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ARTICLES

"Bankruptcy Remote" Does Not Mean "Bankruptcy Proof"

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To file a voluntary petition for relief under the Bankruptcy Code, an entity's directors must approve a resolution authorizing such action, subject to the requirements of the entity's organizational documents. A copy of such authorization is generally filed along with the voluntary petition.

In bankruptcy parlance, "bankruptcy remote" is a term used to describe provisions of an entity's organizational documents that make it difficult (or impossible) for the entity to voluntarily seek bankruptcy relief. Entities are generally made bankruptcy remote for the benefit of one or more key classes of creditors or equity holders, and two typical provisions in the organizational documents act in concert to achieve this result—one that requires the appointment of at least one "independent" director loyal to the class that wishes to avoid bankruptcy and one that requires unanimous approval of the entity's directors to authorize a filing.

When a bankruptcy remote entity faces distress, constituencies that wish to invoke the protections of the Bankruptcy Code must utilize unconventional tactics. In some instances,

independent directors are swiftly replaced immediately before the key vote to authorize a voluntary filing. *See, e.g., In re Gen. Growth Props. Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009). In other cases, the other directors may organize creditors and orchestrate an involuntary filing. Under either scenario, once bankruptcy protection is invoked, the aggrieved parties may move to dismiss the case on the theory that the machinations leading to the filing constitute bad faith. This article summarizes the standard for "bad faith" dismissal of involuntary bankruptcy cases filed against bankruptcy remote entities under 11 U.S.C. § 1112(b), including the recent decision in *In re Houston Regional Sports Network, LP*.

Dismissal of Bad Faith Filings Under 11 U.S.C. § 1112(b)

A chapter 11 case may be dismissed "on request of a party in interest, and after notice and a hearing . . . for cause . . . ." 11 U.S.C. § 1112(b)(1). The term "cause" specifically includes the 16 circumstances set forth in 11 U.S.C. § 1112(b)(4), and bankruptcy courts have consistently held that the term also includes situations where the petition is filed in "bad faith." Though the standard for bad faith varies slightly by circuit, most courts apply a test that includes both objective and subjective prongs. *See, e.g., C-TC 9th Ave. P'ship v. Norton Co. (In re C-TC 9th Ave P'ship)*, 113 F.3d 1304, 1309–10 (2d Cir. 1997) (dismissal warranted if "there was no reasonable likelihood that the debtor intended to reorganize and no reasonable probability that it would eventually emerge from bankruptcy proceedings"); *NMSBPCSLDHB, L.P. v. Integrated Telecom Express, Inc. (In re Integrated Telecom Express, Inc.)*, 384 F.3d 108, 119–20 (3d Cir. 2007) (test focuses on "whether the petition serves a valid bankruptcy purpose . . . [and] whether the petition is filed merely to obtain a tactical litigation advantage"); *Maryland Port Admin. v. Premier Auto. Servs., Inc. (In re Premier Auto. Servs., Inc.)*, 492 F.3d 274, 279–80 (4th Cir. 2004) ("a lack of good faith in filing a Chapter 11 petition requires a showing of 'objective futility' and 'subjective bad faith.").

Dismissal of Involuntary Filings against Bankruptcy Remote Entities

In *In re Kingston Square Associates*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997), the debtor was bankruptcy remote because its organizational documents included a unanimous consent requirement for a voluntary bankruptcy filing, and the senior lender was entitled to appoint an independent director. Following certain defaults, the senior lender commenced a foreclosure of the debtor's assets. Because the independent director held a blocking position on any vote to authorize a voluntarily bankruptcy filing and because the other directors believed there was equity in the debtor's assets beyond the senior lender's liens, the other directors led an effort to enlist creditors to file an involuntary petition. The senior lender promptly moved to dismiss the case as a bad faith

filing, arguing that the directors' actions were intended to circumvent the debtor's bankruptcy remote nature.

The court noted that under binding Second Circuit precedent, "a bankruptcy petition will be dismissed if **both** objective futility of the reorganization **and** subjective bad faith in filing the petition are found." *Id.* at 725 (emphasis in original and citing *Baker v. Latham Sparrowbush Assocs. (In re Cohoes Indus. Terminal, Inc.)*, 931 F.2d 222, 227 (2d Cir. 1991)). While the court determined that the directors' machinations in orchestrating the involuntary filing were "suggestive of bad faith," *id.* at 734, it held that "the orchestration [of the filings by the directors] is not sufficient to warrant dismissal of the case without evidence that the Debtors have no chance of rehabilitation." *Id.* at 739.

In *In re Global Ship Sys. LLC*, 391 B.R. 193 (Bankr. S.D. Ga. 2007), the court confronted similar circumstances but came to the opposite conclusion. In *Global Ship*, the debtor issued 20 percent of its Class B equity interests to its senior lender, and the consent of these equity interests was required to authorize a voluntary bankruptcy filing. When the debtor defaulted and the senior lender commenced foreclosure of its collateral, the holders of the Class A interests orchestrated an involuntary filing against the debtor. The senior lender moved to dismiss on bad faith grounds.

The *Global Ship* court considered both objective and subjective elements before dismissing the case. On the objective prong, the court determined that because the senior debt "far exceed[ed] the value of [the] collateral," reorganization was futile. *Id.* at 204. On the subjective prong, the court held that the holders of the Class A interests acted in subjective bad faith because "in circumventing the rights of [the senior lender] as shareholder to consent to a bankruptcy filing through the ruse of soliciting an involuntary case and failing to contest the involuntary petition once it was filed, Global engaged in bad faith . . . ." *Id.* The court also noted that under Eleventh Circuit precedent, it was bound to dismiss the case upon a finding of subjective bad faith, "even if I conclude that a feasible reorganization is in prospect . . . ." *Id.* (citing *Phoenix Piccadilly, Ltd. v. Meritor Savs. Bank (In re Phoenix Piccadilly, Ltd.)*, 849 F.2d 1393, 1395 (11th Cir. 1988)).

In re Houston Regional Sports Network

Against the backdrop of the conflicting authority of *Kingston Square* and *Global Ship*, the U.S. Bankruptcy Court for the Southern District of Texas considered the case of *In re Houston Regional Sports Network, LP*, No. 13-35998, 2014 WL 554824 (Bankr. S.D. Tex. Feb. 12, 2014). The debtor's directors were appointed by the Houston Astros, the Houston Rockets, and Comcast, and its

organizational documents prohibited a voluntary bankruptcy filing absent unanimous consent. After a payment default by the debtor, the Astros threatened to terminate a key agreement with the debtor. In response, creditors controlled by Comcast filed an involuntary petition against the debtor, and affiliates of the Rockets subsequently joined. The Astros moved to dismiss on bad faith grounds.

The *Houston Sports* court applied both the objective and subjective prongs in denying the motion to dismiss. First, the court rejected the Astros' argument that any reorganization would be objectively futile because the Astros' director would exercise its veto power of any proposed plan. The court held that once the order for relief entered, the Astros' director would be in breach of his fiduciary duties to the debtor if he rejected a viable plan of reorganization. *Id.* at *11–13. Second, the court held—contrary to *Global Ship* and *Kingston Square*—that the actions by Comcast and the Rockets to circumvent the unanimous consent requirement "was a far cry from [subjective] bad faith." *Id.* at *9. While the actions may have given rise to a cause of action for damages, they were insufficient to establish bad faith warranting dismissal in the face of testimony stating that the petition had been filed to preserve value and rehabilitate the debtor.

Conclusion

Entities are made bankruptcy remote to protect key equity and creditor constituencies from the risk and uncertainty inherent in bankruptcy proceedings. As this article suggests, however, bankruptcy remote hardly means bankruptcy proof. A bankruptcy remote entity may be forced into bankruptcy involuntarily, and sometimes as part of an orchestrated scheme by insiders who are otherwise prohibited from authorizing a voluntary filing by the unanimous consent requirements of the debtor's organizational documents. When this occurs, courts must grapple with motions for bad faith dismissal under 11 U.S.C. § 1112(b), including both objective and subjective inquiries.

Prior to *Houston Sports*, the limited precedent in this area uniformly suggested that orchestration of an involuntary bankruptcy filing by insiders constituted subjective bad faith. In *Global Ship*, this finding was determinative; in *Kingston Square*, however, it was insufficient where the debtor's reorganization was not objectively futile. The decision in *Houston Sports* was the first to determine that orchestration of an involuntary filing by such insiders "was a far cry from bad faith." In light of this holding, practitioners are well-advised to focus their investigation and arguments on whether an involuntary debtor's rehabilitation is objectively futile or in reasonable prospect, as this issue may be determinative.

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