463-64 (9th Cir. 2010); *Glannon v. Carpenter* (In re Glannon), 245 B.R. 882, 894-95 (D. Kan. 2000); *In re Landmark Distribs. Inc.*, 195 B.R. 837, 845 (Bankr. D.N.J. 1996); *In re Advance Press & Litho Inc.*, 46 B.R. 700, 703 (Bankr. D. Colo. 1984).

6 See, e.g., *In re Rosenberg*, 779 F.3d at 1264-65.

7 See, e.g., *In re Anmuth Holdings LLC*, 600 B.R. 168, 186-88 (Bankr. E.D.N.Y. 2019).

8 *In re Taub*, 438 B.R. 761, 775 (Bankr. E.D.N.Y. 2010) (internal quotations omitted).

9 See, e.g., *Arbor Hill Concerned Citizens Neighborhood Ass'n. v. Cnty. of Albany*, 522 F.3d 182, 190 (2d Cir. 2008).

10 *Millea v. Metro-North R.R. Co.*, 658 F.3d 154, 166 (2d Cir. 2011) (quoting *Arbor Hill*, 522 F.3d at 183).

11 *In re Bayshore Wire Prods. Corp.*, 209 F.3d at 105.

12 *Id.* at 105-06.

is demonstrated under both the improper use and objective tests where the petitioning creditors file an involuntary petition despite their knowledge that their claim is subject to a *bona fide* dispute.¹³ Bad faith is also present under the improper-use test where a petitioning creditor could have pursued its claim in a nonbankruptcy venue but instead decided to file an involuntary petition in order to gain a disproportionate advantage for itself.¹⁴ As one court stated, “[w]here ... a petition is filed as a litigation tactic, solely to avoid the consequences of an adverse state court decision, bad faith is manifest.”¹⁵

Filing an involuntary petition as part of a litigation strategy to coerce the involuntary debtor to settle is relevant for purposes of bad faith determination.¹⁶ Furthermore, bad faith can be found where a petitioning creditor fails to conduct a reasonable inquiry before filing an involuntary petition that has no basis in law or fact.¹⁷

Compensatory Damages

Upon a finding of bad faith, a court may, in its discretion, award compensatory damages caused by the filing of the involuntary petition.¹⁸ An award can include claims for present and future lost sales, loss of goodwill, increased credit and bank costs, and litigation costs.¹⁹ The involuntary debtor has the burden to establish its right to compensatory damages.²⁰ The evidence must be specific, calculable with a reasonable degree of certainty and show that it was proximately caused by the involuntary filing.²¹

Compensatory damages awarded under § 303(i)(2)(A) can be substantial where an involuntary petition causes serious disruption to an operating business. For example, one bankruptcy court awarded the involuntary debtor record distributor \$3.2 million in compensatory damages following a trial.²² The court in that case heard expert witness testimony regarding the debtor’s fair market valuation prior to the filing of the involuntary petition, and considered evidence showing that the filing caused the debtor to cease its operations. In another case, a bankruptcy court awarded the involuntary debtor — a home-building company — \$4.1 million in compensatory damages based on evidence and expert testimony at trial establishing that the debtor sustained lost profits as a result of the involuntary filing.²³

Punitive Damages

An award of punitive damages does not require proof of actual damages.²⁴ Punitive damages are not measured by actual loss or the impact of the creditor’s bad faith in filing the invol-

untary petition.²⁵ In addition, punitive damages are not automatically imposed upon a finding of bad faith, but a finding of bad faith is required if punitive damages are to be awarded.²⁶

The purpose of punitive damages is to punish a wrongdoer and deter similar conduct rather than to compensate for actual loss.²⁷ In order to determine the amount of punitive damages sufficient to serve those objectives, courts generally consider the degree and nature of the wrong to the debtor, the intent of the creditors, and any surrounding aggravating or mitigating circumstances.²⁸ For example, in calculating punitive damages, courts may consider a petitioner’s net worth and the gravity of the consequences of an involuntary petition.²⁹

Although courts often will deem an award of attorneys’ fees and/or compensatory damages sufficient to effectuate the deterrence policies of § 303(i)(2) and thus refrain from awarding meaningful punitive damages, egregious bad-faith conduct may result in substantial awards of punitive damages. In the same case cited herein, in which the bankruptcy court awarded the involuntary debtor \$4.1 million in compensatory damages, the court also awarded punitive damages in the amount of \$2 million.³⁰ In this case, the petitioning creditor knew that his claim was disputed; he withheld information from his bankruptcy counsel that the claim was disputed; he threatened other creditors who did not join his petition that they would not be paid; he hired a public relations firm to publicize the bankruptcy; and he threatened the principal of the involuntary debtor with criminal prosecution.

In a recent case, the bankruptcy court awarded \$600,000 in punitive damages where the petitioning creditors were found to have acted vindictively, and with malice and ill will in filing blatantly deficient petitions.³¹ The court found that the egregiousness of their conduct was heightened by their post-filing conduct in, among other things, threatening to put the principal of the involuntary debtors into an involuntary case if he did not settle with the petitioning creditors. Interestingly, the court used as a guidepost the warning notice contained in the official bankruptcy form for filing an involuntary petition against a non-individual, which reads as follows: “**WARNING**—Bankruptcy fraud is a serious crime. Making a false statement in connection with a bankruptcy case can result in fines up to \$500,000 or imprisonment for up to 20 years, or both.” The court reasoned that the three petitioning creditors each could have received fines of \$500,000 for each of the two bad-faith involuntary petitions that were filed, for a total of \$3 million in fines.³² Accordingly, the court concluded that an award of \$600,000 in punitive damages was reasonable.

Non-Monetary Relief

An involuntary debtor may wish to seek non-monetary relief in connection with the dismissal of an involuntary peti-

13 See *In re Skyworks Ventures Inc.*, 431 B.R. 573, 577-79 (Bankr. D.N.J. 2010) (finding bad faith where petitioning creditor knew that its standing to file involuntary petition was questionable).

14 *In re Tichy Elec. Co. Inc.*, 332 B.R. 364, 373 (Bankr. N.D. Iowa 2005) (“[The] filing of an involuntary petition for a non-bankruptcy purpose is evidence of bad faith.”); *In re WLB-RSK Venture*, 296 B.R. 509, 515 (Bankr. C.D. Cal. 2003) (finding bad faith where petitioning creditor “filed this involuntary petition against the alleged debtor as a litigation tactic, after his litigation in other courts was unavailing, and in a forum-shopping effort to avoid the latest, still pending litigation in the state court”).

15 *In re Anmuth Holdings LLC*, 600 B.R. at 193.

16 *In re Reveley*, 148 B.R. 398, 411 (Bankr. S.D.N.Y. 1992).

17 See *In re Anmuth Holdings LLC*, 600 B.R. at 197.

18 See *Adell v. John Richards Homes Bldg. Co.* (*In re John Richards Homes Bldg. Co.*), 439 F.3d 248, 260 (6th Cir. 2006).

19 See *In re Tichy Elec. Co.*, 332 B.R. 364 (Bankr. N.D. Iowa 2005).

20 See *In re Anmuth Holdings LLC*, 600 B.R. at 201.

21 See *In re John Richards Homes Bldg. Co.*, 291 B.R. at 735.

22 *In re Landmark Distribs. Inc.*, 189 B.R. 290, 319 (Bankr. D.N.J. 1995).

23 *In re John Richards Homes Bldg. Co.*, 291 B.R. at 736.

24 See *In re Advance Press & Litho Inc.*, 46 B.R. at 706.

25 See *In re Silverman*, 230 B.R. 46, 52 (Bankr. D.N.J. 1998).

26 *Id.*

27 See, e.g., *In re Anmuth Holdings LLC*, 600 B.R. at 202 (“The purpose of punitive damages under § 303(i)(2) is to punish a wrongdoer and deter similar conduct in the future.”) (citing *In re Grecian Heights Owners’ Ass’n*, 27 B.R. 172, 174 (Bankr. D. Ore. 1982)).

28 See *In re Meltzer*, 535 B.R. 803, 815 (Bankr. N.D. Ill. 2015).

29 See *In re Silverman*, 230 B.R. at 54.

30 *In re John Richards Homes Bldg. Co.*, 291 B.R. at 739.

31 *In re Anmuth Holdings LLC*, 600 B.R. at 204-05.

32 *Id.* at 204.

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tion that is not specifically provided for in § 303(i). A court's ability to fashion equitable relief is grounded in the broad equitable powers under § 105(a) of the Bankruptcy Code.³³ For example, a debtor may request that an order dismissing the involuntary petition be effective retroactively, so that the bankruptcy filing itself be deemed *void ab initio* — as if it never happened.³⁴ This relief might be important to an involuntary debtor with legitimate concerns about removing the stigma of an involuntary petition that should never have been filed.

An involuntary debtor may also ask a court to impose restrictions on petitioning creditors prohibiting them from filing future involuntary petitions.³⁵ As one court noted,

³³ See, e.g., *In re Casse*, 198 F.3d 327, 336 (2d Cir. 1999).

³⁴ See *In re Anmuth Holdings LLC*, 600 B.R. at 206 (dismissing involuntary case *nunc pro tunc* to filing date and voiding filing *ab initio*); *In re Central Park Estates LLC*, 485 B.R. 72, 77 (Bankr. S.D.N.Y. 2013) (same); *In re Albert*, 2011 WL 1594953, at *1 (E.D.N.Y. April 26, 2011) (same).

³⁵ See *In re Anmuth Holdings LLC*, 600 B.R. at 206-07 (barring petitioning creditors from filing anything in bankruptcy court against principal of involuntary debtors or any of his entities for period of two years); *In re Meltzer*, 535 B.R. at 820-24 (imposing restrictions on petitioning creditors and anyone acting on their behalf to file any documents in the bankruptcy court other than notice of appeal of decision without leave of court).

“Courts are places in which serious people attend to serious business, or should be. When litigants abuse the courts — in the classic sense of using the courts to pursue ends other than the vindication of claims believed to be meritorious — the business of the courts is disrupted.... Federal courts have a responsibility to protect themselves from abuse, and they have ample authority to do so by restricting the ability of abusive litigants to file.”³⁶

Conclusion

Filing an involuntary bankruptcy petition can be a risky proposition. The remedies available to a debtor targeted by an unsuccessful involuntary proceeding can be substantial. Indeed, “subjecting someone to an involuntary petition is ‘serious business.’ An involuntary case is an extreme remedy with serious consequences to the alleged debtor....”³⁷ Filer beware. **abi**

³⁶ *In re Casse*, 198 F.3d at 336 (internal quotations and citations omitted).

³⁷ *In re Meltzer*, 535 B.R. at 816 (internal citations omitted).

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