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Circumstances Under Which a Court Will Dismiss a Chapter 11 Filing Made in Bad Faith

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INTRODUCTION

Under section 1112(b) of title 11 of the United States Code (the “Bankruptcy Code”), a bankruptcy court may dismiss a Chapter 11 filing “for cause.”¹ It is a generally accepted principle that “for cause” dismissal includes dismissal of filings made in bad faith, and this concept originates in a need for bankruptcy courts to uphold the jurisdictional integrity of the Chapter 11 process from those who would seek to abuse it.² Courts deciding whether dismissal for bad faith is warranted typically employ a two-step analysis: first to determine whether a bad faith filing is “cause” for dismissal under section 1112(b) and second whether dismissal is “in the best interests of creditors and the estate.”³

This memorandum explores the considerations made by bankruptcy courts when deciding whether to dismiss a bad faith Chapter 11 filing. Part I explains the origin and purpose of the

¹ See 11 U.S.C. § 1112(b).

² See *Little Creek Dev. Co. v. Commonwealth Mortg. Corp. (In re Little Creek Dev. Co.)*, 779 F.2d 1068 (5th Cir. 1986).

³ See *In re Mech. Maint., Inc.*, 128 B.R. 382, 386 (E.D. Pa. 1991).

good faith requirement. Part II analyzes how courts determine whether such dismissal is warranted and examines case law that exemplifies how various bankruptcy courts have approached the issue.

DISCUSSION

I. The Origin and Purpose of the Good Faith Requirement for Chapter 11 Filings

A. The Good Faith Requirement is the Result of Judicial Interpretation of the Bankruptcy Code

The Bankruptcy Code does not explicitly describe a good faith requirement, but from the Bankruptcy Code's creation most courts have found such a requirement to be implicit.⁴ Section 1112(b) gives Bankruptcy courts the power to dismiss a Chapter 11 filing "for cause." Courts have identified the need for good faith in a filing as cause under section 1112(b) "in light of established policy considerations" such as ensuring that the bankruptcy process is not abused by debtors that do not have "clean hands" and that would inevitably cause delay to creditors and to the courts.⁵ The good faith requirement "furthers the balancing process between the interests of debtors and creditors which characterizes so many provisions of the bankruptcy laws and is necessary to legitimize the delay and costs imposed upon parties to a bankruptcy."⁶

II. How Courts Determine Whether a Bad Faith Chapter 11 Filing Warrants Dismissal

A. Dismissal of a Chapter 11 Filing Made in Bad Faith is an Extreme Remedy

The integrity of the bankruptcy process sometimes requires courts to dismiss filings that were made in bad faith. However, courts are sometimes hesitant to dismiss these cases because they might nevertheless result in an equitable outcome for all involved parties (despite being

⁴ Judith Greenstone Miller, *Amendment to Provide Good Faith Filing Requirement for Chapter 11 Debtors*, 102 COM. L.J. 181, 187 (1997).

⁵ See *Carolin Corp. v. Miller*, 886 F.2d 693, 698 (4th Cir. 1989).

⁶ *Little Creek Dev. Co.*, 779 F.2d at 1072.

filed in bad faith).⁷ Courts are particularly hesitant to dismiss filings early in the Chapter 11 process: “[d]ecisions denying access at the very portals of bankruptcy, before an ongoing proceeding has even begun to develop the total shape of the debtor's situation, are inherently drastic and not lightly to be made.”⁸ Courts must be careful not to over-extend such dismissal when other potential remedies, “such as relief from stay, adequate protection, and dismissal or conversion based on the enumerated grounds in 11 U.S.C. § 1112(b)” would better suit the needs of the involved parties.⁹

B. The Two-Step Analysis of a Chapter 11 Filing's Dismissal for Lack of Good Faith

The evaluation of a debtor's good faith or lack thereof in a Chapter 11 filing is inherently fact specific. Courts have nevertheless described two broad steps in the analysis: first to determine whether cause exists to dismiss the Chapter 11 filing, and second to determine whether dismissal is in the best interest of creditors and the estate.¹⁰ As an alternative, courts may also convert a Chapter 11 case to Chapter 7 under section 1112.¹¹

The first step to determine whether “cause” exists is a fact-intensive inquiry which requires the court to consider the “totality of the circumstances.”¹² The court must evaluate where the circumstances fall on a spectrum between acceptable and patently abusive.¹³ Two considerations that are particularly relevant to the question of good faith are (1) whether the petition serves a valid bankruptcy purpose, and (2) whether the petition is filed to obtain a

⁷ See A. Kenneth Hennesay, Jr., *Fickle Gatekeepers: Application of the "Good Faith" Doctrine in Sylmar Plaza and PPI Enterprises Inspires Little Faith in the Integrity of the Chapter 11 System*, 27 CAL. BANKR. J. 255, 258 (2004).

⁸ *Carolin Corp.*, 886 F.2d at 700.

⁹ *In re Mill Place Ltd. P'ship*, 94 B.R. 139, 141 (Bankr. D. Minn. 1988).

¹⁰ See *Rollex v. Associated Materials, Inc. (In re Superior Siding & Window, Inc.)*, 14 F.3d 240, 242 (4th Cir. 1994).

¹¹ *Id.*

¹² See *NMSBPCSLDHB, L.P. v. Integrated Telecom Express, Inc. (In re Integrated Telecom Express, Inc.)*, 384 F.3d 108, 118 (3d Cir. 2004).

¹³ *Id.*

tactical litigation advantage.¹⁴ Furthermore, a court will typically frame this stage of the analysis as requiring a subjective inquiry (into the debtor’s motivations for filing) and an objective inquiry (whether the debtor’s plan is realistic).¹⁵ The reason that the objective inquiry is needed is that “using the subjective test is too reliant on the whims of judicial fiat,” meaning a debtor’s motives are often difficult to evaluate—there is a need for objective evidence that a debtor’s plan is pretextual or incompatible with Chapter 11.¹⁶

The second step requires the court to analyze the impact on creditors and the estate if the filing were to be dismissed.¹⁷ This inquiry “cannot be completed without comparing the creditors’ interests in bankruptcy with those they would have under state law.”¹⁸ Additionally, it is also important that a court consider the impact on all creditors. Equality among creditors is an important value of the Bankruptcy Code, which “is not served by merely tallying the votes of the unsecured creditors and yielding to the majority interest.”¹⁹

C. Case Illustrations Demonstrating Judicial Application of the Good Faith Analysis

In re Syndicom Corp. is a case that demonstrates judicial application of the good faith Chapter 11 analysis and is particularly useful as an example of how other remedies may be preferable to dismissal to protect the interests of creditors. There, the Bankruptcy Court of the Southern District of New York held that a debtor’s Chapter 11 filing was made in bad faith but chose to lift the automatic stay (rather than to dismiss the case) and allowed the creditor to proceed with evicting the debtor.²⁰ The court relied on precedent and restated that dismissal

¹⁴ See 15375 Mem’l Corp. v. Bepco, L.P. (*In re* 15375 Mem’l Corp.), 589 F.3d 605, 618 (3d Cir. 2009).

¹⁵ See *Carolin Corp. v. Miller*, 886 F.2d 693 (4th Cir. 1989) (describing how even a plan filed for improper bankruptcy purposes may nevertheless be allowed to escape dismissal if the plan is objectively viable).

¹⁶ See *Miller*, supra note 4, at 195.

¹⁷ See *Rollex v. Associated Materials, Inc. (In re Superior Siding & Window, Inc.)*, 14 F.3d 240, 243 (4th Cir. 1994).

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ See *In re Syndicom Corp.*, 268 B.R. 26 (Bankr. S.D.N.Y. 2001).

“should be used sparingly to avoid denying bankruptcy relief to statutorily eligible debtors except in extraordinary circumstances.”²¹ The court then evaluated the “totality of the circumstances” and employed both a subjective and objective inquiry.²²

In analyzing the motives of the debtor, the court found that the purpose of the filing was not to reorganize but to prohibit eviction, which was evidenced by the fact that the debtor's interest in the apartment was their only asset.²³ Furthermore, the timing of the filing (one day before the warrant of eviction could be executed) suggested this purpose.²⁴ Another relevant factor was that the debtor had no income or business outside pending litigation, and therefore objectively could not succeed in using reorganization to repay its debts.²⁵ These factors and others ultimately led the court to find that the debtor had sought to abuse the bankruptcy process by creating “a corporate shell . . . as a vehicle for protecting the occupancy rights of [the debtor’s tenants] . . . ultimately for their private financial advantage.”²⁶ The court also found that despite the debtor's statements of a sincere intent to reorganize, these “ipse dixit” contentions could not override the court’s factual findings as to the debtor’s motives. Thus, both the subjective facts concerning motive and the objective facts concerning the viability of the reorganization plan weighed toward dismissal.

Considering the second prong of the analysis, the court found that the interests of the creditors were best served by lifting the automatic stay rather than dismissing the filing. The court held that although it “remains firmly of the view that this case has improperly invoked the jurisdiction of the Bankruptcy Court, and does not belong here,” that choosing to lift the stay

²¹ *Id.* at 49.

²² *Id.*

²³ *Id.* at 50.

²⁴ *Id.* at 51.

²⁵ *Id.*

²⁶ *Id.* at 52.

rather than dismiss the petition prevented the debtor from merely refiled under chapter 11 and further causing undue delays and costs.²⁷ Also, the court noted that the other creditors did not “need the ability to go after the Debtor at this time” and were not prejudiced by this outcome.²⁸

Another decision that demonstrates the good faith analysis is *In re National Rifle Association of America*, where, unlike *In re Syndicom Corp.*, the court dismissed the Chapter 11 filing. The National Rifle Association’s (“NRA”) Chapter 11 filing was found by the court to be a bad faith filing to avoid regulation and an investigation by the New York Attorney General.²⁹ Applying the first step of the two-step analysis, the Texas bankruptcy court analyzed whether there was cause for dismissal by examining the totality of the circumstances.³⁰ In doing so, the court evaluated whether the petition served a valid bankruptcy purpose and whether the petition was filed to gain a tactical litigation advantage.³¹ The court found that the purpose of the NRA’s filing was “to avoid dissolution . . . as a remedy in a state regulatory action” rather than to preserve the NRA.³² Furthermore, the court noted that “the NRA is financially healthy” and that the NRA’s intent in filing was indeed to gain a “distinct litigation advantage.”³³

Addressing the second prong of the analysis, the *Nat'l Rifle Ass'n of Am.* Court found that dismissal of the filing was in the best interests of the creditors and the estate and chose not to appoint a trustee or examiner.³⁴ The court found that “[o]utside of bankruptcy, the NRA can pay its creditors” and that appointing a trustee or examiner could have the negative effect of leading the NRA’s supporters to withdraw their donations and support.³⁵ The court further reasoned that

²⁷ *Id.* at 55.

²⁸ *Id.*

²⁹ *In re Nat'l Rifle Ass'n of Am.*, 628 B.R. 262 (Bankr. N.D. Tex. 2021).

³⁰ *Id.* at 280.

³¹ *Id.*

³² *Id.*

³³ *Id.* at 280–81.

³⁴ *Id.* at 285.

³⁵ *Id.* at 284–85.

the NRA’s polarizing political status and role as a non-profit would not make it “easy to find a suitable individual to serve in the role of trustee or examiner with expanded powers.”³⁶

Ultimately, *In re Nat'l Rifle Ass'n of Am.* demonstrates why a court applying the good faith analysis to a Chapter 11 filing may decide to dismiss a filing outright.

CONCLUSION

Courts faced with a request to dismiss a Chapter 11 case as a bad faith filing will typically consider the totality of the circumstances and engage in a two-step analysis that asks whether there is cause for dismissal and if cause exists whether dismissal is in the best interests of creditors and the estate. To determine whether cause exists, courts will evaluate both the subjective motives of the debtor and the objective viability of the reorganization plan. In determining whether involved parties will be prejudiced by dismissal, courts will balance the extreme remedy of dismissal with the need to protect the goals of Chapter 11 against debtors who would seek to use it for litigation advantage or other unlawful purposes.

³⁶ *Id.* at 284.