"Get Me Out of This Eleven!" Dealing with Bad-Faith Filings in Chapter 11 Cases

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ABI SOUTHEASTERN BANKRUPTCY WORKSHOP:
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"Get Me Out of This Eleven!" Dealing with Bad-Faith Filings in Chapter 11 Cases:

This panel will explore how to navigate the myriad issues caused by bad-faith Chapter 11 filings and will discuss current case law and trends, including how and when a case should be dismissed, whether a business entity can be formed by real estate investors solely to file a Chapter 11 bankruptcy, venue-shopping and a host of other issues.

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Select Recent Decisions regarding Bad-Faith Issues in Chapter 11 Cases

Kimrow, Inc. v. Cohilas (In re Kimrow, Inc.), 2015 Bankr. LEXIS 1833 (Bankr. MDGA 2015). Where creditor objected to debtor's right to convert from a Chapter 11 to a Chapter 7 due to the debtor's alleged pre-conversion misconduct, arguing that the Court should consider "extreme circumstances" (i.e. the debtor's alleged bad-faith) as an additional exception to the debtor's right to convert under 11 U.S.C. §1112(a), the Court disagreed. The Court distinguished the Supreme Court's decision in *Marrama*, explaining that it did not have a "one to one" application to the instant case, since *Marrama* involved a debtor's conversion to a Chapter 13 case. The Court further found that the eligibility requirements for conversion set forth in 11 U.S.C. §1112(f) did not "leave room for an extreme circumstances exception" either, based on the plain language of the statute.

In re Ronald Cohen Mgmt. Co., 2015 Bankr. LEXIS 384, (Bankr. D.Md. 2015). The Court dismissed debtor's Chapter 11 case for "cause" under 11 U.S.C. §1112(b), finding subjective evidence of bad-faith and that the debtor had no realistic possibility of reorganizing, where the debtor filed bankruptcy in an attempt to evade enforcement of a valid state court judgment and in effort to protect certain third party entities by the imposition of the automatic stay.

Sullivan v. Harnisch (In re Sullivan), 522 B.R. 604 (B.A.P. 9th Cir. 2014). The BAP reversed the bankruptcy court's dismissal of the debtor's individual Chapter 11 fifteen days after the bankruptcy case was filed as a bad-faith filing under 11 U.S.C. §1112(b), because the Court failed to consider whether dismissal or conversion of the case was in the best interest of all creditors and because the record did not support the Court's finding that there was no possibility of plan confirmation, where the plan had not yet been filed.

In re 412 Boardwalk, Inc., 520 B.R. 126 (Bankr. MDFL 2014). The Court denied creditor's motion for relief from the automatic stay and motion for dismissal of the debtor's Chapter 11 case, based on the debtor's alleged bad-faith filing, despite finding that several objective bad-faith factors outlined by the Eleventh Circuit in *In re Phoenix Piccadilly, Ltd.* were present, explaining that "the appearance of some of the objective bad faith factors from *Phoenix Piccadilly* cannot be determinative in any given case, as virtually every reorganization case in the current market exhibits certain of the *Phoenix Piccadilly* factors."

In re Quartz Hill Mining, LLC, 25 Fla. Weekly Fed. B. 125 (Bankr. SDFL 2014). Where substantively consolidated debtors had no presence in Florida other than the existence of their power of attorney, the Court held that venue was improper. The Court further held that the debtors' "attempt to manipulate venue," together with their failure to pay taxes and the filing of the bankruptcy on the eve of foreclosure, demonstrated bad-faith sufficient to dismiss the bankruptcy case under 11 U.S.C. §1112.

In re Soundview Elite, Ltd., 503 B.R. 571 (Bankr. SDNY 2014). Among many other issues, the Court heard and denied motions to dismiss the Chapter 11 cases of six related debtors under 11 U.S.C. §1112, as bad-faith filings, explaining that "it is not bad faith to file a chapter 11 petition for purpose of a more orderly liquidation," even at "the eleventh hour." However, the Court did find cause under 11 U.S.C. §1104 to appoint a Chapter 11 trustee, explaining that the Court had "no faith that the Debtors' current managers [were] capable of acting independently and in the best interests of the estate, or in objectively investigating themselves."

In re Patriot Coal Corp., 482 B.R. 718 (Bankr. SDNY 2012). In a mega bankruptcy case filed in the Southern District of New York, the Court held that the debtor's "manufactured" compliance with the "affiliate rule" of 28 U.S.C. §1408(2) was improper venue-shopping and not sufficient to overcome motions for venue transfer filed by multiple parties, pursuant to 28 U.S.C. §1412. Accordingly, focusing "on the interests and convenience of all parties," the Court transferred the case to the Eastern District of Missouri, where the debtor's executive offices and corporate books and records were located.

Fact Pattern for Discussion

Over a period of a year, a group of private real estate investors formed multiple LLCs to purchase 40 single-family residences out of foreclosure proceedings initiated by Condo Associations or Home Owners Associations. Each property was obtained for $2,000 - $3,000, had a market value ranging from $110,000 - $160,000, and was subject to at least one properly perfected mortgage. The investors took title to each property with the intent to manage and rent the properties out long enough to reach a deal with the mortgage holders to resolve the mortgage claims at a discounted amount. Because the investors failed to make any payments to the mortgage holders, the majority of the mortgage holders commenced foreclosure proceedings. Because the investors were unable to reach agreements with the mortgage holders to satisfy the mortgage liens at a discounted value, and the mortgage holders had begun to foreclose, the investors transferred the ownership of the properties to a new LLC formed solely to file a Chapter 11 reorganization proceeding, with the hope that each of the mortgage creditors could be crammed down in the Chapter 11 proceedings. Upon the filing of the case, the debtor continued to collect rental income on each of the properties, but failed to make any adequate protection payments to the mortgage creditors. Should this case be dismissed, and if so, when?

Feature

By Gregory W. Fox

Patriot Coal: Interest of Justice Trumps Convenience of the Parties

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A spirited debate has been brewing for years over the propriety of debtors in "mega" chapter 11 cases filing their bankruptcy petitions in the U.S. Bankruptcy Courts in the Southern District of New York (SDNY) or the District of Delaware when there are minimal ties between those venues and the company's operations. Some argue that because the courts and bankruptcy practitioners in New York and Delaware have handled so many large chapter 11 cases, the well-developed case law and experience of the local judges and bar create efficiencies that benefit all stakeholders. Others argue that large corporate filers should not be permitted to exploit the venue rules to steer their chapter 11 cases to what they view as "debtor friendly" courts that are located far away from the company's employees, retirees and general unsecured creditors.[1]

The existing bankruptcy venue laws permit companies to file a bankruptcy petition in any district in which there is a pending bankruptcy for one of its corporate affiliates.[2] In other words, an entire corporate family can file chapter 11 petitions and have its cases jointly administered in any jurisdiction in which one affiliate (1) has its domicile, residence, principal U.S. place of business or principal U.S. assets; and (2) has commenced a bankruptcy case. The "affiliate rule" of § 1408 allows many large companies to properly venue their chapter 11 cases in New York or Delaware.

In a recent case, however, the bankruptcy court for the SDNY ruled that the debtors in a "mega" chapter 11 stepped over the line in their efforts to use the "affiliate rule" to establish venue for bankruptcy cases in the SDNY. Specifically, on Nov. 27, 2012, Hon. **Shelley C. Chapman** ruled that the debtors in *In re Patriot Coal Corp.* had improperly manufactured venue in New York and that the cases had to be transferred to St. Louis, where the company was headquartered.[3]

In so holding, the court sent a strong message that technical compliance with § 1408 is not enough to properly venue a case in the SDNY if that technical compliance was achieved through methods at odds with the purpose of the venue statute. The venue considerations in *Patriot Coal* are a perfect example of the tension between the "convenience of the parties" and "interests of justice" that exists under the current statutory scheme whenever a court is asked to transfer venue pursuant to 28 U.S.C. § 1412.[4]

Factual Background

Patriot Coal Corp. and its affiliates operate a large-scale coal mining, preparation and transportation business that supplies coal to customers in numerous U.S. states and countries around the world. Patriot Coal's headquarters and executive offices are located in St. Louis; however, Patriot Coal's coal mining facilities are located in West Virginia and Kentucky.[5] Citing reductions in the demand for coal, substantial labor costs and increased regulation of power plants and coal mining, Patriot Coal and 98 of its subsidiaries filed chapter 11 petitions in the SDNY on July 9, 2012.[6]

Shortly after the bankruptcy filing, the United Mine Workers of America (UMWA)—the union representing about 42 percent of the debtors' 4,000 active employees and more than 10,000 retirees receiving benefits from the debtors—filed a motion seeking to transfer venue of the chapter 11 cases to the Southern District of West Virginia. A group of insurance companies that had issued surety bonds for the debtors also moved for transfer to the Southern District of West Virginia. The Office of the U.S. Trustee separately filed a motion seeking transfer of venue to any district "where venue is proper;" however, the U.S. Trustee did not specify to which jurisdiction it felt the cases should be transferred.[7]

1 In fact, Rep. Lamar Smith (R-Texas) introduced a bill in the House of Representatives in 2011 entitled "Chapter 11 Bankruptcy Venue Reform Act of 2011" in an attempt to thwart perceived forum-shopping for large chapter 11 cases. Action on this bill (H.R. 2533) has stalled, however, and there is no indication that the bankruptcy venue statute will be amended anytime soon. For analyses of H.R. 2533 and the ongoing bankruptcy venue debate, *see* Jeffrey G. Hamilton and Kelly Cavazos, "The Venue Reform Debate," 9 *ABI Legislative Committee Newsletter*, No. 3 (July 2012), www.abiworld.org/committees/newsletters/legis/vol9num3/venue.html; Michael J. Gartland and J. Wesley Harned, "Overview of H.R. 2533: Chapter 11 Bankruptcy Venue Reform Act," 9 *ABI Legislative Committee Newsletter*, No. 1 (February 2012), www.abiworld.org/committees/newsletters/legis/vol9num1/overview.html.

2 28 U.S.C. § 1408 provides that "a case under title 11 may be commenced in the district court for the district—(1) in which the domicile, residence, principal place of business in the United States or principal assets in the United States, of the person or entity that is the subject of such case have been located for the [180] days immediately preceding such commencement, or for a longer portion of such [180]-day period than the domicile, residence or principal place of business, in the United States, or principal assets in the United States, of such person were located in any other district; or (2) in which there is pending a case under title 11 concerning such person's affiliate, general partner, or partnership."

3 *In re Patriot Coal Corp.*, 482 B.R. 718, 718 (Bankr. S.D.N.Y. 2012).

4 28 U.S.C. § 1412, which governs the transfer of venue of bankruptcy cases, provides that "[a] district court may transfer a case or proceeding under title 11 to a district court for another district, in the interest of justice or for the convenience of the parties."

5 *Patriot Coal*, 482 B.R. at 729.

6 *Id.* at 723.

7 *Id.*

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Patriot Coal: *Interest of Justice Trumps Convenience of the Parties*

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The statutory basis for these motions was 28 U.S.C. § 1412, which provides that a court may transfer a bankruptcy case to another district "in the interest of justice or for the convenience of the parties." Each movant argued that the venue needed to be transferred in the interest of justice because Patriot Coal had manufactured a venue a month before filing for bankruptcy by incorporating two subsidiaries (PCX Enterprises Inc. and Patriot Beaver Dam Holdings LLC) in New York. By creating these New York entities, which have no employees, business operations or offices, Patriot Coal was able to comply with § 1408(1)'s requirement that a debtor be located and/or have its principal assets in the SDNY for the majority of the 180-day period before the bankruptcy filing. In addition, once these two subsidiaries filed chapter 11 petitions in the SDNY, the entire Patriot Coal corporate family was able to take advantage of the "affiliate rule" of § 1408(2) and file in the SDNY. The movants argued that incorporating these entities in New York for the sole purpose of establishing venue—a fact that the debtors conceded[8]—was impermissible forum-shopping and misuse of the venue statutes.

The UMWA and the sureties (but not the U.S. Trustee) also argued that the cases should be transferred to the Southern District of West Virginia under the "convenience-of-the-parties" prong of § 1412 because the company and its stakeholders had strong ties to West Virginia. Specifically, they pointed to the following facts: (1) 54 of the debtor entities and some unsecured creditors with large claims were incorporated in West Virginia; (2) most of the debtors' equipment and mines were located in West Virginia; and (3) many of the employees and retirees (some of whom may appear as witnesses in anticipated bankruptcy litigation) lived in West Virginia.

With the support of the creditors' committee, the administrative agent under the debtors' debtor-in-possession (DIP) financing agreement and numerous unsecured creditors, the debtors opposed the venue transfer motions. Their argument was essentially twofold.

First, the debtors argued that because they had achieved technical compliance with 28 U.S.C. § 1408 (and did nothing improper in taking advantage of a loophole in the statute to do so), the company's choice of forum was entitled to deference. Second, the debtors argued that because a strong connection existed between these chapter 11 cases and New York, the resulting efficiencies of proceeding in New York (*i.e.*, cost savings to the estate) meant that it was in the interest of justice and more convenient for the parties to maintain venue in the SDNY.[9] Specifically, in support of the argument that New York was the most convenient and preferred venue, the debtors pointed to the following facts: (1) the bankruptcy professionals representing the debtors and other key parties in interest (including the UMWA) were based in New York; (2) many of the debtors' bank lenders, bondholders and other creditors were also located in New York; (3) New York law governed key financing agreements, debt instruments and coal sales contracts; and (4) New York is an easily accessible transportation hub.[10]

Judge Chapman's Decision

After conducting two days of contested hearings,[11] Judge Chapman issued a decision transferring venue of Patriot Coal's chapter 11 cases to the Eastern District of Missouri. She ruled that although there was no evidence that the debtors' actions with regard to establishing venue in the SDNY were done in bad faith or with the intention to hinder parties-in-interest, condoning the manner by which Patriot Coal complied with § 1408 would "elevate form over substance in a way that would be an affront to the bankruptcy venue statute and the integrity of the bankruptcy system."[12] In other words, she held that incorporating entities for the sole purpose of establishing venue in a preferred jurisdiction is clearly not what Congress intended when drafting § 1408. Judge Chapman relied on *In re Winn-Dixie Stores Inc.*, another case in which the court transferred chapter 11 cases out of the SDNY when a debtor incorporated entities in New York shortly before filing in order to satisfy § 1408.[13] Echoing Hon. **Robert D. Drain**'s ruling in *Winn-Dixie*, Judge Chapman pointed out that when deciding whether there is impermissible forum-shopping going on, there is a clear distinction between "creating facts to fit the statute" and "taking advantage of the facts as they existed before the debtors embarked on their path to a chapter 11 filing."[14]

The court was mindful that its decision to transfer venue of these cases would likely result in additional costs to the estates and could potentially diminish ultimate creditor recoveries. In fact, the court recognized that it would be efficient to have these cases proceed in New York because (1) it is home to the banks and other sources of capital that could fund a successful reorganization, (2) it is easily accessible by all modes of transportation and (3) it is home to many accomplished chapter 11 practitioners.[15] Judge Chapman explained that if the "efficiency" factor were given too much weight, "a forum such as the [SDNY] would invariably trump other jurisdictions," a result at odds with the purpose of the venue statutes.[16] In other words, she ruled that the "end" of efficiency could not justify the "means" of manufacturing venue in a jurisdiction in which a debtor previously did not have any meaningful presence.[17]

Having ruled that transfer of Patriot Coal's cases out of the SDNY was necessary to uphold the interests of justice, Judge Chapman next needed to determine the forum to which she should transfer the cases. She flatly rejected the

8 "Of particular significance to the Court's decision and analysis is the fact that the parties stipulated prior to the Hearing that the Debtors formed both PCX and Patriot Beaver Dam to ensure that the provisions of 28 U.S.C. § 1408(1) were satisfied, and for no other purpose." *Id.* at 729.

9 *Id.* at 747.

10 *Id.* at 747-48.

11 The hearings on the motions to transfer venue were broadcast live to courtrooms in Charleston, W.Va., and St. Louis to allow interested parties to view the proceedings without having to travel to New York.

12 *Id.* at 744.

13 *Id.* at 745 (citing *In re Winn-Dixie Stores Inc.*, Case No. 05-11063 (RDD) (Bankr. S.D.N.Y. April 12, 2005)).

14 *Id.* at 746.

15 *Id.* at 745-46.

16 *Id.* at 747.

17 *See id.*

UMWA's and the sureties' arguments that the interests of justice and convenience of the parties dictated a transfer to "coal country" in West Virginia.[18] She pointed out that the movant's burden on a motion seeking a transfer of venue under § 1412 is not satisfied merely because that constituency prefers a particular forum, perceiving a "home field advantage" there. Instead, what is required is an analysis focusing "on the interests and convenience of *all* parties."[19]

After considering the various potential venues to which the cases could be transferred,[20] Judge Chapman concluded that transferring the cases to the Eastern District of Missouri would best serve the interests of justice and convenience of the parties because, *inter alia*, Patriot Coal's headquarters, executive offices and corporate books and records were located in St. Louis.[21] She noted that because Patriot Coal was reorganizing in bankruptcy and not liquidating, the locus of its key corporate functions carried more weight in her analysis under § 1412 than the locus of the company's coal-related assets.[22] Moreover, Judge Chapman noted that St. Louis was an accessible transportation hub located not far from the Illinois Basin coal region where many Patriot employees and retirees live.[23]

Conclusion

Patriot Coal should be viewed not as a game-changer but as a warning shot. The case does nothing to change the "affiliate rule" of § 1408. Debtors with subsidiaries having a naturally existing (as opposed to manufactured) presence in New York can and likely will continue to file in the SDNY. *Patriot Coal* also does not undermine cases in which courts denied venue-transfer motions because it would be more efficient to proceed in New York when it is home to the restructuring professionals and sources of capital involved in the case.[24] In fact, Judge Chapman strongly hinted that she may have reached the opposite conclusion on transferring venue if there had been no opposition to venue in the SDNY by parties with "money on the line" (*i.e.*, by parties other than the U.S. Trustee) or if the debtors had been able to present evidence of substantial economic harm to the estates that would result from transferring venue.[25] In other words, if not for the "manufactured venue" issue, *Patriot Coal* would likely have been another in a long string of SDNY "mega" chapter 11 cases (*Enron*, *General Motors* and *Chrysler*) in which the majority of the debtor's business operations took place outside New York.

Judge Chapman certainly sent a strong warning to the professionals advising debtors contemplating a bankruptcy filing in the SDNY (and the DIP lenders that often condition their loans on the case being filed in a particular jurisdiction). Debtors will need to think twice if they are planning to file a petition in the SDNY by means of a clever method of achieving technical compliance with § 1408, especially if they anticipate opposition to their chapter 11 goals. Manufacturing venue through the incorporation of "dummy" entities with no true commercial purpose will not be in the interest of justice, even if the debtor has efficiency, convenience and creditor support on its side. It appears that the debtors in *Patriot Coal* took a calculated risk that they would have enough stakeholder and judicial support to overcome justice-based arguments against venue in the SDNY. That risk did not pay off, and the debtors had to learn the hard way where the line in the sand on manufacturing venue is located. abi

18 *See id.* at 751-52.
19 *Id.* at 750.
20 Aside from New York and West Virginia, the venue for the *Patriot Coal* chapter 11 cases would have been proper under § 1408 in Delaware, Kentucky, Illinois, Missouri, Indiana and Virginia. *Id.* at 753.
21 Hon. **Kathy A. Surratt-States** now oversees the *Patriot Coal* chapter 11 cases.
22 *Id.* at 710 n.31 (citing *In re Commonwealth Oil Refining Co.*, 596 F.2d 1239, 1248 (5th Cir. 1979)).
23 *Id.* at 754.
24 *Id.* at 746 (citing *In re Enron Corp.*, 274 B.R. 327 (Bankr. S.D.N.Y. 2002)).
25 *Id.* at 748 (citing *In re Houghton Mifflin Harcourt Publ'g Co.*, 474 B.R. 122, 124 (Bankr. S.D.N.Y. 2012)).