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Smelling Smoke, Seeing Fire, Getting Burned: Good Faith as a Bankruptcy Filing Requirement

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CONCURRENT SESSION

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Smoke or Fire?: Financial Distress as a Prerequisite for "Good Faith" Chapter 11

- 11 U.S.C. § 109 ("Who may be a debtor") does not include a "good faith" or a "financial distress" requirement for filing bankruptcy.
  - 11 U.S.C. § 1123 requires that a plan be filed in good faith.
- 11 U.S.C. § 1112 allows dismissal "for cause." § 1112(b)(4) sets forth a non-exclusive list of "causes" for dismissal, that does not include either bad faith or lack of financial distress. But, nearly all circuits recognize that lack of good faith in filing a petition constitutes "cause" for dismissal.
- So: what is the basis for requiring that (a) Chapter 11 petitions be filed in good faith and (b) good-faith filers be in financial distress?
- Can financially healthy companies use Chapter 11 to impose an automatic stay on tort claimants?

> *Truck Insurance Exchange v. Kaiser Gypsum Co*., 602 U.S. __ (2024): "Bankruptcy offers individuals and businesses ***in financial distress*** a fresh start to reorganize, discharge their debts, and maximize the property available to creditors." Slip Op. at 2. (Emphasis added).

Does Lack of Financial Distress Alone Constitute Cause For Dismissal?

- S.Rep. No. 95-989, July 14, 1978 (Bankruptcy Act): "Chapter 11 deals with the reorganization of a financially distressed business enterprise, providing for its rehabilitation by adjustment of its debt obligations and equity interests."
- 1st Cir:
  - A debtor need not be insolvent before filing Chapter 11, "provided it is experiencing some kind of financial distress." In re Capital Food Corp., 490 F.3d 21, 25 (1st Cir. 2007).
- 3d Cir:
  - Good faith requirement is grounded in "equitable nature of bankruptcy" and "purposes underlying Chapter 11." In re SGL Carbon, 200 F.3d 154, 161-62 (3d Cir. 1999). "When financially troubled petitioners seek to remain in business," exercise of bankruptcy powers is justified." Id. at 165.
  - A Chapter 11 petition must have a "valid bankruptcy purpose" (i.e., preserving a going concern or maximizing the value of the estate). A valid bankruptcy purpose "assumes a debtor in financial distress." In re Integrated Telecom, 384 F.3d 108, 128 (3d Cir. 2004).
- 4th Cir:
  - Finding of subjective bad faith was supported by record where debtor was not "experiencing financial difficulties," noting "this fact alone may justify dismissal." In re Premier Automotive Servs., 492 F.3d 274, 280 (4th Cir. 2007).
- 7th Cir:
  - "The public has an interest in limiting the use of bankruptcy for the purposes for which it was intended rather than permitting it to be used as a vehicle by which solvent firms can beat taxes... The object of bankruptcy is to adjust the rights of creditors of a bankrupt company." In re South Beach Secs., Inc., 606 F.3d 366, 371 (7th Cir. 2010).
- 9th Cir:
  - Good faith requirement is designed to deter filings that seek to obtain objectives outside the "legitimate scope of bankruptcy law." In re Marsch, 36 F.3d 825 (9th Cir. 1994).

When Does Lack of Financial Distress Constitute Cause For Dismissal? Little Circuit-Level Guidance pre-LTL

- Report of the Commission on the Bankruptcy Laws of the United States (1973): "Belated commencement of a case may kill an opportunity for reorganization or amendment."
- 2d Cir:
  - "Although a debtor need not be *in extremis* in order to file [a Chapter 11] petition, it must, at least, face such financial difficulty that, if it did not file at the time, it could anticipate the need to file in the future." In re Cohoes Indus. Terminal, 931 F.2d 222, 228 (2d Cir. 1998).
    - In re Johns Manville Corp., 36 B.R. 727 (Bankr. S.D.N.Y. 1984): "[A] financially beleaguered debtor with real debt and real creditors should not be required to wait until the economic situation is beyond repair in order to file a reorganization petition."
- 3d Cir:
  - "[A]n attenuated possibility standing alone" that a debtor "may have to file bankruptcy in the future" does not constitute good faith." In re SGL Carbon, 200 F.3d at 164.
  - BUT: The code contemplates "the need for early access to bankruptcy relief to allow a debtor to rehabilitate its business before it is faced with a hopeless situation."
- 9th Cir:
  - Bad-faith dismissal upheld where debtor had means to pay debts without danger of disrupting business interests. In re Marsch, 36 F.3d 825 (9th Cir. 1994).

When Does Lack of Financial Distress Constitute Cause For Dismissal? Mass Tort Examples

- In re Johns Manville, 36 B.R. 727 (Bankr. S.D.N.Y. 1984)
  - But for the petition, the debtor would have had to book a $1.9 liability reserve that would have triggered acceleration of debt, forcing the debtor to liquidate certain key business segments.
- In re A.H. Robins Company, 89 B.R. 555 (E.D. Va. 1988)
  - Liabilities arising out of Dalkon Shield caused a "critical depletion" of operating cash, and its "financial picture had become so bleak that financial institutions were unwilling to lend it money. With only $5 million in unrestricted funds and the inability to secure commercial financing, it appears that Robins had no choice but to file for relief under Chapter 11 of the Bankruptcy Code."
- In re Dow Corning Corp., 244 B.R. 673 (Bankr. D. Mich. 1999)
  - Legal costs and logistics of defending worldwide product liability suits "threatened [the debtor's] vitality by depleting its financial resources and preventing its management from focusing on core business matters."

In re LTL Mgmt. LLC ("LTL 1.0")
Bankr. D.N.J. 2021

- J&J and Johnson & Johnson Consumer Inc. ("JJCI") face talc claims in MDL.
- JJCI conducts divisive merger.
- LTL is vested with JJCI's talc liabilities and $6 million in cash. "New JJCI" is vested with all productive business assets.
- LTL also receives a funding agreement:
  - Outside of bankruptcy, J&J and New JJCI will satisfy all talc-related litigation costs (including payment of judgments) and normal business expenses, up to value of JJCI (over $61.5 billion).
  - Inside bankruptcy, J&J and New JJCI would provide (i) administrative costs and (ii) funding for a trust, within a plan, to address current and future talc liability, up to value of JJCI.
  - No repayment obligations.

In re Aearo Techs. LLC
Bankr. S.D. Ind. 2022

- Aearo was acquired by 3M in 2008, transfers Combat Arms earplug business to 3M in 2010 for a ~$965M unpaid receivable, on which no demand was ever made.
- 3M and certain subs (including Aearo) face tort suits related to Combat Arms in largest MDL ever. 3M paid all costs; Aearo had no participation in MDL.
- 3M and Aearo enter into Funding Agreement:
  - Aearo indemnifies 3M
  - 3M makes uncapped funding commitment for all earplug and respirator liabilities, including Aearo's obligation to indemnify 3M, inside or outside bankruptcy.
  - No repayment obligations.

Official Tort Claimants' Committees and others file motions to dismiss each case as a bad-faith filing, alleging, among other things, lack of financial distress.

In re LTL Mgmt. LLC ("LTL 1.0")
Bankr. D.N.J. 2021

- Bankruptcy Court held that LTL was in financial distress, focusing on the scope of litigation faced by JJCI and transferred to LTL, and speculating that drawing on the Funding Agreement could force J&J/JJCI to deplete their available cash and have a "horrific impact" on those companies. 637 B.R. 396 (Bankr. D.N.J. 2022)
- 3d Circuit reversed, holding that it was "legal error" to hold JJCI, rather than LTL, as the "lodestar" of the financial distress analysis and ignore the benefits of the Funding Agreement to LTL. 64 F.4th 84 (3d Cir. 2023).
- 3d Circuit ruled that Funding Agreement was "not unlike an ATM disguised as a contract, that it can draw on to pay liabilities without disruption to its business or threat to its financial liability."
- If talc verdicts continue to accrue to the point that cash available under Funding Agreement cannot adequately address talc liability, "[p]erhaps at that time LTL could show it belonged in bankruptcy….At best, the filing was premature."
- "**Financial distress must not only be *apparent*, but it must be *immediate* enough to justify a filing**."

In re Aearo Techs. LLC
Bankr. S.D. Ind. 2022

- Bankruptcy Court declined to apply a multi-factor good-faith test, agreeing with the Third Circuit that "good faith is better measured by whether the Chapter 11 case serves a valid reorganizational purpose . . . and that a debtor's 'need' for relief under Chapter 11 is central to that inquiry." 2023 WL 3938436 (Bankr. S.D. Ind. June 9, 2023).
- "[A]re the problems the debtor is facing within the range of difficulties envisioned by Congress when it crafted Chapter 11?"
- Bankruptcy Court found that Aearo could use Funding Agreement inside or outside bankruptcy to request that 3M fund any liability resulting from Combat Arms actions, and there was no evidence that Combat Arms liability threatened 3M's ability to honor Funding Agreement.
- "It is simply to early to conclude that the MDL is enterprise threatening or will result in the liquidation of either 3M or Aearo."
- Aearo and 3M commence appeal, then settle.

In re LTL Mgmt. LLC ("LTL 2.0")
Bankr. D.N.J. 2023

- After the Third Circuit's opinion, J&J caused LTL to jettison the Funding Agreement and replace it with a more limited Funding Agreement under which only JJCI, not J&J, was liable. In the interim, JJCI had spun off its consumer health business.
- LTL entered into a "support agreement" with J&J that was only available in bankruptcy and conditioned J&J's funding on final, non-appealable approval of a J&J-approved plan and capped it at $8.9 billion (over 25 years).
- J&J then caused LTL to file a second bankruptcy proceeding two hours and eleven minutes after the dismissal of LTL 1.0.
- LTL alleges 3d Cir. opinion caused initial funding agreement to be "void or voidable" and, under new funding agreement, LTL was in financial distress.
- LTL further alleges that "the vast majority" of claimants support the plan.
- Official Committee of Talc Claimants moves to dismiss for subjective bad faith and lack of financial distress and files a standing motion and complaint.

Motion to Dismiss Granted
652 B.R. 433

- Under 3d Circuit's guidance, LTL did not establish that its financial distress was "immediate."
- While LTL argued that litigation cost in the tort system would increase, there was no evidence that the aggregate amount of talc liability would surpass LTL's ability to pay.
- LTL's estimate of near-term trial costs assumed a number of trials that LTL conceded it would be unable to conduct.
- LTL appeals; J&J threatens "LTL 3.0".

Now: When Does Lack of Financial Distress Constitute Cause For Dismissal?

- Debtors need "immediate" and "apparent" financial distress.
- But, situation does not have to be "hopeless" or "beyond repair."

- Possible gauge: Ability to pay debts as they come due, without disruption to business?
  - Too close to equitable insolvency?

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Financial Distress

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July 2024

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Financial Distress

- Financial distress is not clearly defined.
  - ➢ It is easier to measure insolvency as it can be clearly defined, unlike financial distress.
    - Balance Sheet Test
    - Cash Flow Test
    - Capital Adequacy Test
  - ➢ Financial distress does not necessarily imply insolvency.
  - ➢ Insolvency usually means that a company is financially distressed.
- Indications of financial distress should not be considered in isolation.

Financial Distress

Typical Analyses

- Historical trends
- Comparison to peers
- Competition
- Ratio analysis
- Solvency analysis
- Valuation
  - Income Approach
  - Market Approach
  - Asset Based Approach
  - Cost Approach
- Public information
  - Stock prices
  - Bond prices
  - Credit ratings
  - News

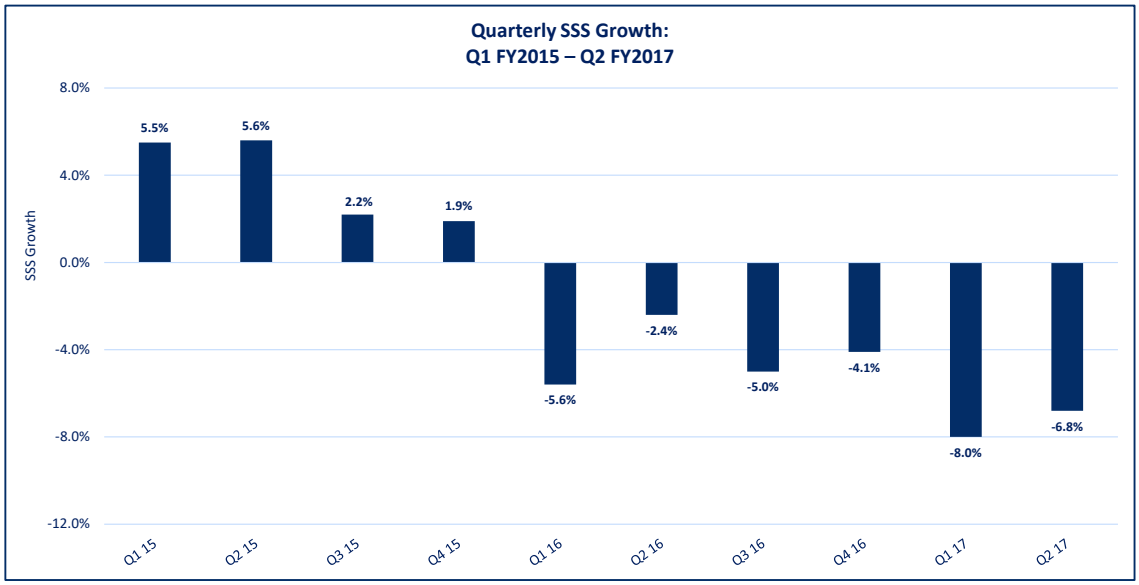
Financial Distress

Additional Factors to Consider

- Cyclicality
- Seasonality
- Debt maturities
- Debt covenants
- Access to capital markets
- Regulatory changes
- Key person issues
- Parental support
- Intellectual property
- Macro economic factors
  - Interest rates
  - Exchange rates
  - Labor supply
  - Trade terms
  - Political environment
  - Real estate values
- Legal liabilities, class actions, mass tort – materiality

Examples of Possible Financial Distress

Retail Company's Historical Same Store Sales



Examples of Possible Financial Distress

Management's Inability to Forecast Monthly Revenue

- For the 36 months prior to May 2015, management overestimated revenue in 34 out of the 36 months, or more than 94% of the time.

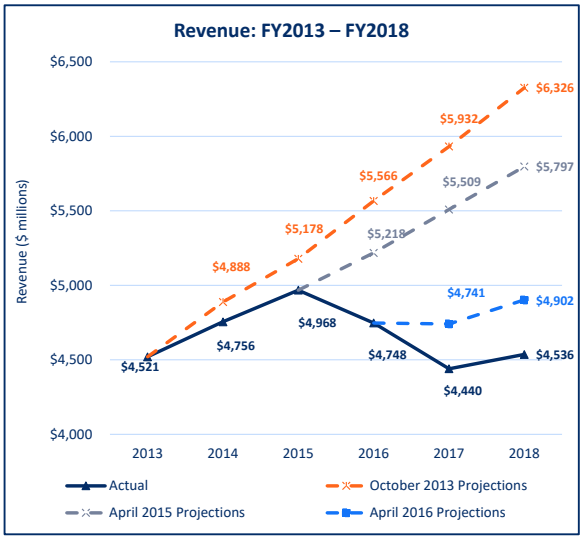
Monthly Sales: Budget vs. Actual				
Month	Budget	Actual	Variance	Outcome
Jun-12	$ 265,851	$ 256,887	-3.4%	Worse
Jul-12	200,470	191,289	-4.6%	Worse
Aug-12	205,972	199,217	-3.3%	Worse
Sep-12	237,307	228,998	-3.5%	Worse
Oct-12	208,906	197,846	-5.3%	Worse
Nov-12	239,398	225,810	-5.7%	Worse
Dec-12	372,232	350,174	-5.9%	Worse
Jan-13	175,092	165,220	-5.6%	Worse
Feb-13	175,092	165,220	-5.6%	Worse
Mar-13	200,014	193,045	-3.5%	Worse
Apr-13	250,635	238,659	-4.8%	Worse
May-13	207,673	199,203	-4.1%	Worse
Jun-13	261,780	253,257	-3.3%	Worse
Jul-13	198,605	192,912	-2.9%	Worse
Aug-13	210,073	202,720	-3.5%	Worse
Sep-13	254,660	241,654	-5.1%	Worse
Oct-13	192,758	188,619	-2.1%	Worse
Nov-13	253,524	235,343	-7.2%	Worse

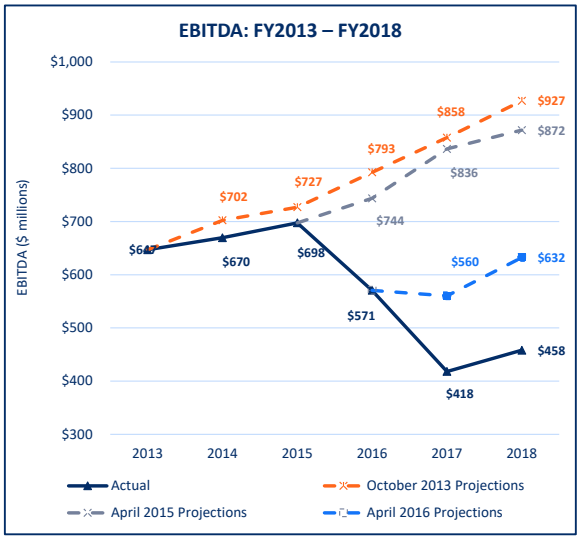
Monthly Sales: Budget vs. Actual				
Month	Budget	Actual	Variance	Outcome
Dec-13	$ 383,579	$ 348,589	-9.1%	Worse
Jan-14	169,067	157,248	-7.0%	Worse
Feb-14	198,432	189,059	-4.7%	Worse
Mar-14	242,903	233,572	-3.8%	Worse
Apr-14	211,211	205,109	-2.9%	Worse
May-14	209,732	205,975	-1.8%	Worse
Jun-14	259,106	261,191	0.8%	Better
Jul-14	198,923	194,826	-2.1%	Worse
Aug-14	209,841	212,892	1.5%	Better
Sep-14	255,123	249,896	-2.0%	Worse
Oct-14	198,286	188,747	-4.8%	Worse
Nov-14	258,975	237,351	-8.3%	Worse
Dec-14	368,776	349,592	-5.2%	Worse
Jan-15	178,572	160,057	-10.4%	Worse
Feb-15	188,961	181,707	-3.8%	Worse
Mar-15	254,152	252,949	-0.5%	Worse
Apr-15	203,683	200,475	-1.6%	Worse
May-15	216,281	205,859	-4.8%	Worse

Examples of Possible Financial Distress

Management's Inability to Forecast Revenue and EBITDA

- The chart below summarizes management's consistent forecast misses and downward revisions of revenue projections from FY2013 to FY2016. As shown below, management displayed a consistent record of overestimating the retail company's revenue.





Examples of Possible Financial Distress

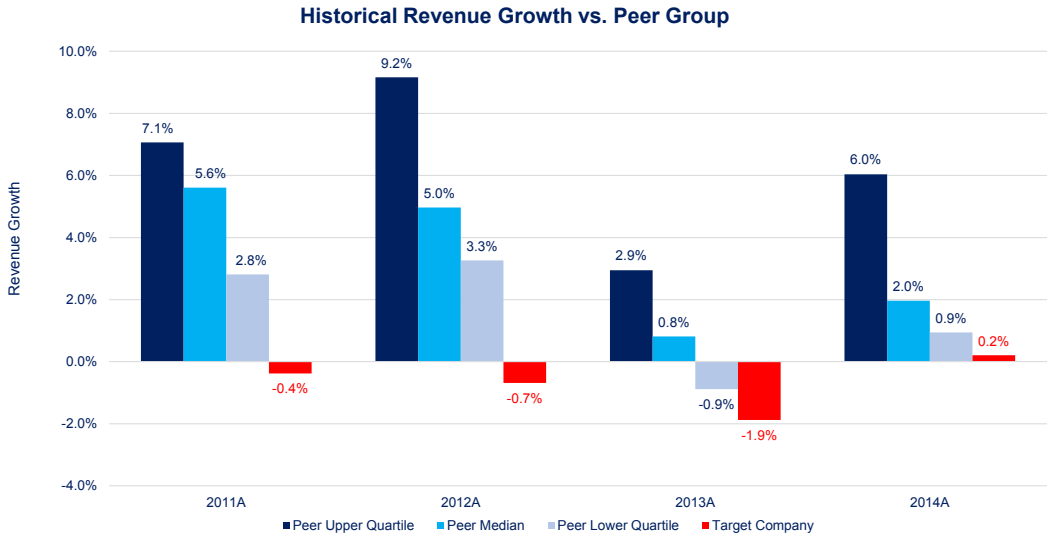
Debt Capacity

- The chart below illustrates a retail company's available revolver facility. The fiscal year end balance declines consistently over the prior four years.

Examples of Possible Financial Distress

Operating Performance vs. Peer Group

- Historical revenue growth was significantly lower than the lower quartile of the peer group.



Examples of Possible Financial Distress

Operating Performance and Leverage vs. Peer Group

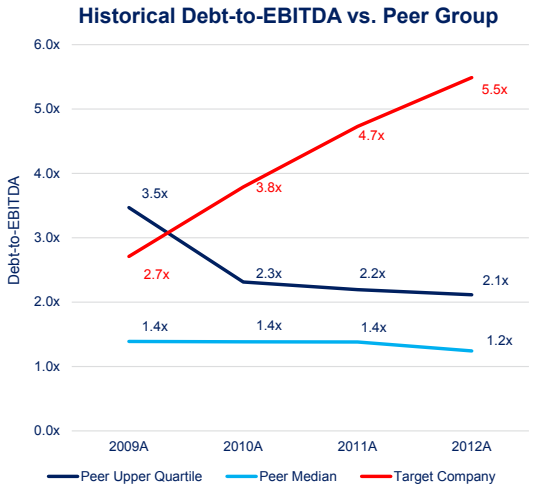
- Historical performance relative to the peer group.

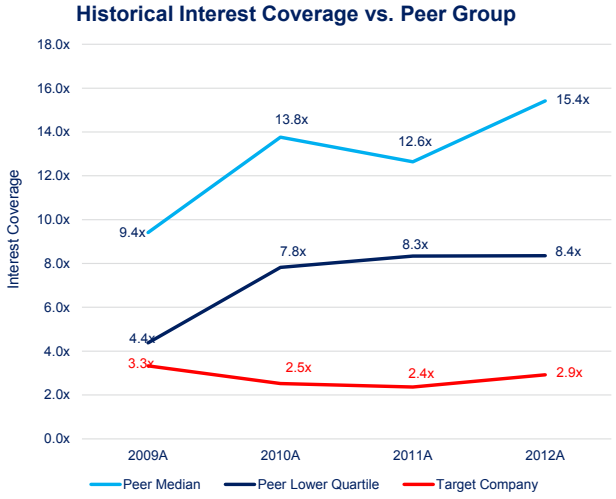
Metric	Metric Indicator	Upper Quartile	Median	Lower Quartile	Target Company	Outcome vs. Peers
Revenue Growth	Performance	7%	3%	2%	-1%	Worse
EBITDA Margin	Performance	12%	8%	6%	3%	Worse
Return on Assets	Performance	9%	7%	5%	0%	Worse
Store Count	Size	7,572	1,238	702	329	Worse
Debt-to-EBITDA	Coverage	1.8x	1.1x	0.3x	5.1x	Worse
Interest Coverage	Coverage	47.7x	16.0x	9.1x	2.9x	Worse

Examples of Possible Financial Distress

Leverage vs. Peer Group

- While the subject company has significantly more debt relative to EBITDA that its peer group, it still earns almost three times its interest expense in EBITDA.





The Origins and Evolution of the Bad Faith Doctrine in Chapter 11 Filings

Daniel C. Cohn and Lindsey M. McComber

I. Introduction

The bad faith doctrine is a judicially created requirement that Chapter 11 cases must be filed in "in good faith."[1] Courts generally employ the term "good faith" to mean that there "exists a reasonable likelihood that the debtor's plan will achieve a result consistent with the objectives and purposes of the Bankruptcy Code."[2] By requiring good faith, judges seek to prevent "abuse of the bankruptcy process by debtors whose overriding motive is to delay creditors without benefitting them in any way[.]"[3] This requirement also serves to protect "the jurisdictional integrity of the bankruptcy courts by rendering their powerful equitable weapons (i.e. avoidance of liens, discharge of debts, marshalling and turnover of assets) available only to those debtors and creditors with 'clean hands.'"[4] When a bankruptcy court determines that a Chapter 11 petition was not filed in good faith, it may dismiss the case or convert it to Chapter 7.[5]

When dismissing for bad faith, courts may invoke Section 1112(b) or (less often) Section 362(d) of the Bankruptcy Code. As further discussed below, Section 1112(b) permits dismissal of a case and Section 362(d) permits lifting of the automatic stay, in each instance "for cause." Courts may also dismiss a petition for a lack of good faith under Rule 9011 of the Federal Rules of Bankruptcy Procedure, which requires that all pleadings and papers – including a bankruptcy

[1] Michael J. Venditto, *The Implied Requirement of "Good Faith" Filing: Where Are the Limits of Bad Faith*, 1993 DET. C.L. REV. 1591, 1592 (1993).

[2] *Matter of Madison Hotel Associates*, 749 F.2d 410, 425 (7th Cir. 1984).

[3] *In re Little Creek Dev. Co*., 779 F.2d 1068, 1072 (5th Cir. 1986).

[4] *Id*.

[5] *In re Humble Place Joint Venture*, 936 F.2d 814, 816-17 (5th Cir. 1991).

petition – be filed for a proper purpose and be supported by existing law or an argument in good faith to extend existing law.[6]

Courts have developed different standards to measure whether a petition was filed in good faith. Some courts analyze whether the debtor filed for relief with subjective bad faith motivations.[7] Other courts look solely at whether the debtor had a reasonable prospect of reorganizing.[8] Most courts will consider the totality of the circumstances to determine whether a filing was made in bad faith.[9] If bad faith is found under any of these tests, the court has the ability to dismiss or convert the case.

Most bad faith filings fall into three common (and sometimes overlapping) categories: single asset cases typically filed on the eve of foreclosure, repeat filer cases, and those in which bankruptcy is deployed as a litigation tactic.[10] A fast-developing subset of the "litigation tactic" cases concerns those – particularly in the mass-torts area – where lack of a legitimate bankruptcy purpose is premised on the debtor's not-unhealthy-enough financial condition.[11] The specific challenges presented by such cases are beyond the scope of this article.

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[6] Fed. R. Bankr. P. 9011(b). An "improper purpose" expressly includes "to harass or to cause unnecessary delay or needless increase in the cost of litigation." *Id.*, 9011(b)(1).

[7] Steven Fruchter, *The Objective and Jurisdictional Origins of Chapter 11's Good Faith Filing Requirement,* 96 AM. BANKR. L.J. 63, 63 (2022).

[8] *Id*.

[9] *Id*.

[10] William T. Thurman & Brett P. Johnson, *Article: Bankruptcy and the Bad Faith Filing*, 10 UTAH BAR J. 12, 15 (1997).

[11] *See In re NRA of Am*., 628 B.R. 262 (Bankr. N.D. Tex. 2021); *see also In re LTL Mgmt. LLC*, 652 B.R. 433 (Bankr. D.N.J. 2023).

II. Origins of the Requirement that Chapter 11 Petitions Be Filed in Good Faith

The Great Depression led to the enactment of four sections of the Bankruptcy Act in the 1930s. Three of these sections imposed an express good faith requirement for both filing and confirmation.[12] If a petition was filed under these sections, courts would protect their jurisdictional integrity by dismissing the petition for not having been filed in good faith.[13] One of these sections, Section 77B, allowed for the reorganization of corporate debtors.[14]

In 1938 Congress passed the Chandler Act which replaced Section 77B of the Bankruptcy Act with two new corporate reorganization chapters – Chapters X and XI.[15] Chapter X, designed for large, publicly-held companies, required the court to "enter an order approving the petition, if satisfied that it complies with the requirements of th[at] chapter *and has been filed in good faith*, or dismissing it if not so satisfied."[16] Chapter XI, designed for smaller non-public companies, did not contain a good faith filing requirement.[17] With these changes, the Securities and Exchange Commission developed a regular practice of seeking to dismiss Chapter X cases.[18] The resulting costs and delays made Chapter X unpopular, and it came to be widely regarded as a failure.[19] Not surprisingly, Congress dropped the good faith filing requirement when it modernized the

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[12] *Id*.

[13] *Id*.

[14] Fruchter, *supra* note 16, at 64.

[14] *Id*.

[15] *Id*. at 68.

[16] Patrick A. Jackson & Robert S. Brady, *Dismissal for Bad-Faith Filing Under §1112(b)(1): Whose Burden Is It Anyway?*, AM. BANKR. INST. J. *citing* Bankruptcy Act of 1898, §141, 11 U.S.C. §541 (1976) (repealed 1978) (emphasis added).

[17] Fruchter, *supra* note 16, at 63.

[18] Walter W. Miller, *Bankruptcy Code Cramdown Under Chapter 11: New Threat to Shareholder Interests*, 62 B.U. L. REV. 1059, 1093 (1982).

[19] Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 66 (1997).

bankruptcy law in 1978, consolidating Chapter X and Chapter XI into a single reorganization chapter: Chapter 11 of the Bankruptcy Code.[20]

It did not take long after enactment of the Bankruptcy Code for good faith to reappear as a bankruptcy filing requirement.[21] Despite the best efforts of reformers haunted by the dysfunctionality of Chapter X, good faith has become a judicially imposed condition for a Chapter 11 petition.[22]

III. The Good Faith Filing Requirement

The text of Chapter 11 contains no requirement of good faith at the petition-filing stage. Good faith is not expressly required until plan confirmation, at which point the court must determine that the plan was "proposed in good faith and not by any means forbidden by law."[23] This has not stopped courts from holding that good faith is an implicit prerequisite to the right to file a Chapter 11 petition, the "absence of which may constitute cause for dismissal."[24] Courts have held that a Chapter 11 case is not filed in good faith unless it serves a "valid bankruptcy purpose."[25] The basic purposes of Chapter 11 are "preserving going concerns" and "maximizing property available to satisfy creditors."[26] A valid bankruptcy purpose also assumes that a debtor is in financial distress.[27] Therefore, in order to be filed in good faith, a debtor must intend to

[20] *Id*. at 73.

[21] Venditto, *supra* note 1, at 1597.

[22] *Id*. Mercifully, however, the SEC no longer automatically objects to public-company bankruptcy filings.

[23] 11 U.S.C. § 1129(a)(3).

[24] *In re Winshall Settlor's Trust*, 758 F.2d 1136, 1137 (6th Cir. 1985).

[25] *Off. Comm. Of Unsecured Creditors v. Nucorp*, 200 F.3d 154, 165 (3d Cir. 1999).

[26] *In re Integrated Telecom Express Inc*., 384 F.3d 108, 119 (3d Cir. 2004) *citing Bank of Am. Nat. Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 435 (1999).

[27] *Off. Comm. Of Unsecured Creditors v. Nucorp*, 200 F.3d 154, 165 (3d Cir. 1999).

reorganize and cannot be "motivated by a desire not to pay his creditors rather than an inability to pay."[28] Further, there must be some relation "between the Chapter 11 plan and the reorganization-related purposes that the chapter was designed to serve."[29]

While it is hard to quarrel with these mellifluous generalities, the real-world force behind judicial development (or resuscitation) of the good faith filing requirement is the drive to avoid injustice. In dealing with meritless filings, the statutory scheme of Chapter 11 contains a flaw. It's not just that time may elapse until the debtor seeks confirmation of a plan (providing creditors their first opportunity to invoke an express requirement for the debtor to act in good faith) but in the prototypical bad faith filing, a plan will likely not be proposed at all. To prevent months of prejudicial delay to creditors, with accompanying costs and waste of judicial resources, courts now impose a threshold requirement of good faith based on three sources of authority.

First, Bankruptcy Code Section 1112(b) allows the court to dismiss or convert a case for "cause."[30] "Cause" is not defined in the Bankruptcy Code, but bankruptcy courts have held that the term provides "flexibility to the bankruptcy courts."[31] Section 1112(b)(4) contains a list of what constitutes "cause" for purposes of dismissal. While the list is non-exhaustive ("the term 'cause' includes . . ."), the enumerated examples of "cause" all consist of acts, omissions, or events during the case rather than before or in connection with the petition. If a court finds cause, it must dismiss the case or convert it to Chapter 7, unless the court determines that appointment of a trustee

[28] *Gier v. Farmers State Bank*, 986 F.2d 1326, 1330 (10th Cir. 1993).

[29] *In re Coastal Cable T.V., Inc.,* 709 F.2d 762, 765 (1st Cir. 1983).

[30] 11 U.S.C. § 1112(b).

[31] *See In re Little Creek Development Co*., 779 F.2d 1068 (5th Cir. 1986).; *In re Humble Place Joint Venture*, 936 F.2d 814 (5th Cir. 1991).

under Section 1104 is in the best interests of the creditors of the estate.[32] Courts have overwhelmingly concluded that although section 1112(b) does not explicitly require that cases be filed in good faith, lack of good faith in filing a Chapter 11 petition establishes cause for dismissal.[33]

The Bankruptcy Code's provision governing relief from the automatic stay under Section 362 also implies a bankruptcy court's authority to dismiss a Chapter 11 filing for a lack of good faith.[34] Section 362(d)(1) provides that a party in interest can request that the court grant relief from the stay such as by "terminating, annulling, modifying, or conditioning" the stay – "(1) for cause, including the lack of adequate protection of an interest in property of such party in interest."[35] This "for cause" language allows the court to "determine whether, with respect to the interests of a creditor seeking relief, a debtor has sought the protection of the automatic stay in good faith."[36]

Rule 9011(a) of the Federal Rules of Bankruptcy Procedure – the bankruptcy analog to Rule 11 of the Federal Rules of Civil Procedure – also supplies a basis to dismiss a petition for not being filed in good faith. This rule requires a signature from an attorney certifying that every petition, pleading, motion, or other paper served on behalf of a party, after reasonable inquiry, is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law; and that it is not interposed for any improper purpose, such as to harass, to cause

[32] *Id.,* 111(b)(1); *see In re Gonic Realty Trust*, 909 F.2d 624, 626 (1st Cir. 1990).

[33] *In re Marsch*, 36 F.3d 825, 828 (9th Cir. 1994) *citing In re Little Creek Dev. Co*., 779 F.2d 1068, 1072 (5th Cir. 1986).

[34] *Carolin Corp. v. Miller*, 886 F.2d 693, 699 (4th Cir. 1989).

[35] 11 U.S.C. § 362(d)(1).

[36] *Carolin Corp. v. Miller*, 886 F.2d 693 (4th Cir. 1989); *See also Laguna Assocs. Ltd. Pshp. v. Aetna Cas. & Sur. Co*., 30 F.3d 734 (6th Cir. 1994); *In re Albany Partners, Ltd*., 749 F.2d 670 (11th Cir. 1984);

delay, or to increase the cost of litigation.[37] Rule 9011 is meant to discourage frivolous claims and abusive tactics. It requires that a bankruptcy petition, as well as all subsequent bankruptcy pleadings, be filed in good faith. Albeit a rule rather than statute, Rule 9011 is perhaps the most solid basis for dismissing a bankruptcy petition on grounds of bad faith.

IV. Tests Applied to Determine Whether a Petition Was Filed in Good Faith

Once a movant raises the existence of an issue concerning a debtor's good faith, the burden shifts to the debtor to prove good faith by a preponderance of the evidence.[38] Bankruptcy courts apply different standards to determine whether a petition was filed in good faith. These standards consist of the subjective test, the objective futility test, and the totality of the circumstances test.

A. Subjective Test

The subjective test emphasizes that bankruptcy is an equitable process. It asks whether the debtor intends to use Chapter 11 to "reorganize or rehabilitate an existing enterprise, or to preserve going concern values of a viable business."[39] Under this standard, good faith does not exist if it is "obvious that a debtor is attempting unreasonably to deter and harass creditors in their bona fide efforts to realize upon their securities[.]"[40] However, if the petitioner is attempting to invoke the operation of bankruptcy law to attempt to "effect a speedy efficient reorganization, upon a feasible

[37] *See* Fed. R. Bankr. P. 9011.

[38] *In re S & S/Moab Enters*., No. 95-55038, 1996 U.S. App. LEXIS 10967, *5 (9th Cir. Apr. 25, 1996).

[39] *Carolin Corp. v. Miller*, 886 F.2d 693, 702 (4th Cir. 1989) *citing In re Victory Constr. Co.*, 9 B.R. 549, 564 (Bankr. C.D.Cal. 1981).

[40] *In re Thirtieth Place, Inc*., 30 B.R. 503, 505 (B.A.P. 9th Cir. 1983).

basis … good faith cannot be denied."[41] The Eleventh Circuit has held that subjective bad faith alone is sufficient to dismiss a Chapter 11 petition.[42]

B. Objective Futility Test

The objective futility test is "designed to insure that there is embodied in the petition 'some relation to the statutory objective of resuscitating a financially troubled [debtor].'"[43] The petitioner's subjective motivations are irrelevant.[44] Under this test, a petition is not filed in good faith if it is clear from the outset of the case that the debtor has no reasonable prospect of reorganizing.[45] Courts applying this test have held that objective futility supports a finding of cause under Section 1112 because if rehabilitation is not possible the purpose of Chapter 11 is frustrated.[46] Some courts, such as those within the Fourth Circuit, will consider both objective futility and subjective bad faith.[47]

C. Totality of the Circumstances Test

Most courts apply the totality of the circumstances test to determine whether a Chapter 11 petition has been filed in good faith. Courts within the Third, Fifth, Sixth, and Eighth Circuits

[41] *Id*. Note that "upon a feasible basis" mixes in an objective element similar to non-futility.

[42] Noel S. Cohen, *Note & Comment: Serial Chapter 11 Filings: Finding Method in the Madness*, 17 BANKR. DEV. J. 461, 467 (2001).

[43] *Carolin Corp. v. Miller*, 886 F.2d 693, 701 (4th Cir. 1989) *citing In re Coastal Cable TV, Inc.,* 709 F.2d 762, 765 (1st Cir. 1983).

[44] *Id.* at 699.

[45] Fruchter, *supra* note 16, at 63.

[46] *In re Murph's Bowling Ctr.,* 244 B.R. 162, 166 (Bankr. D. Mont. 2000); *In re Winshall Settlor's Trust*, 758 F.2d 1136, 1137 (6th Cir. 1985).

[47] *In re Palmetto Interstate Dev. II., Inc*., 653 B.R. 230, 240-41 (Bankr. D.S.C. 2023).

utilize this test.[48] This test requires consideration of the totality of the circumstances and does not hinge on a single factor.[49] Courts consider the following badges of bad faith:

> (1) a debtor's ownership interest in only one asset; (2) improper prepetition conduct by the debtor; (3) the presence of unsecured creditors; (4) the posting of the debtor's property for foreclosure coupled with an unsuccessful fight against the foreclosure in state court; (5) the debtor and the principal creditor have litigated to a standstill in state court and the debtor has lost or been required to post a bond; (6) the debtor evaded court orders by filing the petition; (7) the debtor lacks an ongoing business or employees; (8) the timing of the petition is overly strategic; (9) the debtor's motive for filing the petition is improper; and (10) the debtor's actions negatively affected creditors, both before and after the debtor filed the petition.[50]

When evaluating the badges of faith, courts may place more weight on one factor than another, but two inquiries are particularly relevant: (1) whether the petition serves a valid bankruptcy purpose; and (2) whether the petition is filed merely to obtain a tactical litigation advantage.[51] As in the case of many judicially-developed tests where some but not all factors need to be present, "totality of the circumstances" is a smell test masquerading as a legal standard.

V. Common Types of Cases Where Bad Faith is Found

Most instances where a case is dismissed for bad faith fall into one (or more) of three categories: (i) single asset cases, typically filed on the eve of foreclosure; (ii) repeat filer cases; and (iii) cases where bankruptcy is deployed as a litigation tactic. What these situations have in common is that the debtor is trying to gain an unfair advantage through the bankruptcy process.[52]

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[48] *See In re Cedar Shore Resort, Inc*., 235 F.3d 375, 379 (8th Cir. 2000); *In re Integrated Telecom Express*, 384 F.3d 108, 120 (3d. Cir. 2004*); In re NRA of Am*., 628 B.R. 262, 266 (Bankr. N. D. Tex. 2021); *In re Elmwood Dev. Co*., 964 F.2d 508, 510 (5th Cir. 1992).

[49] *In re Integrated Telecom Express Inc*., 384 F.3d 108, 118 (3d Cir. 2004).

[50] William T. Thurman & Brett P. Johnson, *supra* note 10, at 14.

[51] *In re 15375 Mem'l Corp*., 589 F.3d 605, 618 (3d Cir. 2009).

[52] *See In re NRA of Am*., 628 B.R. 262, 281 (Bankr. N.D. Tex. 2021); *In re Antelope Tecs, Inc*., 431 App'x 272 (5th Cir. 2011).

A. Single Asset Debtor and Eve of Foreclosure Cases

Single asset debtors seeking the benefit of the automatic stay have created most of the bad faith jurisprudence.[53] In these cases, the debtor is an entity with only one asset (typically, real estate) that is subject to a lien – sometimes it received transfer of that asset just before bankruptcy – and then files under Chapter 11 before the lienholder can foreclose on the asset.[54] Although the debtor's ownership of only a single asset is not determinative of bad faith, lack of other assets may correlate with factors such as not having a business that is currently operating, or not having any employees, that render a finding of bad faith more likely.[55] "In most single asset cases, bad faith is found when the intended effort to create equity is to occur either: (i) by the passage of time while the debtor is sheltered by the stay, or (ii) through an attempt to 'cram down' the secured creditor's claim."[56]

Occurrence of the bankruptcy filing on the eve of foreclosure also commonly provides a basis for determining faith. This may signal a last-ditch attempt to hang on to the property with no real hope of rehabilitation.[57] In this situation, courts often dismiss based on a determination that the petition was filed to "delay or frustrate creditors."[58] However, bad faith claims have been rejected where, even though the Chapter 11 petition was filed on the eve of foreclosure, the debtor's assets were "still capable of forming the basis of a successful plan[.]"[59] Factors such as

[53] William T. Thurman & Brett P. Johnson, *supra* note 10, at 15.

[54] *Id*.

[55] *Id*.

[56] Venditto, *supra* note 1, at 1612.

[57] William T. Thurman & Brett P. Johnson, *supra* note 10, at 15.

[58] *In re Phoenix Piccadilly, Ltd.,* 849 F.2d 1393, 1394 (11th Cir. 1988).

[59] *See In re I-95 Technology-Industrial Park*, 126 B.R. 11, 16 (Bankr. D. R.I. 1991).

filing on the eve of foreclosure, no other assets, lack of employees or an ongoing business do not constitute bad faith *per se* but instead must be balanced against any facts suggesting legitimate reasons for seeking reorganization.

B. Repeat Filer Cases

The bad faith doctrine is also commonly invoked when a debtor files successive Chapter 11 cases. The Bankruptcy Code bars modification of a confirmed plan once it has been "substantially consummated."[60] Therefore, if the purpose of a new petition is to evade responsibilities under the old plan, the petition will likely be dismissed.[61] Although in most instances a repeat filing will support a finding of bad faith, this is not always the case.[62] Where the subsequent filing reflects a need for bankruptcy relief because the debtor cannot perform under the old plan, rather than an attempt to evade responsibilities under that plan, the court can find good faith and refuse to dismiss or convert the case.[63]

C. Filings as a Litigation Tactic

Courts consistently find that a bankruptcy case filed for the purpose of obtaining an unfair litigation advantage is not filed in good faith and must therefore be dismissed. These cases focus on whether there are other legitimate reasons for bankruptcy. But if the bankruptcy process is being exploited for reasons unrelated to reorganization – such as to gain a tactical advantage in a

[60] 11 U.S.C. § 1127(b).

[61] *In re AT of Me., Inc*., 56 B.R. 55, 56-57 (Bankr. D. Me. 1985); *see also In re Northampton Corp*., 39 B.R. 955 (Bankr. E.D. Pa. 1984).

[62] *See e.g., In re Jartran, Inc*., 886 F.2d 859 (7th Cir. 1989).

[63] *Id*. at 868.

two-party dispute or circumvent state law requirements regarding the posting of a supersedeas bond as a condition to appealing an adverse judgment – the case will be dismissed.[64]

A prominent example where bad faith took the form of seeking litigation advantage is the recent bankruptcy filing of the National Rifle Association of America.[65] The NRA filed a Chapter 11 petition after the New York Attorney General filed a lawsuit seeking the NRA's dissolution because it allegedly "conducted its business in a persistently illegal manner."[66] Trial testimony revealed that there was no financial reason for the NRA to file for bankruptcy.[67] Employing a totality of the circumstances approach, the court found that the purpose in the NRA's filing was to obtain litigation advantage by blocking the remedy of dissolution available to the Attorney General as part of New York's regulatory scheme for non-profit organizations.[68] The Court dismissed the case for lack of good faith.[69]

VI. Conclusion

Although the Bankruptcy Code does not explicitly require that a Chapter 11 petition has to be filed in good faith, courts have determined that it implicitly does. Lacking a statutory framework to dismiss based on bad faith filing, courts have developed (invented) a number of tests to determine bad faith. This doctrinal development, however non-uniform and *ad hoc*, is underpinned by a necessity that few would dispute: Nipping abusive bankruptcies in the bud.

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[64] *In re Marsch*, 36 F.3d 825, 828 (9th Cir. 1994); Lawrence Ponoroff & F. Stephen Knippenberg, *Legal Theory: The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U. L. REV. 919, 938 (1991).

[65] *See In re Nat'l Rifle Ass'n of Am*., 628 B.R. 262, 266 (Bankr. N.D. Tex. 2021).

[66] *Id*. at 264.

[67] *Id*. at 275.

[68] *Id.* at 281.

[69] *Id*. at 264.

Courts have largely confined themselves to three common situations of clear abuse: where a (typically) single asset debtor seeks to stave off the inevitable by filing on the eve of foreclosure with no genuine prospect of reorganization; where a debtor is attempting to evade its responsibilities under a previously confirmed and substantially consummated plan; or where the petition is a mere litigation tactic, without legitimate bankruptcy purpose. Developed for the purpose of preventing abuse, the good faith filing requirement itself presents a meaningful danger of abuse. Courts should not extend this judge-made doctrine, resting on a weak-to-nonexistent statutory foundation, to any situation where there can be legitimate debate over whether the bankruptcy petition is abusive. Otherwise, we risk reviving the wreck of Chapter X wherein parties wasted time and treasure wrangling over whether the debtor should even be allowed to present a plan, rather than testing its merits.

Faculty

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