

The New Chapter 11 Means Test

In their own “good faith” and well-intentioned (but misguided) attempt to establish a bad faith standard for testing newly-filed Chapter 11 cases, the courts have unwittingly established a new “Chapter 11 Means Test.” In doing so, they have violated the will of Congress and opened a Pandora’s Box of unwieldy litigation.

Preface

In their well-intentioned attempt to articulate a reasonable set of bad faith standards and guidelines, the courts have, in effect, established a revolutionary Chapter 11 “Means Test” that is directly contrary to the will of Congress and that will be highly unwieldy and expensive to apply.

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Congress may have erred in not directly addressing the very important subject of good faith in this context.

With the enactment of the Bankruptcy Code, Congress eliminated any requirement that the debtor in a voluntary Chapter 11 case be insolvent.

Most non-bankruptcy lawyers are surprised to learn that, under “black letter” bankruptcy law, an entity or person does not need to be insolvent to become a Chapter 11 debtor. With the enactment of the Bankruptcy Reform Act of 1978, Congress eliminated any requirement that a petitioner in a voluntary Chapter 11 case have debts, much less that it be insolvent. The Bankruptcy Code establishes no financial qualifications or conditions for access to Chapter 11. In contrast, to be a debtor in a Chapter 9 case, a political subdivision or public agency must be “insolvent” in the sense that it either is not paying or cannot pay its undisputed debts as they become due.

Similarly, the Code does not require objective or subjective good faith, or the absence of bad faith, or some proper motive, objective, or state of mind on the part of the Chapter 11 petitioner. While Congress incorporated (and obviously knew how to engraft) the presumably converse and correlative con-

cepts of “good faith” and “bad faith” into various provisions of the Code (See, for examples Sections 303(i)(2) [which allows the victim of an involuntary bankruptcy petition that has been filed in bad faith by a creditor or creditors to recover compensatory and punitive damages from the petitioners], 363(m) [which immunizes “good faith” purchasers and lessees from the successful appeal of bankruptcy court orders authorizing such sales or leases], and 1129(a)(3) [which requires, as a condition precedent to confirmation of a plan of reorganization, a finding that the “plan has been proposed in good faith”]), it nowhere established good faith, or the absence of bad faith, as a condition precedent to the exercise of bankruptcy jurisdiction in Chapter 11.

Moreover, in Section 1112(a)(4) of the Code, where Congress articulated a non-exhaustive list of 16 separate “causes” for the dismissal of a Chapter 11 case, Congress failed to include such seemingly logical bases for dismissal as solvency, the unreasonable attempt by a solvent debtor to avail itself of some of the extraordinary rights provided by Sections 362 (automatic stay), 363 (use, sale or lease of property), 365 (assumption or rejection of executory contracts and unexpired leases), 502 (the capping of various kinds of unsecured claims), and/or other provisions of the Code, or the use of the provisions of the Code to obtain either a strategic advantage in litigation or to generate negotiating leverage in a single-creditor dispute. The statutory list admittedly includes a number of highly significant bases for dismissal of a Chapter 11 case including, but not limited to, “absence of a reasonable likelihood of rehabilitation,” “gross mismanagement,” “unauthorized use of cash collateral substantially harmful to 1 or more creditors,” and “mate-

rial default by the debtor with respect to a confirmed plan.” It also includes such seemingly lesser sins as “unexcused failure to satisfy timely any filing or reporting requirement,” “failure to pay any fees or charges required under chapter 123 of title 28,” and “failure timely to provide information or attend meetings reasonably requested by the United States Trustee...” One would expect to find a significant basis for dismissal, like the bad faith commencement of a voluntary case, among the listed grounds for dismissal. It is not there.

Notwithstanding the foregoing, the Bankruptcy Courts have developed a financial “means test” that must be passed by all prospective Chapter 11 debtors

In short, quite curiously and inexplicably, Congress left it to the courts both to decide whether bad faith would be a basis for dismissal of a voluntary Chapter 11 case and, if they (the courts) decided to invoke the power to dismiss on bad faith grounds, to define bad faith. Inevitably, the law governing the dismissal of voluntary cases on bad faith grounds has emanated totally from the judiciary. The resultant state of the law and “state of affairs” in the bankruptcy world is this:

- Virtually every, if not every, court that has considered the issue has, at a minimum, recognized the power of the court, upon motion by a party in interest or *sua sponte*, to dismiss a Chapter 11 case on the grounds that the case was filed in “bad faith.”
- The courts’ articulation of the law of bad faith has been quite uniform and consistent in the sense that, again and again, regardless of how they have decided the ultimate dismissal issue, the courts have recited the same platitudes about bad faith and provided essentially the same definitions, standards, guidelines, and examples.
- Most surprisingly, in these bad faith cases, the courts have delved deeply into such financial issues as the degree of the debtor’s financial distress, whether the debtor has a *sufficiently healthy* business to survive bankruptcy and avoid liquidation, whether the debtor is *sufficiently unhealthy* to have a legitimate need for Chapter 11 relief,

whether the need for Chapter 11 relief is premature, or whether the debtor has in effect waited so long to file its case that reorganization is no longer possible.

- Ironically, the courts have in effect determined that the correct answer to this question falls somewhere between the two extremes. They have found that healthy debtors have no right to the benefits of Chapter 11 and that utterly unhealthy ones should be liquidated in Chapter 7.

In short, in their own well-intentioned attempt to establish a bad faith standard for testing newly-filed Chapter 11 cases, the courts have established a new “Chapter 11 Means Test.” In doing so, they have gone into the business of deciding whether a debtor really needed to avail itself of the benefits of Chapter 11, whether the business was capable of reorganization, and whether the debtor could have waited until some later time to file its case. Wading shoulder deep into these difficult and highly unwieldy areas of inquiry, the courts have acted not only without any Congressional mandate, but without any legislative rules or guidelines. Moreover, they are often acting without benefit of any reliable evidence. They have directly (if not consciously) ignored the legislative history and express language of the Bankruptcy Code. Congress never intended that the courts assume this role. The result is a veritable hodge-podge of inconsistent and unpredictable rulings, in which the courts try (without much success, I would humbly suggest) to establish standards and benchmarks that are utterly inconsistent with the intent and language of the Bankruptcy Code. If there is to be a Chapter 11 means test, it should be established by Congress, not the courts.

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