In Search of a "Good Faith" Filing Requirement for Non-Consumer Debt Chapter 7 Cases

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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 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 forty 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 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.

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 who 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 loathe 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 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).