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OPINION

Litigating a bad-faith bankruptcy filing

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You've been there before. Opposing counsel in your case announces that his client is preparing to file or already has filed for bankruptcy, and succinctly declares that your case is "over."

But is your case really over? Probably, but maybe not.

Sometimes, "bankruptcies" are not bankruptcies at all but rather attempts to avoid the outcome of a lawsuit or to use a bankruptcy filing or the threat of such a filing as a litigation tactic.

Armed with a working knowledge of the law with respect to the dismissal of a bankruptcy petition filed in bad faith, you may be able to mitigate the effect of such an outcome or tactic.

Good-faith standard

Bankruptcy courts dismiss petitions not filed in good faith pursuant to the dictates of both statutory and common law. Such dismissals are rooted in Section 1112(b) of the Bankruptcy Code, which provides that where "cause" is established, "on request of a party in interest, and after notice and a hearing," then "the court *shall* ... dismiss a case under this chapter ... ." (emphasis added)

Courts have squarely established that cause for dismissal exists when a Chapter 11 petition is not filed in good faith. See, e.g., *In re Bryan*, 104 B.R. 554, 557 (Bankr. D. Mass. 1989) ("courts have defined 'cause' broadly to include a lack of good faith").

Courts consider a host of non-exclusive factors in determining whether a petition should be dismissed as filed in bad faith. Some of the factors are specified in Section 1112(b), including "gross mismanagement of the estate," "inability to effectuate substantial consummation of a confirmed plan," and failure to meet Bankruptcy Court filing requirements.

In addition, courts consider many other factors in a bad-faith analysis, such as the futility of reorganization; whether the petition serves a valid bankruptcy purpose, such as maximizing the estate's value; and whether the filing constitutes a litigation maneuver. *In re General Growth Props., Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009); *In re Integrated Telecom Express, Inc.*, 384 F.3d 108, 119-20 (3d Cir. 2004).

Importantly, "[i]t is the totality of circumstances, rather than any single factor, that will determine whether good faith exists." *In re General Growth Props., Inc.*, 409 B.R. at 56 (quotations omitted).

Bad-faith filings

When a petition in bankruptcy is dismissed on bad-faith grounds, more often than not the debtor fails to demonstrate that the petition was filed with the primary goal of reorganizing and obtaining financial stability as a result. See *In re Bryan*, 104 B.R. at 557-58 ("In finding a lack of good faith, courts have emphasized an intent to abuse the judicial process and the purposes of the reorganization provisions.").

Although there is no requirement that a debtor demonstrate insolvency before filing for relief under the Bankruptcy Code, "[i]t is nevertheless necessary that there be at least an arguable relation between the proposed reorganization and the purposes of Chapter 11." *In re The Bible Speaks*, 65 B.R. 415, 425 (Bankr. D. Mass. 1986).

Accordingly, courts dismiss petitions filed without any reorganizational purpose. See, e.g., *In re Bryan,* 104 B.R. 554 (dismissing petition where debtor could not show any realistic prospect of reorganization and lacked viable business to reorganize).

Intertwined with an analysis of whether the petition was filed for the purpose of reorganization, courts also focus on whether a petition was filed as a litigation tactic to avoid or escape liability.

Indeed, "petitions filed for the purpose of frustrating the legitimate processes of a non-bankruptcy forum constitute use of the reorganization vehicle inconsistent with the congressional intent." *In re HBA East, Inc.*, 87 B.R. 248, 260 (Bankr. E.D.N.Y. 1988).

When "the timing of a Chapter 11 petition is such that there can be no doubt that the primary, if not sole, purpose of the filing was a litigation tactic, the petition may be dismissed as not being filed in good faith." *In re 15375 Memorial Corp.*, 400 B.R. 420, 427 (Bankr. D. Del. 2009) (quotations omitted).

A debtor cannot file a petition "merely because they are disgruntled with the process in the State Court," and accordingly, "Chapter 11 relief should not be available to entities filing to obtain a perceived advantage in litigation with others or to provide an alternate forum." *In re Double W Enters., Inc.*, 240 B.R. 450, 455 (Bankr. M.D. Fla. 1999) (citations omitted).

Bankruptcy courts readily dismiss petitions filed to "obtain tactical litigation advantages

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[which are] not within the 'legitimate scope of the bankruptcy laws.'" See, e.g., *In re SGL Carbon Corp.*, 200 F.3d 154, 165 (3d Cir. 1999) (dismissal "in the face of potentially significant civil antitrust liability" where there was no evidence that adverse judgment would force debtor out of business); *In re C-TC 9th Ave. P'ship*, 113 F.3d 1304, 1310 (2d Cir. 1997) (dismissal where petition "was made with no hope of reorganization and at the very moment that the state litigation had taken a turn adverse to [the debtor]"); *In re 15375 Memorial Corp.*, 400 B.R. at 427 (dismissal where debtor had no office or employees and filed principally as litigation tactic); *In re Double W Enters., Inc.*, 240 B.R. at 455 (dismissal where no on-going business, income, creditors, employees or revenue, and petition filed as litigation tactic); *In re HBA East, Inc.*, 87 B.R. at 260 (dismissal where petition filed as a litigation tactic); *In re Schur Mgmt. Co.*, 323 B.R. 123, 127 (Bankr. S.D.N.Y. 2005) (dismissal where petition filed in advance of state court trial).

In addition to evaluating whether a petition was filed for the purpose of reorganization or as a litigation tactic, courts consider other related factors in evaluating the presence of bad faith.

For example, courts assess whether "[t]here has been no showing of any financial pressure on the [d]ebtor on the part of creditors other than the counter-party ... to the two-party dispute," whether "[u]nsecured creditors would not benefit in any material way from the [d]ebtor's filing," and whether the petition was "filed with both the purpose and effect of securing benefits for non-debtor individuals ... ." *In re Syndicom Corp.*, 268 B.R. 26, 51-52 (Bankr. S.D.N.Y. 2001); see also *In re C-TC 9th Ave. P'ship*, 113 F.3d at 1311.

Courts do not hesitate to dismiss cases in which the reorganization "essentially involves the resolution of a two-party dispute." *In re Bryan*, 104 B.R. at 558; *In re Sydnor*, No. 08-14229DK, 09-22084DK, 2010 WL 2428655 (Bankr. D. Md. June 11, 2010); *In re Integrated Telecom Express, Inc.*, 384 F.3d 108; *In re Thane Dev. Assocs., L.P.*, 143 B.R. 310, 312 (Bankr. D. Mass. 1992).

While courts dismiss bankruptcy petitions filed in bad faith, the recent denial of various motions to dismiss based on alleged bad-faith filings in *In re General Growth*, 409 B.R. 43, serves as a reminder that courts will not readily dismiss petitions without a solid factual basis.

In *General Growth*, secured lenders and their servicers moved to dismiss hundreds of petitions filed by debtors affiliated with General Growth. Upon filing the petitions, "the Debtors did not dispute that [their] shopping center business had a stable and generally positive cash flow and that it had continued to perform well, despite the current financial crisis." *Id.* at 55.

When an opposing party threatens to file, or files, a petition, it is important to know that you may have the opportunity to seek dismissal of such a filing.

However, "faced with approximately $18.4 billion in outstanding debt that matured or would be maturing by the end of 2012," General Growth "believed its capital structure had become unmanageable due to the collapse of the credit markets." *Id.*

The moving parties argued, inter alia, that the petitions were premature because "none of the [debtors] had a mortgage with a maturity date earlier than March 2010, and that the [debtors] should have waited until much closer to the respective maturity dates on their loans to file for bankruptcy." *Id.* at 57.

The court denied the motions and held that the petitions were not filed in bad faith. The court determined that the petitions were not prematurely filed and any argument that the debtors would never be able to confirm a plan was itself premature. *Id.* at 65.

As the court stated, "[t]here is no requirement in the Bankruptcy Code that a debtor must prove that a plan is confirmable in order to file a petition," and in fact, "[c]ourts have consistently refused to dismiss on this ground before a plan has been proposed." *Id.*

The court further noted that courts have denied motions to dismiss even when the debtors are able to meet current expenses. *Id.* at 61, citing *In re Century/ML Cable Venture*, 294 B.R. 9 (Bankr. S.D.N.Y. 2003) (denying motion where "despite being able to meet current expenses, the debtor had a huge financial liability which it does not have the ability to pay out of current cash flow, and without a substantial liquidation of its assets").

In its ruling, the court found that the debtors "were in varying degrees of financial distress," they carried "an enormous amount of fixed debt that is not contingent," and they made a determination of this distress after intensive financial and restructuring analyses. *Id.* at 57-58.

The lesson learned from the *General Growth* ruling is that courts will carefully evaluate all facts and circumstances prior to dismissing a bankruptcy.

While the *General Growth* court denied the moving parties' request for dismissal on bad-faith grounds, other courts, including those referenced above and many others, have dismissed petitions as bad-faith filings after reviewing the totality of the circumstances.

Conclusion

When an opposing party threatens to file, or files, a petition, it is important to know that you may have the opportunity to seek dismissal of such a filing where the petition is contemplated or filed in bad faith and fails to meet the threshold requirements under Chapter 11.

When filing a motion to dismiss a petition, it is important to keep in mind that the burden of proof on a motion seeking dismissal for "cause" is a shifting one. The movant has the initial burden. See *In re Mazzeo*, 167 F.3d 139, 142 (2d Cir. 1999).

However, once good faith is called into question, the burden shifts to the debtor to demonstrate that the bankruptcy case was commenced in good faith. *In re Syndicom Corp.,* 268 B.R. at 49.

When the debtor cannot meet its burden, the petition will be dismissed, and the parties will be returned to their pre-petition status.

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