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## Bankruptcy, Restructuring and Creditors' Rights Client Service Group

To: Our Clients and Friends

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### Creditors: Proceed with Caution on Involuntary Bankruptcy Filings

A recent Ninth Circuit Court of Appeals decision provides several clear messages regarding the dangers of poorly thought out involuntary bankruptcy petitions. In *In re Southern California Sunbelt Developers, Inc.*, 608 F.3d 456 (9<sup>th</sup> Cir. 2010), the two debtors placed into involuntary bankruptcies won an attorney fee award of \$745,000 and a punitive damages award of \$130,000 against all 13 petitioning creditors.

Section 303(b) of the Bankruptcy Code provides the general rule that an involuntary chapter 7 or 11 case may be commenced "by three or more entities, each of which is either a holder of a claim . . . that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount, or an indenture trustee representing such a holder, if such noncontingent, undisputed claims aggregate at least \$13,475 . . ." more than the value of the underlying collateral (if any). (There are different rules for entities with less than 12 creditors and partnership debtors. See 11 U.S.C. § 303(b)(2), (3).)

In *Southern California Sunbelt*, the circumstances were somewhat unusual. Two individuals controlled all 13 petitioning creditors. The debtors proved the 13 petitioning creditors had debts which were the subject of a bona fide dispute. Their counsel then litigated whether or not the involuntary filings were "bad faith filings" which would open up the petitioning creditors to an award for actual or punitive damages.

The Ninth Circuit affirmed judgments against all 13 petitioning creditors, and upheld the "fees on fees" portion of the trial court's ruling. Specifically, the Ninth Circuit not only awarded the debtors their fees incurred in litigating the dismissal of the petitions but also awarded fees incurred in litigating the issue of damages and whether the involuntary filings were in bad faith. The trial lasted *one month* and the total legal bill was \$745,000.

The Ninth Circuit went even further to rule a \$130,000 punitive damages award was appropriate even in the absence of actual damages under section 303(i)(2)(A). Finally, the Ninth Circuit upheld the trial court's decision that it had the "inherent power" to enter a joint a several judgment for fees in obtaining the dismissal of the petitions against the two individuals who controlled the petitioning entities.

The lessons of *Southern California Sunbelt* are important to all involved in representing creditors in distressed company situations. While creditors are often very frustrated with their debtors and "Throw

them into bankruptcy” is a phrase that is used on a regular basis, involuntary bankruptcy filings require forethought, analysis, and planning.

There are two primary ways a business involuntary case is typically challenged. First, the petitioning creditors have to prove the debtor is generally not paying its debts as they come due unless they are subject to a bona fide dispute. Second, as noted above, the petitioning creditors cannot have debt that is subject to a bona fide dispute as to liability or amount. Any creditor contemplating an involuntary filing strategy needs to carefully address these issues, which will often be disputed by the debtor. Otherwise, the creditor may find itself changing roles from the pursuer to the pursued.

More fundamentally, however, the result in *Southern California Sunbelt* should leave conservative creditors and their advisors erring on the side of caution and only pursuing an involuntary bankruptcy strategy in clear cut cases and in the absence of other less risky alternatives.

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