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RECENT DEVELOPMENTS IN BANKRUPTCY AND RESTRUCTURING

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MAKING THE MOST OF AN UNDERSECURED CREDITOR'S CLAIM: THE NUANCES OF CREDIT BIDDING IN BANKRUPTCY

Mark G. Douglas

The ability of a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to sell assets free and clear of liens and other competing interests has long been recognized as one of the most important vehicles for restructuring a debtor's balance sheet and generating value to fund distributions to creditors pursuant to a plan of reorganization or liquidation. If property is sold free and clear of a lien, the rights of the secured creditor are adequately protected even though it is denied access to its collateral if, as is done in most cases, the lien is transferred to the proceeds of the sale. Those proceeds will later be distributed to the secured creditor to the extent of the allowed amount of its secured claim either pursuant to a chapter 11 plan (at confirmation or over time) or in accordance with the liquidation scheme established under chapter 7 of the Bankruptcy Code.

A secured creditor whose collateral is to be sold free and clear is also afforded another important right in connection with the sale. Section 363(k) of the Bankruptcy Code gives a secured creditor the right to credit bid its claim. In this way, the creditor can ensure that the collateral is not sold for less than the face amount of the debt it secures. It is well settled among bankruptcy and district courts that a secured creditor can credit bid the full amount of its claim at a sale, even if the claim amount exceeds the value of the collateral. However, no court of appeals at the circuit level had addressed this issue directly until the Third Circuit handed down its ruling in *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Systems Corporation)*. There, the Court of Appeals held that certain lenders' credit bids were not capped at the economic value of the collateral securing their claims.

SALES FREE AND CLEAR OF LIENS IN BANKRUPTCY

Under section 363(b) of the Bankruptcy Code, a trustee or DIP may use, sell, or lease property of the estate outside the ordinary course of the debtor's business with bankruptcy-court approval. In addition, under section 363(f), the sale may be "free and clear of any interest in such property of an entity other than the estate" provided it satisfies any one of certain specified conditions. These include, among other things, whether applicable non-bankruptcy law permits a sale free and clear, whether the sales price exceeds the aggregate value of all liens encumbering the property, or whether the interest is in bona fide dispute.

A bankruptcy court's power to approve sales free and clear of competing interests without the consent of the party asserting the interest has long been recognized. Free and clear sales promote the expeditious liquidation of estate assets by avoiding delay attendant to sorting out disputes concerning the validity and extent of competing interests, which can later be resolved in a centralized forum. They also facilitate the estate's realization of the maximum value possible from an asset. A prospective buyer would discount its offer significantly if it faced the prospect of protracted litigation to obtain clear title to an asset. Pending the bankruptcy court's resolution of any disputes, the non-debtor is entitled to "adequate protection" of its interest. This most commonly takes the form of a replacement lien on the proceeds of the sale.

CREDIT BIDDING AND PROTECTION OF UNDERSECURED CREDITORS

Section 363(k) of the Bankruptcy Code provides that at a sale under section 363(b) of property "that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property." In most cases, a secured creditor has the right to credit bid only if the validity or extent of its lien is not subject to bona fide dispute.

The credit bid mechanism preserves the secured creditor's bargain by ensuring that either its debt is paid in full or the collateral stands in its place. It is an important protection afforded to a secured creditor — especially an undersecured creditor — whose collateral is being liquidated during the course of a bankruptcy case. If the secured creditor believes that its collateral will be sold for less than its actual value, the creditor has the option to take the collateral by credit bidding its debt. Alternatively, it can simply allow the sale to run its course, after which its lien will typically attach to the proceeds with the validity and priority that existed prior to the sale. If collateral is sold under a chapter 11 plan rather than in a non-ordinary course sale under section 363(b), a dissenting secured creditor may exercise its rights under section 363(k) in connection with the sale.

> *SubMicron* confirms the viability of credit bidding at face value even if the collateral's value is less than the secured creditor's claim.

The protection given to secured creditors in section 363(k) is closely related to rights found in another provision of the Bankruptcy Code. Section 1111(b) (which applies only to chapter 11 cases) provides that a secured claim will be treated as a recourse claim even if the claim is not actually recourse to the debtor by contract or under applicable state law. This means that the creditor will have a secured claim to the extent of the value of its collateral and an unsecured claim for any deficiency, unless the class of claims of which the secured creditor is a member makes a "section 1111(b) election" to have all claims in the class treated as fully secured.

The provision was designed to prevent the debtor from confirming a chapter 11 plan that deprives a non-recourse undersecured lender of its right to foreclose on its collateral by retaining the property (with the hope that it will later appreciate in value), stripping down the secured claim to the value of the collateral at the time of confirmation, and paying pennies on the dollar (or nothing at all) in respect of the unsecured deficiency claim. Under section 1111(b), the debtor may retain possession of the property, but a creditor holding a lien on the property can elect to have its claim treated as if fully secured, and that status must be reflected in any treatment of the creditor's claim under a chapter 11 plan. Section 1111(b) does not apply if the property is to be sold under either sec-

tion 363 or a chapter 11 plan. In that event, section 363(k) applies to protect an undersecured creditor's rights.

Parties opposing credit bidding sometimes rely on section 363(k)'s reference to "a lien that secures an allowed claim" to argue that a secured creditor may not credit bid the full face value of its claim or may credit bid only the value of its collateral on the date of the sale. This position arguably is buttressed by section 506(a) of the Bankruptcy Code, which provides that a claim secured by collateral is an allowed secured claim only to the extent of the value of any collateral, with any deficiency being classified as a separate unsecured claim. Arguably, if an "allowed" secured claim is capped at the value of the collateral under section 506(a), section 363(k) should be read to limit the amount of a credit bid to the allowed amount of a secured claim rather than the full face value of the underlying debt. This was the question addressed by the Third Circuit in *SubMicron Systems*.

SUBMICRON SYSTEMS

Semiconductor tool designer and manufacturer SubMicron Systems Corporation and its affiliates (collectively, "SubMicron") were forced to restructure their debt several times in the late 1990s in an effort to weather a steep downturn in the semiconductor industry. In 1997, SubMicron's debt structure consisted of: (i) a $15 million working-capital facility provided by Greyrock Business Credit secured by first-priority liens on substantially all of SubMicron's assets; (ii) $20 million in senior subordinated notes (the "1997 Notes") held by KB Mezzanine Fund II, LP ("KB") and its managing partner, Equinox Investment Partners, LLC (collectively referred to as "KB/Equinox"), secured by second-priority liens on substantially all of SubMicron's assets; (iii) two tranches of junior subordinated notes in favor of The BOC Group, Inc. in the aggregate amount of $13.7 million that, being secured by third-priority liens on substantially all of SubMicron's assets, were not at issue in SubMicron.

SubMicron was compelled to borrow more during the next two years as its financial problems worsened and Greyrock reduced the maximum availability under the company's working capital facility. In 1998, the company issued $4 million in senior subordinated notes (the "1998 Notes") to KB/Equinox and Celerity Silicon LLC *pari passu* with the 1997 Notes. The following year, it issued approximately $7 million in notes (the "1999 Notes") to KB/Equinox and Celerity, which loaned an additional $4 million to SubMicron during the course of that year to fund the company's critical working-capital needs. Both the 1999 Notes and the additional borrowing from KB/Equinox and Celerity (collectively, the "1999 Funding") were booked as secured debt, although no notes were issued to evidence the $4 million in additional funding. By June of 1999, three KB/Equinox principals or employees and one employee of Celerity sat on SubMicron's board of directors — only SubMicron's CEO remained as a management representative on the board.

SubMicron began acquisition discussions with Sunrise Capital Partners LP in the summer of 1999. KB/Equinox, rather than SubMicron's management, conducted the negotiations, which resulted in an agreement whereby Akrion LLC, an acquisition entity created by Sunrise, would acquire the company as part of a pre-packaged chapter 11 case. It was generally understood at the time that absent an agreement with Sunrise, SubMicron would be forced to liquidate, leaving secured creditors other than Greyrock with pennies on the dollar and unsecured creditors and shareholders with nothing.

Under the agreement, KB/Equinox and Celerity, in exchange for a 32 percent interest in Akrion, would contribute their secured claims (*i.e.*, the 1997 Notes, the 1998 Notes, and a portion of the 1999 Funding) to allow Akrion to credit bid the claims in a sale under section 363(b) of the Bankruptcy Code. In addition, at the closing of the sale, SubMicron would be required to disburse $5.5 million to KB/Equinox and Celerity in partial repayment of the 1999 Funding.

The SubMicron debtors filed for chapter 11 in September of 1999 and immediately filed a motion to sell their assets to Akrion in accordance with the terms of the sale agreement. The United States District Court for the District of Delaware withdrew the reference of the bankruptcy case to the United States Bankruptcy Court for the District of Delaware. At the hearing before the district court to approve the sale, Akrion submitted a bid of approximately $55.5 million, consisting of $10.2 million in cash to repay Greyrock's pre- and post-petition financing and to cover administrative claims, a credit bid in the amount of just over $40 million, and assumption of

various liabilities aggregating approximately $5.3 million. No other bids were submitted for SubMicron's assets. The district court approved the sale over the objection of the creditors' committee, which contended, among other things, that the consideration paid by Akrion was not fair and reasonable and the sale was not undertaken in good faith.

Instead of appealing the order approving the sale, the creditors' committee sued KB/Equinox and Celerity in district court, seeking to recharacterize their debts as equity investments or, in the alternative, to designate those debts as unsecured — in either case invalidating the 1999 Funding as a basis for a credit bid under section 363(k). Failing either of those options, the committee (which was later succeeded in the litigation by the plan administrator for SubMicron's estate) sought to equitably subordinate the claims under section 510(c) of the Bankruptcy Code based upon fiduciary improprieties and other misconduct allegedly committed by KB/Equinox and Celerity. The district court ruled in favor of KB/Equinox and Celerity on all counts. The administrator appealed to the Third Circuit.

THE THIRD CIRCUIT'S RULING

The Court of Appeals affirmed. It found no error in the district court's refusal to recast the 1999 Funding as an equity investment based upon the underlying documentation and the parties' intent. According to the Third Circuit, given the previous loans made by KB/Equinox and Celerity and the lenders' legitimate desire to protect the integrity of the credit, neither SubMicron's undercapitalization at the time of the 1999 Funding nor the presence of KB/Equinox and Celerity personnel on SubMicron's board necessarily supported an equity characterization. The Court also accepted the district court's conclusion that the parties did not intend the undocumented portion of the funding to be treated as equity merely because apparently no notes were issued in connection with the financing transaction — the evidence clearly indicated that "SubMicron's accounting department made numerous mistakes and errors when generating notes."

Having concluded that the 1999 Funding should be properly treated as debt rather than equity, the Third Circuit turned to the administrator's contention that the debt should be treated as unsecured because the UCC financing statements filed in connection with the loans identified as the secured party KB's managing partner Equinox "as Collateral Agent," rather than KB or Celerity. The Court of Appeals rejected this argument as well, ruling that the financing statements contained adequate information to comply with the UCC's perfection requirements and that SubMicron had acknowledged the status of KB and Celerity as secured noteholders in schedules that it filed in its bankruptcy case.

The Third Circuit proceeded to address the plan administrator's argument that Akrion's credit bid was invalid because KB/Equinox and Celerity were undersecured. Acknowledging that the district court had determined that "there was no collateral [value] available to actually secure the 1999 fundings," the Court of Appeals explained that section 363(k) has uniformly been interpreted to allow a secured creditor to credit bid the face value rather than the economic value of a secured creditor's claims. According to the Third Circuit, "logic demands that § 363(k) be interpreted in this way; interpreting it to cap credit bids at the economic value of the underlying collateral is theoretically nonsensical." This is so, the Court of Appeals emphasized, because whatever amount a secured creditor credit bids under section 363(k) up to the face amount of its claim automatically becomes the economic value of the claim by operation of section 506(a).

The Third Circuit explained that the legislative history indicates that Congress meant to incorporate this degree of protection for undersecured creditors when it enacted sections 363(k) and 1111(b) of the Bankruptcy Code. It rejected the administrator's contention that there should be an exception to the rule in this case because there were no unencumbered assets available to secure the 1999 Funding when it was provided:

> Because the Lenders had a valid security interest in essentially all the assets sold, by definition they were entitled to the satisfaction of their claims from available proceeds of any sale of those underlying assets. Their credit bid did nothing more than preserve their right to the proceeds, as credit bids do under § 363(k).

The term "allowed claim" in section 363(k), the Third Circuit observed, clearly means both the secured and unsecured portions of a creditor's claim secured by a lien on property

WHAT'S NEW AT JONES DAY?

Paul D. Leake (New York) gave a presentation on April 19, 2006, in Toronto concerning "The Automotive Industry—Stakeholder Perspectives" at a Commercial Insolvency and Restructuring Conference sponsored by the Canadian Association of Insolvency and Restructuring Professionals. He moderated a panel discussion on May 21, 2006, concerning "First and Second Lien Intercreditor Dynamics" at the INSOL annual regional conference in Scottsdale, Arizona.

An article written by **Paul D. Leake (New York)** and **Mark G. Douglas (New York)** entitled "Caveat Emptor: Claim in Innocent Transferee's Hands Can Be Equitably Subordinated Based Upon Transferor's Misconduct" appeared in the March/April 2006 edition of *Pratt's Journal of Bankruptcy Law*.

David G. Heiman (Cleveland), **Brad B. Erens (Chicago)**, **Mark A. Cody (Chicago)**, **Robert E. Krebs (Chicago)**, **Kelly M. Neff (Chicago)**, **Eric R. Goodman (Cleveland)**, and **David A. Beck (Columbus)** are part of a team of Jones Day attorneys advising USG Corporation in connection with its landmark settlement of asbestos personal injury liabilities as part of a chapter 11 plan of reorganization. As part of that settlement, USG will fund a section 524(g) asbestos personal injury trust with approximately $900 million if asbestos national trust fund legislation passes by the end of the current Congress or $3.95 billion if such legislation does not pass during that Congress. The settlement will resolve approximately 150,000 existing claims, as well as all unknown claims and future demands.

Heather Lennox (Cleveland) was named by *Turnarounds & Workouts* as one of the "Outstanding Young Restructuring Lawyers" in the United States for 2006.

Tobias S. Keller (San Francisco) delivered a lecture on April 26, 2006, at Stanford Law School concerning the "Chapter 11 Confirmation Process."

Adam Plainer (London) spoke on May 18, 2006, in London at a conference entitled "Distressed Investing Europe," jointly sponsored by Renaissance Global Management, Inc. and the Beard Group. The topic of his presentation was "Successful Strategies for Optimizing Value After a European Filing." His article entitled "Global Focus: the European Distressed Debt Market" appeared in the March 2006 edition of *Pratt's Journal of Bankruptcy Law*.

Claus Köhler (Munich) sat on the Bankruptcy and IP Panel of the 14th Fordham Annual Conference on International Intellectual Property Law & Policy on April 20 and 21, 2006, in New York.

of the estate. According to the Court, reference to section 506(a) to determine the amount of a secured claim is unnecessary in the context of a sale under section 363. Section 363, the Third Circuit remarked, "attempts to avoid the complexities and inefficiencies of valuing collateral altogether by substituting the theoretically preferable mechanism of a free market sale to set the price."

Finally, the Third Circuit agreed with the district court that the plan administrator's equitable subordination argument was legally untenable. Declining to address whether creditor misconduct is a necessary prerequisite to equitable subordination of a claim under section 510(c) of the Bankruptcy Code, the Court of Appeals held that the absence of any injury or disadvantage to SubMicron's other creditors as a consequence of actions undertaken by KB/Equinox and Celerity meant that subordination was unjustified. To the contrary, the Court noted, had the lenders not extended additional financing to the debtor, "the company would have been forced to close down and liquidate, leaving the unsecured creditors with nothing." It accordingly affirmed the ruling of the district court in all respects.

OUTLOOK

SubMicron does not represent a departure from prior case law concerning the circumstances under which a secured creditor may credit bid its claims pursuant to section 363(k).

Like section 1111(b), the provision was designed to ensure that a secured creditor can realize the maximum value from its collateral, even if the amount of the debt it secures exceeds that value at any given time during the course of the bankruptcy case. Under *SubMicron*, unless the secured creditor's liens are subject to bona fide dispute, it may credit bid the face amount of its secured claim in any sale of the collateral under section 363.

Even so, *SubMicron* is notable because it is the first federal court of appeals to render a ruling on the issue. *SubMicron* confirms the viability of credit bidding at face value even if the collateral's value is less than the secured creditor's claim. Because SubMicron's first-priority lender was paid off in cash at the time of the sale, KB/Equinox and Celerity, by virtue of the 1997 Notes and the 1998 Notes, had the next priority claim to SubMicron's assets even if they were of insufficient value to act as security for the 1999 Funding. Thus, the fact that part of the credit bid consisted of unsecured debt — the creditors in this instance were undersecured — is not troubling.

SubMicron also illustrates that, when faced with a potential credit bid significantly in excess of the market value of a given asset, other bidders might be unwilling to put serious time, effort, and expense into developing and pursuing a bid. Indeed, as with Akrion, potential purchasers may wish to consider teaming up with undersecured creditors to gain an advantage through credit bidding — which brings up another interesting aspect of *SubMicron*. *SubMicron* is a classic example of creditors working closely with a potential acquirer in the sale process. KB/Equinox and Celerity negotiated the acquisition from start to finish, with SubMicron's equity holders and unsecured creditors sitting in the wings and out of the money.

Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Systems Corporation), 432 F.3d 448 (3d Cir. 2006).

BANKRUPTCY BATTLEGROUND: EVEN "CORE" DISPUTES MAY BE SUBJECT TO ARBITRATION

Mark G. Douglas

Whether an arbitration clause in a contract will be enforced by the bankruptcy courts in accordance with the Federal Arbitration Act (the "FAA") has been the focus of numerous court decisions in recent times. The consensus among most courts addressing the issue has been that a bankruptcy court can adjudicate a dispute otherwise subject to binding arbitration if the dispute falls within the court's "core" jurisdiction. Even so, rulings recently handed down by the Second and Third Circuit Courts of Appeal suggest that the scope of a bankruptcy court's retained discretion in this area may be even less broad than is generally understood. *MBNA America Bank, N.A. v. Hill* and *Mintze v. American General Financial Services Inc. (In re Mintze)* stand for the proposition that arbitration is the favored means of resolving disputes — even those that fall within the bankruptcy court's "core" jurisdiction.

THE FEDERAL ARBITRATION ACT

The FAA provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." A court has the power to stay a proceeding if it determines that an issue is subject to arbitration. In addition, a court may order litigants to proceed to arbitration in the event that one or more parties to an arbitration agreement refuse to comply with it.

Congress declared a strong federal policy in favor of arbitration when it enacted the FAA. The FAA's mandate may be overridden, however, if a party opposing arbitration can demonstrate that "Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue." In *Shearson/Am. Exp., Inc. v. McMahon*, the Supreme Court ruled that such congressional intent can be discerned in one of three ways: (i) the text of the statute; (ii) the statute's legislative history, or (iii) "an inherent conflict between arbitration and the statute's underlying purposes."

ARBITRATION IN BANKRUPTCY PROCEEDINGS

When arbitration law meets bankruptcy law, an inherent conflict exists between two strong policies: the policy favoring

enforcement of arbitration agreements and the policy favoring centralized resolution of disputes involving a debtor and its assets in the bankruptcy court. In the seminal case of *Hays & Co. v. Merrill Lynch Pierce Fenner & Smith, Inc.*, the Third Circuit Court of Appeals held that, confronted with claims falling within the scope of a pre-bankruptcy arbitration agreement, a bankruptcy court must enforce arbitration of "non-core" claims asserted by a trustee, unless the trustee can demonstrate that the purpose of the Bankruptcy Code somehow conflicts with enforcement of an arbitration clause.

A matter falls within a bankruptcy court's "core" jurisdiction if it either invokes a substantive right created by federal bankruptcy law or could not exist outside a bankruptcy case. By contrast, "non-core" matters generally involve disputes that have only a tenuous relationship to a bankruptcy case and would in all likelihood have been litigated elsewhere but for the broad nexus created by the debtor's bankruptcy filing. If a dispute is core, a bankruptcy court can adjudicate it, subject to appeal. The court may also hear non-core disputes, provided they are "related" to the bankruptcy case, but must submit proposed findings to the district court for approval, unless the litigants agree otherwise. The distinction between core and non-core matters is a crucial, yet not necessarily determinative, one in defining a bankruptcy court's discretion when confronting an arbitrable dispute.

In *In re National Gypsum Co.*, the Fifth Circuit addressed whether a bankruptcy court should compel arbitration in "core" matters. According to the Court of Appeals, the core nature of a dispute is insufficient to create the kind of inherent conflict with the FAA that would permit a bankruptcy court to refuse to enforce an arbitration agreement. It ultimately ruled that if a cause of action arises entirely from rights conferred by the Bankruptcy Code (*i.e.*, is core), the bankruptcy court retains significant discretion to determine whether arbitration is inconsistent with the purposes of the Bankruptcy Code. The Second Circuit Court of Appeals subsequently followed this approach in a tandem of carefully reasoned decisions.

The Second and Third Circuits recently had an opportunity to reexamine the conflict between the Bankruptcy Code and the FAA in *MBNA America* and *Mintze*.

THE SECOND CIRCUIT'S RULING IN *MBNA AMERICA*

Kathleen Hill maintained a bank account at MBNA America Bank, N.A. In 1999, she obtained an unsecured consumer loan from the bank. MBNA validly amended the credit account agreement governing the loan in 2000 to include a mandatory arbitration provision. After Hill began to fall behind in making payments on the loan, she authorized MBNA to debit her bank account directly each month.

Hill filed a chapter 7 petition in 2001. Although MBNA received notice of the filing and the existence of the automatic stay, it continued to withdraw funds from Hill's account to apply toward her debt. Hill sued MBNA in the bankruptcy court, claiming that MBNA willfully violated the automatic stay and was unjustly enriched by its actions. She styled the litigation as a class action brought on behalf of herself as well as other similarly situated debtors.

Non-core disputes that fall within the scope of an arbitration agreement clearly deprive the court of any discretion to refuse to defer to arbitration, and the fact that a dispute is core does not automatically mean that the court can adjudicate the dispute.

MBNA sought to stay or dismiss the proceeding based upon the arbitration clause contained in Hill's credit account agreement. The bankruptcy court denied MBNA's motion, concluding that it was the "most appropriate forum to adjudicate the matter." MBNA appealed the ruling to the district court, which reversed in part. According to the district court, although the bankruptcy court did not abuse its discretion in refusing to dismiss or stay the litigation concerning Hill's core stay violation claims, it should not have denied arbitration of the unjust enrichment claim because it was "arbitrable and non-core." Hill, however, had agreed to abandon the unjust enrichment claim if it were held to be arbitrable. Even so, MBNA appealed the district court's ruling concerning the stay violation claims to the Second Circuit.

The Second Circuit reversed. It faulted the lower courts' conclusion that allowing arbitration to go forward "would seriously jeopardize the objectives of the [Bankruptcy] Code in light of the fact that the automatic stay serves the same function

as an injunction." Hill's estate, the Second Circuit explained, had been fully administered so that she no longer needed the protection of the automatic stay, and resolution of her claim would have no impact on her estate. The court also noted that, as a purported class action, Hill's claims lacked the direct connection to her own bankruptcy case that would weigh in favor of refusing to compel arbitration.

Finally, the Second Circuit observed that a stay is not so "closely related to an injunction that the bankruptcy court is uniquely able to interpret and enforce its provisions." According to the court, although "the automatic stay is surely an important provision of the Bankruptcy Code, there is no indication from the statute that any dispute relating to an automatic stay should categorically be exempt from resolution by arbitration." It accordingly reversed the rulings below and remanded the case with directions to grant MBNA's motion to stay the proceedings in favor of arbitration.

THE THIRD CIRCUIT'S RULING IN *MINTZE*

Ethel Mintze obtained a home equity loan from American General Consumer Discount Company ("AGF") in 2000. The loan bore an annual interest rate of just over 13 percent. The loan agreement contained an arbitration clause providing that "all claims and disputes arising out of, in connection with, or relating to [the] loan" must "be resolved by binding arbitration." Mintze filed a chapter 13 case in 2001 after falling behind on the payments.

After filing for bankruptcy, Mintze sued AGF, claiming that it induced her to enter into an illegal and abusive home equity loan. She sought rescission of AGF's mortgage under the Truth in Lending Act ("TILA") and asserted claims under various federal and state consumer protection laws. AGF responded by filing a motion to compel arbitration of the dispute. Noting that the parties had agreed that the dispute was core, the bankruptcy court determined that it had discretion to deny enforcement of the arbitration clause and ruled that it was best situated to resolve the dispute because resolution of the rescission claim would impact Mintze's chapter 13 plan and distributions to her creditors. The district court affirmed on appeal. AGF appealed to the Third Circuit.

The Third Circuit reversed. Examining whether a bankruptcy court has any discretion to adjudicate an arbitrable dispute, it rejected Mintze's argument that the rule of law articulated in *Hays* applies only to non-core proceedings. According to the Court, *Hays* and other similar decisions indicate that the *McMahon* standard must be satisfied before a bankruptcy court has discretion to deny enforcement of an arbitration clause even in cases involving core disputes. In other words, the party opposing arbitration is obligated to prove that there is an "inherent conflict between arbitration and the Bankruptcy Code" that manifests Congress's intent to preclude waiver of judicial remedies for the statutory rights at issue.

The Third Circuit ruled that no such conflict existed in the case before it. Mintze, the court explained, did not assert any statutory claims that were created by the Bankruptcy Code in her suit against AGF — her claims were based on the TILA and several federal and state consumer protection laws. With no bankruptcy issue to be decided in the litigation, the Third Circuit concluded that the bankruptcy court erred when it determined it had discretion to deny enforcement of the loan agreement's arbitration provision.

OUTLOOK

MBNA America and *Mintze* do not represent a steep departure from prior case law determining the circumstances under which a bankruptcy court retains the discretion to adjudicate arbitrable disputes. Non-core disputes that fall within the scope of an arbitration agreement clearly deprive the court of any discretion to refuse to defer to arbitration, and the fact that a dispute is core does not automatically mean that the court can adjudicate the dispute. Instead, the court must carefully examine the nature of the dispute to determine whether its resolution by an arbitrator would seriously undermine the objectives of the Bankruptcy Code.

Even so, we are left to consider what kinds of core proceedings satisfy that standard. *MBNA America* indicates that claims based upon violations of the automatic stay do not, largely because they involve the interpretation and enforcement of a statute, and "[a]rbitration is presumptively an appropriate and competent forum for federal statutory claims." Many kinds of core proceedings, however, arguably fall into the same category. For example, avoidance causes of action are adjudicated in accordance with rules expressly spelled out in the Bankruptcy Code. In addition, something as basic to the administration of the bankruptcy estate as

determining the allowed amount of a creditor's claim generally does not require application of substantive bankruptcy law. Time will tell whether courts will rely on these precedents to remove a broad range of core matters from the centralized forum of the bankruptcy courts to be resolved in piecemeal arbitration proceedings.

MBNA America Bank, N.A. v. Hill, 436 F.3d 104 (2d Cir. 2006).

Mintze v. American General Financial Services Inc. (In re Mintze), 434 F.3d 222 (3d Cir. 2006).

Shearson/Am. Exp., Inc. v. McMahon, 482 U.S. 220, 227 (1987).

Hays & Co. v. Merrill Lynch Pierce Fenner & Smith, Inc., 885 F.2d 1149 (3d Cir. 1989).

In re National Gypsum Co., 118 F.3d 1056 (5th Cir. 1997).

Crysen/Montenay Energy Co. v. Shell Oil Co. and Scallop Petroleum Co. (In re Crysen/Montenay Energy Co.), 226 F.3d 160 (2d Cir. 2000), *cert. denied*, 532 U.S. 920 (2001).

United States Lines, Inc. v. American S.S. Owners Mut. Prot. & Indem. Ass'n, Inc. (In re United States Lines, Inc.), 197 F.3d 631 (2d Cir. 1999), *cert. denied*, 529 U.S. 1038 (2000).

IN BRIEF: NEXTWAVE REDUX

In a landmark 2003 ruling, the U.S. Supreme Court held that the Bankruptcy Code's antidiscrimination provisions prohibited the Federal Communications Commission ("FCC") from revoking broadband spectrum licenses valued at nearly $5 billion awarded at a pre-bankruptcy auction to chapter 11 debtor NextWave Personal Communications, Inc. based upon its failure to make timely payments to the FCC for the purchase of the licenses. The decision put an end to protracted litigation that had for many years limited access to the disputed broadband capacity, and by removing the shroud of controversy from licenses covering a significant percentage of the available electromagnetic spectrum, it was widely perceived as having given the green light to technology developers eager to exploit the public airways.

NextWave's bankruptcy spawned considerable debate concerning the power of the FCC to regulate access to the airwaves in ostensible derogation of various provisions of the Bankruptcy Code. While it did not prevail in the Supreme Court on the antidiscrimination issue, the FCC won a significant victory on another front when the Second Circuit Court of Appeals ruled in 1999 that the bankruptcy court presiding over NextWave's chapter 11 case lacked jurisdiction to abrogate the FCC's licensing authority by allowing NextWave to avoid a portion of its auction payment obligation as a fraudulent transfer. Unfortunately, this issue never made its way to the Supreme Court.

Based in part on the Supreme Court's 2003 ruling, NextWave, in April of 2004, successfully negotiated a global settlement of its auction debt to the FCC. Under the agreement, NextWave satisfied all of its debt obligations to the FCC by returning 90 percent of its licenses and making substantial additional cash payments. NextWave was permitted to keep the remaining licenses free and clear of any debt or claims or liens of the FCC. The settlement resulted in a total recovery of more than $4 billion for the government and allowed NextWave to confirm a chapter 11 plan of reorganization in March of 2005.

It appeared that the cauldron of controversy surrounding NextWave's bankruptcy filing and its efforts to hold on to its hard-won spectrum licenses had finally stopped boiling after more than seven years of contentious litigation — but not quite. Less than a month after confirmation of NextWave's chapter 11 plan, a *qui tam* action was commenced under the False Claims Act ("FCA") against NextWave and its attorneys, alleging that the defendants violated the FCA by failing to advise the federal government of the possible application of the Credit Reform Act ("CRA") to spectrum auction debt and NextWave's related bankruptcy proceedings.

The complaint asserted seven FCA claims against the defendants, each of which stemmed, directly or indirectly, from their alleged knowing failure to inform the courts, the FCC, and Congress of the existence of the CRA and its alleged applicability to spectrum auction debts and, in particular, to NextWave's rights in bankruptcy. In substance, the plaintiff argued that, under the CRA, any disposition of a federal loan that decreases the government's recovery constitutes a "modification" and is thus barred in the absence of advance congressional approval. Because no congressional approval was sought or obtained by NextWave, the plaintiff contended, NextWave was precluded from satisfying its debt obligations to the FCC in the manner provided under the global settlement.

A New York district court recently granted the defendants' motion to dismiss, finding that the cause of action stated against NextWave's attorneys was untimely under the FCA's six-year statute of limitations and that the remaining causes of action both failed to state a claim under the FCA and were barred by the doctrine of *res judicata*. According to the district court, the complaint's causes of action against the non-attorney defendants rested, at least in part, on their alleged use of false statements to obtain payment from the government or to avoid payment obligations to the government, yet it failed to identify a single false statement made by the defendants at any time. Moreover, the court characterized the basic premise of the complaint — that the defendants violated the FCA by failing to bring a federal statute to the attention of the federal government in the course of a litigation to which the federal government was a party — as "patently absurd." In light of its conclusions, the district court never reached the issue of whether the CRA actually superseded NextWave's bankruptcy rights in the absence of congressional approval.

U.S. ex rel. Finney v. NextWave Telecom, Inc., 337 B.R. 479 (S.D.N.Y. 2006).

IN SEARCH OF A "GOOD FAITH" FILING REQUIREMENT FOR NON-CONSUMER DEBT CHAPTER 7 CASES

Mark G. Douglas

The distinction between legitimate recourse to bankruptcy protection as a way to maximize asset values, give individual debtors a fresh start by relieving them of dischargeable obligations, or restructure the operations of a company, on the one hand, and clear bankruptcy abuse, on the other, is sometimes murky. Although several chapters of the Bankruptcy Code incorporate good-faith filing and/or plan proposal requirements that allow bankruptcy courts to gauge the legitimacy of the filing by examining the debtor's motivation in seeking bankruptcy relief, it is unclear whether an even roughly equivalent standard of good faith applies if a debtor instead files for chapter 7 to discharge obligations that are not primarily consumer debts.

The addition in 2005 of a good-faith test to the Bankruptcy Code to gauge whether a debtor with primarily consumer debts should be denied access to chapter 7 due to abuse of the bankruptcy process likewise begs the question whether the motive of non-consumer chapter 7 debtors bears on their ability to file for bankruptcy relief. A ruling recently handed down by the Ninth Circuit Court of Appeals examines this issue by taking a hard look at what qualifies as "cause" for dismissal of a chapter 7 case. In *Sherman v. SEC (In re Sherman)*, the Court of Appeals ruled that misconduct by a debtor cannot constitute "cause" for dismissal under section 707(a) of the Bankruptcy Code if it can be remedied by applying other provisions of the Bankruptcy Code.

BANKRUPTCY ABUSE AND THE GOOD-FAITH FILING REQUIREMENT

Whether a debtor who has the ability to pay his or her obligations can file for bankruptcy protection has been the subject of long-running debate throughout the course of bankruptcy jurisprudence in the U.S. Even so, a debtor's insolvency or inability to pay debts over time has not historically acted as a prerequisite to bankruptcy protection, in keeping with the fundamental policies underlying federal bankruptcy law (*i.e.*, affording the debtor a fresh start or an opportunity to reorganize and equitable distribution of a debtor's assets to its creditors). If, however, a debtor engages in conduct that is deemed to be clear abuse of the bankruptcy process — either in filing for bankruptcy or during the course of the case — the Bankruptcy Code contains various remedies designed to address the abuse.

The most drastic of these is dismissal of the bankruptcy case. In the case of a chapter 7 liquidation, section 707(a) of the Bankruptcy Code provides that the bankruptcy court may dismiss a chapter 7 case "for cause." The provision specifies three non-exclusive examples of conduct qualifying as cause: (i) "unreasonable delay by the debtor that is prejudicial to creditors;" (ii) nonpayment of certain fees; and (iii) the failure to file required information (*e.g.*, lists of creditors, assets, and liabilities) with the bankruptcy court within the time prescribed by the statute. If the debtor is an individual with primarily consumer debts, a separate provision — section 707(b) —describes the circumstances under which a case can be dismissed because the filing is deemed to be "an abuse" of the bankruptcy process. As modified by the recently enacted Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, section 707(b) contains a detailed description of what rises to the level of "abuse," incorporating a means test and allowing the bankruptcy court to deem a filing abusive if it determines that "the debtor filed the petition in bad faith," or that the "totality of the circumstances" of the debtor's financial situation demonstrates abuse.

Except in the context of cases involving primarily consumer debts, it is unclear whether the absence of good faith in filing for chapter 7 can be a basis for dismissing the case under section 707. This stands in marked contrast to the prevailing rule of law governing filings under other chapters of the Bankruptcy Code, particularly chapter 11. Bankruptcy Code section 1112(b), for example, delineates a catalogue of abuses or failures — including "substantial or continuing loss to or diminution of the estate, and the absence of a reasonable likelihood of rehabilitation," gross mismanagement of the estate, and failure to comply with various court orders or filing requirements — that can lead to the outright dismissal of a chapter 11 case or conversion of the case to a chapter 7 liquidation. Courts have consistently found that the prosecution

of a chapter 11 case in "bad faith" — although (as in section 707(a)) it is not among the listed examples — also constitutes "cause" for dismissal under section 1112(b).

The good-faith filing requirement is designed to ensure that the hardships imposed on creditors by a bankruptcy filing are justified by fulfillment of the Bankruptcy Code's objectives. "Bad faith" generally refers to a chapter 11 filing with the purpose of abusing the judicial process. For instance, a chapter 11 filing for the sole purpose of fending off litigation (*e.g.*, foreclosure) if the debtor has no real prospect of reorganizing its business is often found to qualify as the kind of abuse that rises to the level of bad faith. Similarly, a filing by a solvent debtor merely to obtain a tactical litigation advantage has also been found to be abusive. When challenged, the debtor bears the burden of demonstrating that its bankruptcy petition was filed in good faith. The courts must make that determination on a case-by-case basis, undertaking an examination of the totality of the circumstances to decide where a bankruptcy petition falls along the spectrum ranging from acceptable to patently abusive.

The basic thrust of the good-faith inquiry in a chapter 11 case has traditionally been whether the debtor needs bankruptcy relief. "Need" is informed by the Supreme Court's identification of two of the basic purposes of chapter 11 protection as "preserving going concerns" and "maximizing property available to satisfy creditors." Thus, where a chapter 11 filing is motivated by something other than a desire to rehabilitate a financially distressed yet viable entity or to preserve or maximize asset values for the creditor beneficiaries of an orderly liquidation, a court will dismiss the case as having been filed in bad faith.

Provisions in each of the reorganization chapters (9, 11, 12, and 13) add another gloss to the good-faith inquiry by mandating that a plan be "proposed in good faith and not by any means forbidden by law." In the chapter 11 context, this provision has been construed to require that a plan be proposed with "honesty and good intentions" and, except in connection with a liquidating plan, with "a basis for expecting that a reorganization can be effected." In keeping with that mantra, bankruptcy courts are required to determine whether a plan, viewed in light of the "totality of the circumstances," fairly achieves a result consistent with the purposes of the Bankruptcy Code.

The "for cause" standard is not the exclusive test for determining whether dismissal of a bankruptcy case is warranted. Under section 305 of the Bankruptcy Code, a bankruptcy court may dismiss a case if it determines that "the interests of creditors and the debtor would be better served by such dismissal." This most commonly occurs when a bankruptcy case essentially involves a two-party dispute between the debtor and a single creditor, so that a bankruptcy filing serves no purpose other than to prolong resolution of the dispute and/or to give either the debtor or the creditor a tactical advantage. In addition, bankruptcy courts have sometimes invoked their broad equitable powers under section 105(a) of the Bankruptcy Code to issue any order "that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code "or to prevent an abuse of process" in dismissing an abusive bankruptcy filing.

Dismissal is not the only remedy available if a debtor abuses the bankruptcy process. For example, a creditor stymied in its efforts to foreclose on collateral by the debtor's bankruptcy filing can obtain an order lifting the automatic stay to allow foreclosure to proceed. In addition, if an individual debtor engages in certain kinds of misconduct generally or in connection with certain debts, the malfeasance may be grounds for denying the debtor a discharge altogether, or for excepting specific debts from the scope of a general discharge. Misconduct committed by a chapter 11, 12, or 13 debtor can result in conversion of the case to a chapter 7 liquidation. For a chapter 11 or 12 debtor-in-possession, abuse may also be remedied by the appointment of a bankruptcy trustee, or in a chapter 11 case, by the appointment of an examiner to investigate allegations of misconduct. Finally, misconduct consisting of failure to disclose assets or the destruction of records can result in prosecution for bankruptcy crimes under title 18 of the U.S. Code.

If the chosen remedy is dismissal, there is a split of authority among the courts concerning whether "bad faith" is a basis for dismissal under section 707(a). Some courts, including the Third and Sixth Circuit Courts of Appeal, interpret "cause" in section 707(a) to include filing a chapter 7 petition in bad faith. Others have adopted a more restrictive approach, finding that good or bad faith does not figure in a court's analysis under section 707(a). Among the adherents to this approach

IN BRIEF: DISGORGING CRITICAL VENDOR PAYMENTS IN THE AFTERMATH OF KMART?

The Seventh Circuit's invalidation in February 2004 of nearly $300 million in "first day" payments to Kmart's "critical vendors" was the latest salvo in an all-out assault waged at the circuit-court level concerning the controversial "doctrine of necessity" as authority for paying the pre-petition claims of vendors deemed essential to a chapter 11 debtor's prospects for a successful reorganization. Shortly after confirmation of its chapter 11 plan, Kmart filed actions against hundreds of vendors seeking disgorgement of such payments under sections 549 and 550 of the Bankruptcy Code (which provide for the avoidance and recovery of unauthorized post-petition transfers), as well as section 105(a), which confers a bankruptcy court with broad equitable powers to issue any order "that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code.

A substantial bloc of the vendors moved to dismiss Kmart's complaints. Among other things, they argued that: (i) the critical vendor payments cannot be avoided under section 549 because the payments were authorized at the time they were made; (ii) section 105(a) does not provide an independent cause of action for recovery of the payments; and (iii) Kmart's attempt to recover the payments is barred by the doctrine of judicial estoppel, because Kmart previously took the position that such payments were critical to its ability to continue operating and reorganize and would benefit its bankruptcy estate.

In a carefully reasoned opinion spanning over 60 pages, Judge Susan Sonderby of the U.S. Bankruptcy Court for the Northern District of Illinois granted the defendants' motion to dismiss Kmart's claims under section 105(a), but denied dismissal of the remaining causes of action. She rejected the defendants' contention that the plain language of section 549 mandates dismissal because the payments were previously authorized by the court. When Congress intended to insulate parties from the reversal of court orders on appeal, Judge Sonderby emphasized, it specifically incorporated such protection into the statute, as it did in sections 363(m) and 364(e) (providing a safe harbor for good-faith purchasers of a debtor's assets and post-petition lenders). Section 549 contains no such safe harbor, and its reference to asset transfers that are "not authorized under this title or by the court" does not preclude actions to recover payment authorizations that are later reversed on appeal.

Judge Sonderby ruled, however, that Kmart's reliance upon section 105(a) as a vehicle for "implementing" the Seventh Circuit's decision is misplaced. Observing that sections 549 and 550 together provide a "comprehensive remedy" for avoiding and recovering unauthorized post-petition transfers, she ruled that no independent action exists under section 105(a), which "is a means to enforce the Code rather than an independent source of substantive authority." Finally, Judge Sonderby rejected the defendants' judicial estoppel arguments, explaining that Kmart had never taken an inconsistent position regarding the essential nature of the payments or the benefit derived by the estate from them, and that even if it had, it would be irrelevant for purposes of section 549.

In re Kmart Corp., 2006 WL 952042 (Bankr. N.D. Ill. Apr. 11, 2006).

are the Fifth, Eighth, and Ninth Circuits. The Ninth Circuit recently revisited this issue in *In re Sherman*, where it considered whether conduct that is sanctionable under other provisions of the Bankruptcy Code can be grounds for dismissal of a chapter 7 case under section 707(a).

THE NINTH CIRCUIT'S RULING IN *SHERMAN*

Richard Sherman was an attorney for several companies in an enforcement action brought by the Securities and Exchange Commission involving allegations of fraud in the form of a Ponzi scheme. A 1999 judgment entered in favor of the SEC on several counts of securities fraud enjoined the defendants from transferring their assets and ordered them to disgorge specified amounts of ill-gotten gains to an equity receiver appointed by the court to administer the assets of the defendant companies and their subsidiaries.

Sherman violated the federal district court's freeze order by withdrawing over $50,000 from the companies' litigation trust account and soliciting additional funds from investors. The district court accordingly adjudged him in contempt of the injunction and ordered Sherman to disgorge the funds to the receiver.

Sherman also represented investors in the fraud defendants' subsidiaries on a contingency basis in connection with litigation over the ownership rights to certain natural gas assets in Texas. Under the contingency-fee arrangement, Sherman was to receive 40 percent of any net recovery to the investors, and the subsidiaries agreed to pay Sherman periodically throughout the litigation as an advance against his contingency fee, with any excess treated as an interest-free loan. In early 2001, the receiver settled these suits. He (later joined by the SEC) then sued Sherman to recover the amount that he had been paid by the subsidiaries in excess of his contingency fee. Sherman filed a chapter 7 petition before the district court could rule on the issue.

Shortly after the bankruptcy filing, the district court ruled that although the receiver was precluded from continuing with the litigation against Sherman by the automatic stay, the SEC was not, because its prosecution of the action was excepted from the reach of the stay under section 362(b)(4) (making the

automatic stay inapplicable to proceedings to enforce a governmental unit's police or regulatory powers). The district court also ordered Sherman to disgorge nearly $600,000 that he had been paid by the subsidiaries in excess of his contingency fee (without specifying to whom he should pay the money).

The SEC (joined by the receiver) then moved to dismiss Sherman's chapter 7 case under section 707(a). The receiver also commenced a proceeding in the bankruptcy court seeking a determination that Sherman's debts based upon the two disgorgement orders were not dischargeable under section 523 of the Bankruptcy Code. The bankruptcy court denied the motion to dismiss, stating that "[t]his is just another run-of-the-mill bankruptcy." The SEC appealed. Before the appeal could be heard, however, the bankruptcy court entered an order granting Sherman a general discharge.

Shortly afterward, however, the receiver and Sherman entered into an agreement in which Sherman acknowledged that the debts based upon the disgorgement orders were non-dischargeable under section 523, and he agreed to pay the receiver $50,000 in a lump sum as well as the remainder of the $636,000 debt over time.

The district court reversed the bankruptcy court's order denying the SEC's motion to dismiss Sherman's chapter 7 case. According to the court, the timing and circumstances of the chapter 7 filing, along with misrepresentations made by Sherman in connection with it, were sufficient to constitute "cause" for dismissal under section 707(a):

> Sherman filed for bankruptcy to prevent this Court from ordering Sherman to disgorge the funds he wrongfully obtained from the companies. By filing for bankruptcy, the Court finds that Sherman intended to obtain a discharge of his obligations to the SEC, while simultaneously — because he turned over no assets for liquidation — maintaining the lifestyle he currently enjoys, a lifestyle funded in part by the money Sherman obtained by deceiving his clients and by violating this Court's orders.

Sherman appealed to the Ninth Circuit. At the outset, the Court of Appeals addressed certain preliminary arguments challenging the SEC's standing in the litigation and contending that the SEC's appeal of the bankruptcy court order denying its motion to dismiss Sherman's chapter 7 case was moot due to the order granting Sherman a discharge. It then turned to the thorny issue of "cause" for dismissal under section 707(a).

The Ninth Circuit reversed the district court, ruling that "the SEC and the district court chose the wrong vehicle — § 707(a) — for ensuring that Sherman paid the contempt and disgorgement judgment debts and did not misuse the bankruptcy process." Relying on its previous ruling in *In re Padilla*, the Court of Appeals concluded that "cause," rather than "bad faith," is the proper standard for evaluating a motion to dismiss under section 707(a). *Padilla*, the Ninth Circuit explained, prescribes a two-part inquiry: (i) if the circumstances asserted to constitute "cause" are contemplated by any specific provision in the Bankruptcy Code applicable to chapter 7 cases, "cause" does not exist under section 707(a); and (ii) if the asserted "cause" is not contemplated by some other Code section, the court must further consider whether the circumstances otherwise meet the criteria for "cause" for dismissal under section 707(a).

The Ninth Circuit ruled that "cause" was lacking to dismiss Sherman's chapter 7 case because the type of misconduct he allegedly committed is addressed by other provisions of the Bankruptcy Code. The Court of Appeals rejected the SEC's argument that Sherman resorted to bankruptcy as a refuge from the jurisdiction of other courts, remarking that "[t]here is nothing problematic about an individual filing a legitimate bankruptcy petition with the intention of taking advantage of the automatic stay provisions." According to the Ninth Circuit, section 362(d) of the Bankruptcy Code expressly provides a remedy if continuation of the stay is deemed to be unjustified by allowing the court to lift it under the circumstances specified in the statute. The remedy in section 707(a), the Court emphasized, "is too powerful a medicine for the problem at hand, as it precludes adjudication of the bankruptcy even where there are debts aside from pending litigation that exceed assets."

Turning to the contention that Sherman was using bankruptcy as a "scorched earth" tactic, the Ninth Circuit explained that section 547(b) of the Bankruptcy Code, which allows a bankruptcy trustee to avoid preferential asset transfers, speaks directly to the kind of abuse involved (unfair treatment

of a single creditor). The Court of Appeals acknowledged that an avoidance action can ordinarily be filed only by a trustee in a chapter 7 case. Even so, it observed, a creditor may be authorized to prosecute an avoidance action under certain circumstances, and the general rule restricting the power to seek avoidance to a trustee merely fortifies the conclusion that a creditor should not be allowed to accomplish by means of section 707(a) what it cannot do under section 547(b).

Next, the Ninth Circuit examined Sherman's alleged misconduct in misrepresenting his liabilities and expenses. A remedy for such abuse, the Court of Appeals observed, is contained in section 727(a)(4), which provides that the court shall grant the debtor a discharge unless the debtor "knowingly and fraudulently, in or in connection with the case . . . made a false oath or account." According to the Ninth Circuit, denial of Sherman's discharge, rather than dismissal of his chapter 7 case, is the "proper remedy."

The Ninth Circuit emphasized that the SEC's inability to seek dismissal under section 707(a) did not leave it without recourse — its enforcement proceedings were exempted from the reach of the automatic stay under section 362(b)(4), and it could seek to deny Sherman a discharge or a determination that his debts to the SEC were non-dischargeable. In addition, the Court of Appeals explained, a bankruptcy court has the inherent authority to sanction any debtor who files a bankruptcy petition in bad faith by means of its civil contempt power.

Even if outmoded, judging from the significant number of bankruptcy judges who continue to find bad faith as "cause" for dismissal under section 707(a), the vision of the "honest but unfortunate debtor" has not been eradicated entirely from the judicial mindset.

The Court of Appeals concluded that Sherman's alleged behavior may have been sanctionable under other provisions of the Bankruptcy Code, but it did not rise to the level of "cause" for dismissal under section 707(b):

> To respect the complex statutory scheme that Congress has created to deal with malfeasance associated with bankruptcy petitions, we are loath to hold that a factor constitutes "cause" unless the Bankruptcy Code regime is incapable of righting wrongs of the kind alleged.

It accordingly reversed the district court's ruling and remanded the case below for further proceedings.

OUTLOOK

Although not stated as such, the arguments articulated by the SEC in *Sherman* really amount to an allegation that the debtor filed his chapter 7 in bad faith. We can only speculate as to why the SEC chose not to frame the issue as a bad-faith filing. Based on the Ninth Circuit's earlier ruling in *Padilla*, the SEC likely realized that a bad-faith filing argument had little or no chance of prevailing.

Critics of bad faith as a basis for dismissing a chapter 7 case under section 707(a) generally argue that any moral calculus that once may have existed in gauging a non-consumer debtor's eligibility for chapter 7 relief was removed long ago from federal bankruptcy law, and that applying a good-faith filing requirement where Congress has specifically chosen not to impose one amounts to ill-conceived judicial legislation. Consistent with the Ninth Circuit's ruling in *Sherman*, they also argue that the absence of good faith cannot constitute "cause" for dismissal because (i) other provisions of the Bankruptcy Code provide a remedy for the misconduct in question, and (ii) the examples of cause listed in section 707(b) indicate that lawmakers intended to target certain kinds of technical and procedural violations committed by a debtor after filing for bankruptcy, rather than its motives for filing a chapter 7 petition. Courts that deem bad faith as grounds for dismissal under section 707(a), they contend, engage in misplaced juridical activism based upon an outdated and naïve sense of justice and misapplication of inapposite precedent:

> The use of § 707(a) to eliminate bad faith chapter 7 filings deviates from the language and intent of the Bankruptcy Code. Nevertheless, courts use § 707(a) as a magic wand to wave away distasteful debtors instead of forcing creditors to utilize the measures already provided in the Code. It is time for courts to cut the hocus pocus and realize

> that, unlike chapter 11 and chapter 13 plan confirmations, Congress has not required chapter 7 debtors to pass a bad faith "smell test" before filing a petition. In fact, the case law demonstrates that courts' divergent olfactory detections as to what constitutes bad faith lead to inconsistent and illogical decisions. Accordingly, courts should refrain from judicial activism in an area where Congress never instructed them to "follow their nose."

The Good Faith Fable of 11 U.S.C. § 707(a): How Bankruptcy Courts Have Invented a Good Faith Filing Requirement for Chapter 7 Debtors, 13 Bankr. Dev. J. 61, 98 (1996). Finally, critics argue that the policy considerations underlying chapter 7 of the Bankruptcy Code are markedly different from those governing the reorganization chapters, such that it is entirely logical to treat bad faith as "cause" for dismissal under the relevant dismissal provisions in chapters 9, 11, 12, and 13, but not under section 707(a):

> The differing purposes and consequences embodied in the Code's reorganization and liquidation chapters further compel the conclusion that Congress deliberately omitted the good faith requirement from chapter 7. When a debtor reorganizes, it is allowed to retain its assets and reorder its contractual obligations to its creditors. In return for these benefits, Congress requires the debtor to approach its new relationship with the creditors in good faith, for the mutually beneficial purpose of reorganization. . . . On the other hand, when a debtor liquidates, it surrenders all of its nonexempt assets for distribution among its creditors, and the debtor-creditor relationship is presumably terminated. Since liquidation requires no ongoing relationship between the debtor and its creditors, the remedy of discharge should be made available to any debtor who wishes to pay the price . . . and who is willing to risk the chance that some or all of its debts may not be discharged. . . . This is true regardless of whether the debtor's motive in seeking such a remedy was grounded in good faith.

Id. at 65. Rightly or wrongly, many bankruptcy courts are loath to abandon their prerogative as courts of equity to penalize "unworthy" debtors by dismissing bad-faith chapter 7 filings under the rubric of "cause." Even if outmoded, judging from the significant number of bankruptcy judges who continue to find bad faith as "cause" for dismissal under section 707(a), the vision of the "honest but unfortunate debtor" has not been eradicated entirely from the judicial mindset.

Admittedly, many of the policies served by the reorganization chapters do not apply to chapter 7 liquidations. Even so, the reorganization chapters and chapter 7 have some common goals (*e.g.*, preventing piecemeal liquidation of a debtor's estate and equitable treatment of creditors) that are ill-served if a debtor is allowed to invoke the bankruptcy process for reasons that are antithetical to the intended purposes of the Bankruptcy Code. To say that other provisions of the statute provide a remedy for various kinds of abuse arguably is to overlook what many courts firmly believe should be a threshold inquiry — whether filing for bankruptcy in the first place is legitimate. If the answer is no, allowing the debtor to benefit from bankruptcy protection while creditors are forced to bear the cost of seeking relief from the automatic stay, a judgment that a debt is non-dischargeable or an order denying the debtor a discharge altogether is a waste of both judicial and creditor resources. According to the Ninth Circuit in *Sherman*, such a threshold inquiry with respect to good faith needs to be conducted under provisions of the Bankruptcy Code, such as section 305, other than section 707(a).

As noted, Congress amended section 707(b) in 2005 to provide that a court may consider whether the debtor filed its bankruptcy petition in bad faith in determining whether a consumer chapter 7 case should be dismissed as an abuse of the bankruptcy process. Legislators' failure to amend section 707(a) to add any express reference to good faith will likely be cited by critics of an expansive reading of "cause" as evidence that good faith should not be part of the inquiry. On the other hand, if Congress felt that the non-exclusive language of section 707(a) is sufficiently flexible to incorporate bad faith, it may not have perceived any need to make a corresponding change to the provision.

Finally, according to the Ninth Circuit's view, any kind of abuse committed by a debtor that can be remedied by some other provision of the Bankruptcy Code cannot constitute "cause" for dismissal under section 707(a). If this approach is the correct one, we are left to ponder exactly what falls into that designation outside of the listed examples. Relatively few

BILLION-DOLLAR FILINGS

Billion-dollar public bankruptcies for the period 1987 – 2005

Year	Bill. $ Cases	All Cases	Assets Bill. $ Cases	All Cases	% of Total Number	Assets
1987	1	112	32,892	41,503	0.9%	79.3%
1988	3	122	38,347	43,488	2.5%	88.2%
1989	12	135	65,435	71,371	8.9%	91.7%
1990	15	115	73,401	82,781	13.0%	88.7%
1991	18	123	64,310	93,624	14.6%	68.7%
1992	14	91	44,011	64,226	15.4%	68.5%
1993	3	86	5,026	18,745	3.5%	26.8%
1994	1	70	1,139	8,337	1.4%	13.7%
1995	7	85	14,592	23,107	8.2%	63.1%
1996	3	86	4,012	14,201	3.5%	28.3%
1997	4	83	9,003	17,247	4.8%	52.2%
1998	4	122	12,532	29,195	3.3%	42.9%
1999	20	145	40,018	58,760	13.8%	68.1%
2000	23	179	66,824	98,763	12.8%	67.7%
2001	44	263	225,086	256,294	16.7%	87.8%
2002	34	220	348,679	394,300	15.5%	88.4%
2003	21	172	74,391	98,262	12.2%	75.7%
2004	8	92	32,334	47,664	8.7%	67.8%
2005	11	86	124,824	133,843	12.8%	93.3%

decisions address dismissal pursuant to section 707(a) under circumstances involving neither bad faith nor one of the enumerated examples of cause. Because these cases could also have been dismissed under section 305, it is unclear whether the circumstances involved would qualify as "cause" under the Ninth Circuit's construction of section 707(a).

Sherman v. SEC (In re Sherman), 441 F.3d 794 (9th Cir. 2006).

Tamecki v. Frank (In re Tamecki), 229 F.3d 205 (3d Cir. 2000).

Industrial Insurance Services, Inc. v. Zick (In re Zick), 931 F.2d 1124 (6th Cir. 1991).

In re Padilla, 222 F.3d 1184 (9th Cir. 2000).

In re Huckfeldt, 39 F.3d 829 (8th Cir. 1994).

Peterson v. Atlas Supply Corp. (In re Atlas Supply Corp.), 857 F.2d 1061 (5th Cir. 1988).

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