

# **BAD FAITH BANKRUPTCY FILINGS**

## I. STATUTORY REFERENCES OF BAD FAITH

- A. Only statutory reference to bad faith as a basis for dismissal or conversion of a bankruptcy case is 11 U.S.C. § 707(b)(3)(A), which provides that
- (3) In considering under paragraph (1) whether the granting of relief would be an abuse of the provisions of this chapter in a case in which the presumption in subparagraph (A)(I) of such paragraph does not arise or is rebutted, the court shall consider –
- (A) whether the debtor filed the petition in bad faith;
- (B) the totality of the circumstances ... of the debtor’s financial situation demonstrates abuse.
- B. All chapters have statutory provisions providing for the dismissal or conversion of a case for “cause.”
1. 11 U.S.C. § 707(a)
  2. 11 U.S.C. § 1112(b)(1) - “... 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 if the movant establishes cause.”
  3. 11 U.S.C. § 1307(c) - “the court may convert a case under this chapter to a case under Chapter 7 of this title, or may dismiss a case under this chapter, whichever is in the best interests of creditors and the estate for cause,...”
- C. Each chapter statutorily defines “cause” for dismissal or conversion in a non-exclusive manner, although the separate statutes include specific acts that constitute cause.
1. Chapter 7 - Section 707(a)
    - a. Unreasonable delay prejudicial to creditors
    - b. Nonpayment of fees under 28 U.S.C. § 123
    - c. Failure to timely file information required by § 521(1), but only on motion of us Trustee .
  2. Chapter 11 - Section 1112(b)(4) -
    - a. Substantial or continuing loss and absence of reasonable likelihood of rehabilitation
    - b. Gross mismanagement

- c. Failure to maintain insurance
  - d. Unauthorized use of cash collateral
  - e. Failure to pay
3. Chapter 13 -
- a. Section 1307(c)
    - (1) unreasonable delay by the debtor that is prejudicial to the creditors
    - (2) failure to file a plan timely under section 1321 of this title
    - (3) failure to commence making timely payments under section 1326 of this title
    - (4) failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.
  - b. Section 1307(e) - Shall dismiss or convert case where a Chapter 13 debtor fails to file tax returns.

## II. BAD FAITH AS A BASIS FOR DISMISSAL OR CONVERSION IN CHAPTER 11

A. “Although not specifically listed as cause for relief under § 1112(b)(4), bad faith has long been recognized as an appropriate ground for dismissal or conversion of a chapter 11 case.” *In re Zaruba*, 8 ABR 449, 452 (Bankr. D. Alaska 2007)

1. *In re Marsch*, 36 F.3d 825, 828 (9<sup>th</sup> Cir. 1994)

The bankruptcy court may dismiss a Chapter 11 case “for cause” pursuant to 11 U.S.C. § 1112(b). Although section 1112(b) does not explicitly require that cases be filed in “good faith”, courts have overwhelmingly held that a lack of good faith in filing a Chapter 11 petition establishes cause for dismissal.

### B. Test

1. The Ninth Circuit has rejected any formulaic test of bad faith. *Marsch*, 36 F.3d at 828 (good faith, “depends on an amalgam of factors and not upon a specific fact.”) Rather, [t]he ultimate determination of whether a chapter 11 case was filed in good faith is “based on the totality of circumstances” *In re Marshall*, 403 B.R. 668, 690 (Bankr. C.D. Cal. 2009) (quoting *In re Sylmar Plaza, L.P.*, 314 F.3d 1070, 1074 (9<sup>th</sup> Cir. 2002)).

2. The Ninth Circuit has explained that the test “is whether a debtor is attempting to unreasonably deter and harass creditors or attempting to effect a speedy, efficient reorganization on a feasible basis.” *Marsch*, 36 F.3d at 828.
3. “Moreover, a finding that a bankruptcy petition was not filed in good faith ‘should not be lightly inferred.’” *In re South Canaan Cellular Investments, Inc.* 2009 WL 2922959 at 8 (Bankr. E.D. 2009) (quoting *Perlin v. Hitachi Capital America Corp.*, 479 F.3d 364, 373 (3<sup>rd</sup> Cir. 2007))
4. Nor should a debtor be penalized for attempting to take advantage of the rights afforded under the Bankruptcy Code. *see In re PPI Enterprises (US), Inc.*, 324 F.3d 197 (3<sup>rd</sup> Cir. 2003) (debtor’s Chapter 11 filing to cap landlord’s claims under § 502(b)(6) was in good faith as it was filed to use Bankruptcy Code as intended). “Filing a bankruptcy petition with the intent to frustrate creditors does not by itself ‘establish an absence of intent to seek rehabilitation.’” *In re Cohoes*, 931 F.2d 222, 228 (2nd Cir.1991) (quoting *Banque De Financement, S.A. v. First National Bank*, 568 F.2d 911, 917 (2nd Cir.1977)).

C. Alaska Cases

1. *In re Nome Commercial Company*, 4 ABR 358 (Bankr. D. Alaska 1996). Adverse judgment for \$1.46 million entered against individuals and corporation. Appeal without supersedeas bond. Creditors challenged filing as bad faith and as part of confirmation process under 11 U.S.C. § 1129(a)(3). Contains review of cases. Court reconciled the competing decisions by noting that “In the cases denying dismissal motions, the judgment was large and if not reversed on appeal, would force the liquidation of the business.... In those cases dismissing the petition ... the judgments were smaller and the debtor had the apparent ability to satisfy the judgments and stay in business.” *Id.* at 364. Court held that absent bankruptcy the judgment would result in severe disruption of the debtor’s business.
2. *Riesland v. Nenana Heating Services*, 5 ABR 176 (D. Alaska 1998) Chapter 13 debtor lost a trial for his personal injury claims in state court. Judgment was entered against him for \$170,000 in fees and costs. The debtor appealed, but did not post a bond. When the creditor sought to execute, the debtor filed for Chapter 13. Court held, and was affirmed on appeal, that the debtor was solvent with the means to post the bond. The District Court recognized, “[t]he bankruptcy court also noted that “The primary rationale behind cases refusing to dismiss on bad faith grounds has been to protect the business of the debtor from liquidation.” *Id.* at 180. The Court rejected protection of his personal assets pending appeal. Also

relied on debtor's conduct including misleading schedules that understated assets and overstated his liabilities, and the filing of a unconfirmable plan.

3. *In re Zaruba*, 8 ABR 449, 450 (Bankr. D. Alaska 2007) individual and corporations filed to avoid posting a supersedeas bond while the debtor prosecuted its appeal to the Alaska Supreme Court. Judgment with interest at the time of the petition totaled \$425,000 liability. Court found Zaruba had filed the bankruptcy in good faith in large part because: (1) that the debtor remained in business unlike the debtor in *Marsch*, and (2) the debtor did not have sufficient non-business assets to satisfy the pending judgment. No indication of effort to delay the appeal or harass creditors.
4. *In re Alaska Adventure Tours, Inc.*, Case No. 10-00282 (Bankr. D. Alaska 2010) - debtor had judgment of roughly \$100,000 entered, and subsequent supplemental decision for fraudulent conveyance and contempt of court entered for an additional \$100,000. Debtor filed bankruptcy to prevent seizure of boats by executing creditor. Debtor had potential business opportunities, and few, but more than one creditors, including maritime wrongful death claim. Court weighed the factors and found that debtors had engaged in egregious pre-petition conduct and were seeking to "game the system."
5. *In re Iliamna Lakeshore Condominiums, LLC*, Case No. 10-00440 (Bankr. D. Alaska 2010). Newly created limited liability company filed bankruptcy to stop foreclosure. Creditor asserted bad faith filing as basis for relief from automatic stay. Involuntarily dissolved company transferred sole asset to newly formed debtor shortly before foreclosure. Limited creditors, of which roughly half were insiders. Asset was declining in value in the property, with limited, speculative equity. Court terminated the stay noting that cause for relief from the stay existed where the debtor has resorted to Chapter 11 for a variety of tactical reasons not related to reorganization. Court noted no new capital, no new gain in managerial expertise, and the transfer of the asset was not properly authorized.

### III. BAD FAITH FILINGS IN CHAPTER 13

#### A. Conversion from Chapter 7.

1. Section 706(a) - "The debtor may convert a case under this chapter to a case under Chapter 11, 12, or 13 of this title at any time, if the case has not been converted under section 1112, 1208, or 1307 of this title.

2. *Marrama v. Citizens Bank of Massachusetts et al*, 127 S.Ct. 1105 (2007) - Chapter 7 debtor failed to fully disclose assets, including interest in a trust that owned property which debtor valued at zero value, and transfers of property to the trust. Trustee objected to debtors' attempt to convert the case to Chapter 13 on the basis of the debtor's concealment. Supreme Court rejected an absolute right to convert from Chapter 7 to Chapter 13:

More pertinently, 7 the latter provision, § 1307(c), provides that a Chapter 13 proceeding may be either dismissed or converted to a Chapter 7 proceeding "for cause" and includes a nonexclusive list of 10 causes justifying that relief. None of the specified causes mentions prepetition bad-faith conduct (although subparagraph 10 does identify one form of Chapter 7 error -- which is necessarily prepetition conduct -- that would justify dismissal of a Chapter 13 case). *Bankruptcy courts nevertheless routinely treat dismissal for prepetition bad-faith conduct as implicitly authorized by the words "for cause."* See *n. 1, supra*. In practical effect, a ruling that an individual's Chapter 13 case should be dismissed or converted to Chapter 7 because of prepetition bad-faith conduct, including fraudulent acts committed in an earlier Chapter 7 proceeding, is tantamount to a ruling that the individual does not qualify as a debtor under Chapter 13. That individual, in other words, is not a member of the class of "honest but unfortunate debtors" that the bankruptcy laws were enacted to protect. See *Grogan v. Garner*, 498 U.S., at 287, 111 S. Ct. 654, 112 L. Ed. 2d 755. The text of § 706(d) therefore provides adequate authority for the denial of his motion to convert.

*Id.* at 1110 -1111 (Emphasis added).

#### B. Conversion to Chapter 7

1. Section 1307(b) - "On request of the debtor at any time, if the case has not been converted ... the court shall dismiss a case under this chapter."
2. The Ninth Circuit has recognized that bad faith also constitutes cause for purposes of dismissal under § 1307(c). *In re Leavitt*, 171 F.3d 1210, 1224 (9<sup>th</sup> Cir. 1999).
3. Conflict where bad faith debtor wants to dismiss Chapter 13 - *In re Rosson*, 545 F.3d 764 (9<sup>th</sup> Cir. 2008). Chapter 13 debtor belatedly turned over only \$104,000 of \$185,000 arbitration award to trustee despite court order to turnover full award. Court converted case on its own motion,

denying debtor's motion to dismiss under § 1307(b). Debtor asserted absolute right to dismiss Chapter 13. The Court noted a division of courts regarding the debtor's absolute right to dismiss Chapter 13 proceedings, including the Bankruptcy Appellate Panel's decision in *In re Beatty*, 162 B.R. 853 (9<sup>th</sup> Cir. B.A.P. 1994). Ninth Circuit ruled that "after *Marrama*, however, the 'absolute right' position is no longer viable." *Id.* at 772. The Ninth Circuit affirmed conversion of the Chapter finding "it is clear from the record that the bankruptcy court acted to 'prevent' what it reasonably perceived to be 'an abuse of process.' 11 U.S.C. § 105(a)." *Id.* at 774.

### C. Measuring Bad Faith in Chapter 13

1. Bad faith within the Chapter 13 context is measured by the totality of circumstances. The Ninth Circuit has directed courts to examine:
  - a. Whether the debtor "misrepresented facts in his [petition or] plan, unfairly manipulated the Bankruptcy Code, or otherwise [filed] his Chapter 13 [petition or] plan in an inequitable manner.
  - b. The debtor's history of filings and dismissals.
  - c. Whether "the debtor only intended to defeat state court litigation." and
  - d. Whether egregious behavior is present.

*In re Leavitt*, 171 F.3d 1219, 1224 (9<sup>th</sup> Cir.1999); *see also In re Eisen*, 14 F.3d 469, 470 (9<sup>th</sup> Cir. 1994).

2. Hopelessness of reorganization is a clear indication of bad faith. *In re Allen*, 300 B.R. 105, 124, n. 31 (Bankr. D.D.C. 2993). The absence of sufficient income to fund a feasible plan strongly suggests bad faith. *In re Kollar*, 356 B.R. 657 (Bankr. M.D. Fla. 2006); *In re Nealen*, 407 B.R. 194, 201 (Bankr. W.D. Penn. 2009)(presumption of bad faith arose where debtor admitted no regular income precluding confirmable Chapter 13 plan).
  - a. *In re Burke*, 8 ABR 510 (Bankr. D. Alaska 2008) Chapter 13 case dismissed as filed in bad faith where debtor's plan, schedules, and statements were "riddled with errors and inconsistencies," and failed to address substantial unpaid tax liabilities. Debtors also lacked ability to fund a Chapter 13 plan to pay rent or mortgage payments.

3. The Ninth Circuit has held that “neither malice nor actual fraud is required to find a lack of good faith. The bankruptcy judge is not required to have evidence of debtor ill will directed at creditors, or that debtor was affirmatively attempting to violate the law-malfeasance is not a prerequisite to bad faith.” *Leavitt*, 171 F.3d at 1224-25. (Quoting *In re Powers*, 135 B.R. 980, 994 (Bankr. C.D. Cal. 1991)).
4. Conversion of a Chapter 13 petition is warranted for bad faith where the debtor’s only purpose in filing is to defeat state court litigation. *In re Eisen*, 14 F.3d 469, 470 (9th Cir. 1994); *In re Ho*, 274 B.R. 867, 877 (9th Cir. B.A.P. 2002). This is because, “[t]he filing of bankruptcy solely to thwart a creditor claim rather than making an honest effort to pay debts is bad faith.” *In re Fleury*, 294 B.R. 1, 8 (Bankr. D. Mass. 2003) (collectively “cases”).
5. The same reasoning applies where a debtor seeks simply to delay foreclosure rather than propose a viable plan. As recognized in *In re Ortiz*, 200 B.R. 485, 491 (D. Puerto Rico 1996), “[w]hen a bankruptcy case has been filed only for the purpose of inhibiting or forestalling a foreclosure action on the debtor’s assets without the intention of financial rehabilitation, the case should be dismissed as having been filed in bad faith.” (quoting *In re Earl*, 140 B.R. at 739); see also *In re Watkins*, 2008 WL 708413 at 3 n.8 (E.D.N.Y. 2008)(“it is well-established that filing a bankruptcy petition on the eve of foreclosure (or eviction) solely to obtain an automatic stay constitutes “bad faith” and “cause” to dismiss a Chapter 13 case.”); *Allen v. Wells Fargo Bank Minnesota, N.A.*, 334 B.R. 746, 752 (D. D.C. 2005).

#### IV. BAD FAITH FILINGS IN CHAPTER 7

- A. Voluntary dismissal of a pending Chapter 7 is governed by 11 U.S.C. § 707(a) “for cause,” which includes, but is not limited to unreasonable and prejudicial delay, nonpayment of fees under 28 U.S.C. § 123, and failure to timely file information required under § 521 (but only on motion of the US Trustee).
  1. *In re Warren*, 568 F. 3d 1113.1116-17 (9th Cir 2009). Pro se debtors sought to dismiss Chapter 7 after Trustee discovered potential non-exempt assets, apparently \$93,330 in a frozen bank account. Debtor tried to case dismissed for failure to obtain credit counseling, not eligible, failure to file pay advices. Debtor argued that § 521(a)(1) requires that the case “shall be automatically dismissed effective on the forty sixth day.” Ninth Circuit held that “dismissal is not mandated where the debtor is seeking to take advantage of either § 109(h) or § 521(I) to the prejudice of his creditors.” The Ninth Circuit recognized that “our interpretation of § 521 is in conflict with the majority of bankruptcy and district courts to address this issue.”

*Id.* at 1119.

- B. Where there is no specific provision of the Bankruptcy Code that applies to establish cause, “the question becomes whether the totality of circumstances amount to § 707(a) ‘cause.’” *In re Hickman*, 384 B.R. 832, 840 (9<sup>th</sup> Cir. B.A.P. 2008).
1. Within the Ninth Circuit, “a voluntary Chapter 7 debtor is entitled to dismissal of his case so long as such dismissal will cause no ‘legal prejudice’ to interested parties.” *In re Bartee*, 317 B.R. 362, 366 (9<sup>th</sup> Cir. B.A.P. 2004); *In re Leach*, 130 B.R. 855, 857 (9<sup>th</sup> Cir. B.A.P. 1991).
    - a. Evaluation of prejudice requires consideration of both legal and equitable factors. *Hickman*, 384 B.R. at 840. The party seeking dismissal bears the burden of proof. *Id.* at 841.
    - b. Prejudice exists when creditors will be deprived a recovery they would receive in bankruptcy. *In re Bartee*, 317 B.R. 362, 366 (9<sup>th</sup> Cir. B.A.P. 2004). *See also In re Simmons*, 200 F.3d 738, 743 (11<sup>th</sup> Cir.2000) (“When dismissal will only allow the Debtor to hinder creditors, secret assets, and further the Debtor's abuse of the system, dismissal of her voluntary petition is not warranted.”).
    - c. Prejudice exists where the debtor has played fast and loose with the requirements imposed upon debtors. *Bartee*, 317 B.R. at 366-67 (“Debtors offered the bankruptcy court no explanation for the numerous discrepancies in their bankruptcy schedules and statement of financial affairs alleged by the trustee. Nor did they make any effort to explain their failure to comply with the trustee's request for additional information about their assets, income, prepetition transfers and alleged gambling losses. Such facts constitute independent grounds for denial of a motion to dismiss.”); *see also Hickman*, 384 B.R. at 841 (denial of voluntary dismissal where debtor “shirked his duty to disclose all assets and financial affairs.”)
- C. Bad Faith Dismissal of Chapter 7 Petition
1. Statutory basis for dismissal of Chapter 7 filed by a consumer debtor. 11 U.S.C. § 707(b)(3). *See In re Egebjerg*, 574 F.3d 1045 (9<sup>th</sup> Cir. 2009).
    - a. Added by BAPCPA.
  2. Split among the circuits as to whether bad faith is a basis for dismissing a non-consumer Chapter 7.

- a. Third and Sixth Circuits have held that bad faith constitutes cause for dismissing a non-consumer Chapter 7. *In re Tamecki*, 229 F.3d 205 (3<sup>rd</sup> Cir. 2000); *In re Perlin*, 497 F.3d 364 (3<sup>rd</sup> Cir. 2007); *In re Zick*, 931 F.3d 1124 (6<sup>th</sup> Cir. 1991).
- b. Eighth and Ninth Circuits have rejected bad faith as cause for dismissing a non-consumer Chapter 7. *In re Huckfeldt*, 39 F.3d 829 (8<sup>th</sup> Cir. 1994); *In re Padilla*, 222 F.3d 1184 (9<sup>th</sup> Cir. 2000); *In re Sherman*, 491 F.3d 948 (9<sup>th</sup> Cir. 2007).
  - (1) “The Bankruptcy Code’s protracted relationship between reorganization debtors and their creditors lead us to conclude that bad faith per se can be properly constitute ‘cause’ for dismissal of a Chapter 11 or Chapter 13 petition but not of a Chapter 7 petition under § 707(a).” *Padilla*, 222 F.3d at 1193.
- c. Split pre-dates BAPCPA based upon the prior language of 11 U.S.C. § 707(b) which specifically provided for the dismissal of consumer Chapter 7 filings, based upon a motion by the US Trustee only, for substantial abuse.
- d. Test in Ninth Circuit as stated in *Sherman*, 491 F.3d at 970:

First: [a court] must consider whether the circumstances asserted to constitute “cause” are contemplated by any specific Code provision applicable to Chapter 7 petitions. If the asserted “cause” is contemplated by a specific Code provision, then it does not constitute “cause” under 707(a). If, however, the asserted “cause” is not contemplated by a specific Code provision, then [the court] must further consider whether the circumstances asserted otherwise meet the criteria for “cause” for discharge under § 707(a).
- e. Some courts are now holding that excess disposable income is not cause to dismiss a non-consumer Chapter 7. *In re Lobera*, 2011 WL 941331 (Bankr. N.M. 2011); *In re Aldoph*, 441 B.R. 909 (Bankr. N.D. Ill. 2011).