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Section 1112(b) of the Bankruptcy Code Allows a Bankruptcy Court to Dismiss a Case Filed in Bad Faith

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Cite as: *Section 1112(b) of the Bankruptcy Code Allows a Bankruptcy Court to Dismiss a Case Filed in Bad Faith*, 13 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 18 (2021)

Introduction

The United States Bankruptcy Code (the “Bankruptcy Code”) offers a wide range of instances where a bankruptcy court can dismiss a case.¹ Section 1112(b) of the Bankruptcy Code provides that “the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, *for cause . . .*”² Section 1112(b)(4) lists different scenarios that constitute “for cause.”³ Although not explicitly within the statutory scheme, a requirement that the debtor files his bankruptcy petition in good faith is one manifestation of the bankruptcy court’s equitable power that has been implied in the statute.⁴ Thus, courts have interpreted the “for cause” provision in section 1112(b) to include a filing made in bad faith.⁵

In re The Sunshine Group, LLC demonstrates the court using its equitable power to dismiss a bankruptcy petition filed in bad faith.⁶ There, the court held a debtor filed his petition

¹ See 11 U.S.C. § 1112(b)(4) (2018).

² 11 U.S.C. § 1112(b) (2018)(emphasis added).

³ 11 U.S.C. § 1112(b)(4) (2018).

⁴ See *First Nat’l Bank of Sioux City v. Kerr (In re Kerr)*, 908 F.2d 400, 404 (8th Cir. 1990) (holding bankruptcy courts may dismiss cases under section 1112(b) for bad faith, despite its absence from the list of grounds for dismissal).

⁵ See *id.*

⁶ *In re The Sunshine Group, LLC*, CC-19-1105-GSL, 2020 WL 1846940, at *9 (B.A.P. 9th Cir. Apr. 10, 2020).

in bad faith when it was done as a litigation tactic to avoid a state court’s decision to authorize a receiver’s plan.⁷ Moreover, the debtor had no revenues to fund reorganization, no ongoing business, and only had one asset, further supporting the court’s conclusion that the debtor filed the petition in bad faith.⁸

While *In re The Sunshine Group, LLC* provides an example of a bad faith filing, it is only one interpretation of this multi-factored analysis. Bankruptcy courts have highlighted the necessity of treating each inquiry into a bad faith filing on a case-by-case basis.⁹ For that reason, the court weighs many factors to determine whether a debtor filed a petition in bad faith.¹⁰ This article examines the current state of the law by looking at the purpose behind the court reading an implied requirement of good faith into section 1112(b) and the factors that bankruptcy courts use to decide if a debtor filed in bad faith. Part I discusses the purpose for reading a good faith requirement into the statute, and Part II examines the factors that bankruptcy courts have used in defining a bad faith filing.

I. The Purpose of an Implied Good Faith Requirement

The requirement that the debtor files his bankruptcy petition in good faith is not expressly written in section 1112(b) of the Bankruptcy Code.¹¹ However, since “[e]very bankruptcy statute has . . . incorporated literally, or by judicial interpretation, a standard of good faith for the commencement, prosecution, and confirmation of bankruptcy proceedings,” courts have interpreted the statute to have a good faith requirement.¹² This good faith requirement promotes the balancing of interests between creditors and debtors by legitimizing the delay and costs that

⁷ *Id.* at *8.

⁸ *Id.*

⁹ *Id.* at *7.

¹⁰ *Id.*

¹¹ *See* 11 U.S.C. § 1112(b) (2018).

¹² *Matter of Little Creek Development Co.*, 779 F.2d 1068, 1071 (5th Cir. 1986).

bankruptcy proceedings impose on both parties.¹³ Moreover, an implied good faith standard prevents abuse of the bankruptcy process by debtors whose main motivation is to delay the recovery of creditors without providing them any tangible benefit or to reach a wrongful goal.¹⁴ Therefore, a bankruptcy court may use its own equitable powers to dismiss a case filed in bad faith under section 1112(b) of the Bankruptcy Code.¹⁵

Overall, the good faith requirement is based on the fact that bankruptcy itself is an equitable remedy that provides a debtor with strong protections from creditors through the automatic stay.¹⁶ This equitable remedy provides the debtor with the opportunity to receive a fresh start through a structured dispersal of his assets to pay his debts.¹⁷ The good faith standard protects the legitimacy of the bankruptcy courts' equitable powers by preventing debtors who have motives inconsistent with the goals of bankruptcy from receiving the benefit of reorganization.¹⁸ Thus, the Bankruptcy Code's omission of a good faith provision has allowed bankruptcy courts the flexibility to evaluate the circumstantial factors surrounding a debtor's filing.¹⁹

II. Factors Courts have Found Indicative of a Bad Faith Filing

The circumstantial factors that bankruptcy courts use to determine if the debtor filed a bankruptcy petition in bad faith are akin to dismissals "for cause."²⁰ In examining whether or not a debtor filed his petition in good faith, the bankruptcy court evaluates the circumstances

¹³ *Id.* at 1072.

¹⁴ *Matter of Stone*, 814 Fed.Appx. 857, 859 (5th Cir. 2020).

¹⁵ *In re Wentworth*, 83 B.R. 705, 707 (Bankr. D. N.D. 1988) ("The list of grounds for dismissal contained in section 1112(b) is not exclusive and the court may consider all of the circumstances of the Debtor's situation to reach an equitable result.").

¹⁶ *See Matter of Little Creek Development Co.*, 779 F.2d at 1071.

¹⁷ *Id.*

¹⁸ *Id.* at 1072.

¹⁹ *Id.*

²⁰ *Marsch v. Marsch (In re Marsch)*, 36 F.3d 825, 828 (9th Cir. 1994).

surrounding the debtor's financial condition, the debtor's purposes for filing, and the realistic financial outcomes of bankruptcy as it applies to the debtor.²¹ Typically, multiple conditions that signal a debtor filed his petition in bad faith exist in a single case.²²

One factor indicative of a bad faith filing is that the debtor has few or no unsecured creditors who would benefit from equity in the property.²³ The non-existence or lack of creditors demonstrates that the debtor does not require the full protection of the Bankruptcy Code to accomplish a legitimate reorganization.²⁴

A previous bankruptcy petition by the debtor or a related entity is another common trait of a bad faith filing.²⁵ Serial filings where the debtor has filed multiple petitions in a short period of time exemplify this factor.²⁶ Additionally, when the same debtor files a second petition under a different name, that may be considered a serial filing.²⁷ However, merely filing once before does not render a petition *per se* invalid as a bad faith filing.²⁸

Bankruptcy courts also consider improper pre-petition conduct in determining whether a debtor filed in bad faith.²⁹ Deceptive actions by the debtor, false assertions on an affidavit, and violating agreements are some examples that rise to this level.³⁰

²¹ *Matter of Little Creek Development Co.*, 779 F.2d at 1072.

²² *Id.*

²³ *Matter of Grieshop*, 63 B.R. 657, 664 (N.D. Ind. 1986).

²⁴ *In re St. Paul Storage Ltd. P'ship*, 185 B.R. 580, 583 (B.A.P. 9th Cir. Aug. 10, 1995) (holding that the lack of creditors was indicative of a bad faith filing).

²⁵ *Matter of Grieshop*, 63 B.R. at 663.

²⁶ *See In re Lee*, 467 B.R. 906, 917 (B.A.P. 6th Cir. Apr. 18, 2012) (dismissing the debtor's bankruptcy petition for bad faith because it was her third filing in less than eighteen months).

²⁷ *See Matter of Coastal Home Nursing Center, Inc.*, 164 B.R. 788, 797–98 (Bankr. S.D. Ga. Aug. 25, 1993) (“Although this is not a serial filing in the same name as a prior debtor . . . this filing is in substance, the same as if Robert Hagan had dismissed and refiled his case in order to reimpose the automatic stay.”).

²⁸ *Matter of Elmwood Development Co.*, 964 F.2d 508, 511 (5th Cir. 1992) (discussing changed circumstances on the second petition may imply a valid filing, rather than a serial filing).

²⁹ *Matter of Grieshop*, 63 B.R. at 663.

³⁰ *See Trident Associates Ltd. P'ship v. Metro. Life Ins. Co. (In re Trident Associates Ltd. P'ship)*, 52 F.3d 127, 132 (6th Cir. 1995) (finding the debtor's pre-petition conduct of misleading the district court about the possibility of bankruptcy, performing an unauthorized restructure to give all general partners limited liability, and filing a suit under a non-existent entity was improper and indicative of bad faith).

If the bankruptcy petition allows a debtor to evade court orders, that may be indicative of bad faith.³¹ Additionally, a debtor's filing may be in bad faith if the reorganization involves the resolution of a two-party dispute that could be adjudicated in state court.³² However, the existence of a two-party dispute is not a bad faith filing *per se*.³³

Additionally, the lack of debts to or pressure from non-moving creditors is another recurring circumstance in petitions filed in bad faith.³⁴ When there is no threat related to any debt, bankruptcy is improper because it would not maximize any value that could be lost outside of bankruptcy.³⁵

Further, a debtor's petition might have been filed in bad faith if the sole purpose for filing was to invoke the automatic stay.³⁶ Bankruptcy courts have held that there is no basis for access to the protection of the automatic stay when the debtor filed the petition with subverting the rights of creditors as his only objective.³⁷

A petition that has been filed on the eve of foreclosure demonstrates a tactic used to save a secured property, rather than for the purpose of restructuring, suggesting that a debtor filed the

³¹ *Marsch v. Marsch (In re Marsch)*, 36 F.3d 825, 828–29 (9th Cir. 1994) (finding the debtor filed in bad faith when the petition's sole purpose was to delay collection of a restitution judgment which the debtor had the means to pay).

³² *In re St. Paul Self Storage Ltd. P'ship*, 185 B.R. 580, 583–84 (B.A.P. 9th Cir. Aug. 10, 1995) (stating the debtor filed in bad faith when it did so in the midst of litigation with its creditor at the state court level).

³³ *Matter of Hulse*, 66 B.R. 681, 683 (Bankr. M.D. Fla. Nov. 6, 1986) (holding a petition designed with the legitimate interest to protect the business and jobs of employees was not a bad faith filing even though the case was essentially a two-party dispute).

³⁴ *Matter of Grieshop*, 63 B.R. at 663.

³⁵ *See Delaware Integrated Telecom Express, Inc. v. Integrated Telecom Express, Inc. (In re Integrated Telecom Express, Inc.)*, 384 F.3d 108, 122–24 (3d Cir. 2004) (finding the fact that the debtor was highly solvent with no pressure on the value of its assets that could be reduced or avoided by reorganization was indicative of a bad faith filing).

³⁶ *Matter of Grieshop*, 63 B.R. at 663.

³⁷ *See In re Thirtieth Place, Inc.*, 30 B.R. 503, 505–06 (B.A.P. 9th Cir. Mar. 15, 1983) (dismissing the debtor's petition for bad faith when it was made solely to gain the protection of the automatic stay and avoid legitimate recourse by its creditors).

petition in bad faith.³⁸ However, when there is a realistic possibility of reorganization, then this factor may be moot.³⁹

Moreover, the foreclosed property existing as the sole asset of the debtor implies a bad faith filing.⁴⁰ However, this factor may be mitigated by the existence of a valid and viable purpose for reorganization.⁴¹

Furthermore, a filing may be in bad faith if a corporation was formed and received assets immediately before filing for bankruptcy.⁴² Bankruptcy courts commonly refer to this phenomenon as “new debtor syndrome.”⁴³ “New debtor syndrome” demonstrates a bad faith filing because it allows the debtor to pick and choose which assets would be available to its creditors, circumventing the bankruptcy process.⁴⁴

Lastly, there are several factors that demonstrate bad faith because restructuring would be an improbability based on the debtor’s circumstances.⁴⁵ The debtor having no ongoing business or employees, the debtor having insufficient income to operate, or there generally being no possibility of reorganization demonstrates a bad faith filing due to the petition being contrary to the goals of bankruptcy.⁴⁶ The existence of a business to reorganize may be enough to show a

³⁸ *In re Miracle Church of God in Christ*, 119 B.R. 308, 309–10 (Bankr. M.D. Fla. Sep. 13, 1990) (holding a petition filed on the eve of foreclosure to stop the sale of the debtor’s real property with no plan of reorganization constituted a bad faith filing).

³⁹ *In re Con Am Grandview Associates, L.P.*, 179 B.R. 29, 32–33 (S.D.N.Y. 1995) (finding a realistic possibility of reorganization negated a determination that the debtor’s petition filed on the eve of foreclosure was in bad faith).

⁴⁰ *C-TC 9th Ave. P’ship v. Norton Co. (In re C-TC 9th Ave. P’ship)*, 113 F.3d 1304, 1310–12 (2d Cir. 1997) (holding a petition filed where the debtor only had one asset was indicative of bad faith).

⁴¹ *In re 300 Washington Street LLC*, 528 B.R. 534, 551–52 (Bankr. E.D. N.Y. Mar. 31, 2015) (finding the feasibility of the debtor’s plan demonstrated a lack of bad faith even though the debtor held a single asset).

⁴² *Matter of Grieshop*, 63 B.R. 657, 663 (N.D. Ind. 1986).

⁴³ *In re Trident Associates Ltd. P’ship*, 52 F.3d at 131–32 (identifying the purpose of this strategy was to isolate the insolvent property and its creditors).

⁴⁴ *See In re Schmitt Farm P’ship*, 161 B.R. 429, 436 (N.D. Ill. 1993) (stating “new debtor syndrome” independently supported the finding that the debtor filed in bad faith because it deprived the creditor of access to millions of dollars in equity of a property).

⁴⁵ *Matter of Grieshop*, 63 B.R. at 663.

⁴⁶ *See Marsch v. Marsch (In re Marsch)*, 36 F.3d 825, 829 (9th Cir. 1994) (listing lack of business interests as a reason to find the debtor filed the petition in bad faith); *In re St. Paul Self Storage Ltd. P’ship*, 185 B.R. 580, 583 (B.A.P. 9th Cir. Aug. 10, 1995) (finding the debtor’s lack of business for four years indicated a bad faith filing).

valid purpose for bankruptcy and avoid dismissal even when other factors indicating a bad faith filing exist.⁴⁷

Conclusion

The ability for a bankruptcy court to dismiss a petition filed in bad faith using the “for cause” provision in section 1112(b) stems from the goal of reorganization for the benefit of all creditors. The flexibility of a bankruptcy court to determine a bad faith filing has led courts to consider a multi-factored analysis to ensure the legitimacy of the equitable remedies in bankruptcy. In viewing each case uniquely on its own set of facts, bankruptcy courts have created a standard that balances the needs of legitimate debtors requiring the protections and relief of bankruptcy, while dissuading those who want to use the process illegitimately.

⁴⁷ See *In re Stolrow's Inc.*, 84 B.R. 167, 171 (B.A.P. 9th Cir. Mar. 21, 1988) (holding the debtor did not file in bad faith when the purpose was to ensure that its stores did not close and that its employees did not lose their jobs).