Choice of Bankruptcy Venue: Sound Strategy or Forum Shopping?

March/April 2007

Mark G. Douglas

One of the most significant considerations in a prospective chapter 11 debtor's strategic pre-bankruptcy planning is the most favorable venue for the bankruptcy filing. Given varying interpretations of certain important legal issues in the bankruptcy courts (*e.g.*, the ability to pay the claims of "critical" vendors at the inception of a chapter 11 case, to include non-debtor releases in a chapter 11 plan or to reject collective bargaining agreements) and the reputation, deserved or otherwise, that certain courts or judges may be more "debtor friendly" than others, choice of venue (if a choice exists) can have a marked impact on the progress and outcome of a chapter 11 case.

The Southern District of New York and Delaware have long been the preferred forums for large chapter 11 cases. Given New York's recognized status as the financial capital of the U.S. (and arguably the world), the fact that its bankruptcy courts regularly preside over a significantly greater proportion of complex chapter 11 restructurings than courts located elsewhere is not surprising. Delaware's courts have similarly developed considerable experience and expertise in complex chapter 11 cases, but the district's prominence as a frequent venue for chapter 11 "mega" cases may be based in part on the statutory venue requirements that apply to bankruptcy filings.

The rules that determine which particular venue is appropriate for a bankruptcy filing permit a debtor to file for chapter 11 protection in the bankruptcy court located in the debtor's state of incorporation, which for a significant percentage of corporations is Delaware. Even so, because a large number of companies do not do business or own assets in the state in which they are incorporated, state of incorporation as a basis for venue has been criticized as providing a pretext for "forum shopping" that permits a chapter 11 debtor to sort out its financial problems far removed from creditors and other parties with a stake in the outcome of the case.

The perception that chapter 11 forum shopping has been abused led to the introduction of legislation in 2005 to eliminate state of incorporation as a stand-alone basis for venue and to prevent "piggy back" chapter 11 filings by a subsidiary for the sole purpose of manufacturing venue for its corporate parent. The legislation was motivated in part by recent estimates that creditors achieve smaller recoveries in bankruptcies filed in Delaware or New York than in other states. These restrictions, however, were not incorporated into the sweeping bankruptcy reforms enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Still, recent developments suggest that bankruptcy courts may be casting a more critical eye on a chapter 11 debtor's chosen venue, particularly if the nexus between the venue and the debtor's business, assets and creditors is no more than tenuous.

Venue of a Bankruptcy Case

A bankruptcy case (except a case under chapter 15) may be filed in any federal district court containing the debtor's "domicile, residence, principal place of business . . . or principal assets in the United States . . . for the one hundred and eighty days immediately preceding" the filing of the case. The debtor may also file for bankruptcy in the district in which a case is pending

concerning any affiliate, general partner or partnership of the debtor. Consistent with general rules governing the proper venue for litigation in federal courts, a corporation's "domicile" is generally held to be its state of incorporation. Although technically filed in the district court, bankruptcy cases are automatically referred to the bankruptcy court in that district pursuant to standing orders of reference. Bankruptcy courts are actually units or divisions of the federal district courts.

In some cases, more than one venue may satisfy the statutory requirements. If so, any party-in-interest (or the court on its own initiative) claiming that an alternative venue is more appropriate may seek to have venue transferred to any other bankruptcy court that satisfies the venue requirements. The bankruptcy court is authorized to transfer venue of a case to another district "in the interests of justice or for the convenience of the parties." Neither the Bankruptcy Code nor the rules effectuating its provisions specify how this standard is to be applied. Courts typically consider a number of factors in making this determination, including the proximity to the court of creditors and witnesses necessary to administer the bankruptcy estate, the location of the debtor's assets, the economic administration of the estate and the necessity for ancillary administration if the debtor ends up liquidating its assets.

If bankruptcy cases involving the same debtor, or a debtor and an affiliate, are pending in more than one court, the bankruptcy court in which the first case was filed first may determine, "in the interests of justice or for the convenience of the parties," the court or courts in which the cases should proceed. Proceedings before any other court are stayed pending the initial court's decision on a motion to transfer venue.

Malden Mills

The United States Bankruptcy Court for the District of Massachusetts recently had an opportunity to examine the venue rules in connection with chapter 11 cases filed on January 10, 2007 in Delaware by Malden Mills Industries, Inc. and its affiliates (collectively, "Malden").

Malden, the Massachusetts-based manufacturer of Polartec® fleece blankets and apparel for such customers as Lands' End, Northface and the Pentagon, filed for bankruptcy protection in the 1980s and, more recently, November 2001 in Massachusetts, where the company has been based for 101 years. The company confirmed a plan of reorganization in October 2003 in which its existing owner, Aaron Feuerstein, ceded control of Malden to a creditor group led by its largest senior lender, GE Capital Corp., but retained an option to buy back the company over the next two years for $96 million to $120 million. A creditors' trust created under the plan (the "Creditor Trust") received 26 percent of Malden's common stock. All or nearly all of Malden's assets, employees and operations are located in Massachusetts. Malden is incorporated in Delaware, but has never had any meaningful operations in the state.

Its plan of reorganization having been substantially consummated, Malden sought a final decree closing its chapter 11 cases. In connection with its request, Malden and its agent bank, GE Capital Commerce Finance, solicited the Creditor Trusts' assent to entry of a final decree, representing that the "aggressive push to close the cases" was not motivated by anything other than a desire to tie up loose ends. The Massachusetts bankruptcy court, with the Creditor Trust's consent, entered a final decree in the cases on December 28, 2006 and closed the cases on January 9, 2007.

The following day, Malden filed for chapter 11 protection in Delaware with the professed intention of effectuating a sale of substantially all of its assets under section 363(b) of the Bankruptcy Code. Initially, the stalking horse bidder in the proposed $44 million sale was Boston-based Gordon Brothers Group LLC. Another bidder, Philadelphia-based Chrysalis Capital Partners LLC, emerged shortly after the filing to match Gordon's offer, but with less costly overbid protections.

Contending that it had been misled into agreeing to entry of a final decree in the 2001 chapter 11 cases without knowing that Malden planned to refile for bankruptcy in Delaware, the Creditor Trust applied to the Massachusetts bankruptcy court for an order vacating the final decree and transferring venue of the newly-filed chapter 11 cases from Delaware to Massachusetts.

The Bankruptcy Court's Ruling

The Massachusetts bankruptcy court granted both requests. Addressing the motion to vacate its December 28, 2006 final decree, the court explained that the entry of a final decree closing a bankruptcy case after the estate has been fully administered does not prevent the court from reopening the case for "cause" under section 350(b) of the Bankruptcy Code. "Cause" existed in this case, the court emphasized, due to the "unnecessary lack of candor" exhibited by Malden and its agent in soliciting the assent of the Creditor Trust under "false pretenses." According to the court, this lack of candor was clearly designed to expedite the case closure process and "to facilitate the Delaware filing in an attempt to gain some tactical advantage on the inevitable venue transfer motion." Malden and its agent's actions in seeking the Creditor Trust's assent with the knowledge that Malden would immediately file for chapter 11 in Delaware and their

misleading explanation for expedited closure of the existing cases, the bankruptcy court remarked, "demonstrated a serious breach of the duty of candor, which the Court cannot condone." It accordingly vacated the final decree.

Turning to the venue transfer motion, the bankruptcy court explained that, because it had vacated the final decree, Malden's chapter 11 cases were still pending before it. This meant that the venue transfer request was properly addressed to it, rather than the Delaware bankruptcy court. Examining the factors considered in connection with a venue transfer motion, the court ruled that the District of Massachusetts was the more appropriate forum. Malden's contacts with Delaware, the court explained, are minimal, its operations, assets, employees and managers, plus most of its creditors, being situated in Massachusetts. Malden's venue selection, the court observed, "was not based on the convenience of these constituencies given their geographical connection to Massachusetts, and one might even surmise that it was designed to make the venue *inconvenient* and expensive for some."

Moreover, the bankruptcy court emphasized, having presided over Malden's previous reorganization, it is very familiar with Malden, many of the other stakeholders in the cases, the terms of the company's most recently confirmed chapter 11 plan and the legal issues involved. Acknowledging Malden's "extreme plight," the bankruptcy court concluded that it, like the Delaware bankruptcy court, is capable of facilitating the "quick" section 363 sale driving Malden's decision to resort to chapter 11 once again.

Where Do We Go from Here?

Considering alternative venues for a chapter 11 case is an important and perfectly legitimate aspect of any prospective debtor's pre-bankruptcy planning. If more than one venue is available for a bankruptcy filing, it is incumbent upon the debtor-company and its professionals to consider carefully which venue is most likely to achieve the goals of the chapter 11 filing consistent with important policy considerations designed to promote the debtor's prospects for a successful chapter 11 case while protecting the interests of other stakeholders involved.

Malden Mills demonstrates where strategic planning can cross the line into abuse. Interestingly, the bankruptcy court acknowledged that its ruling on vacatur of the final decree "would have been different" had the debtor and its agent not intentionally misled the Creditor Trust in obtaining its assent to closure. The implied subtext is that the court itself felt deceived by conduct it clearly considered duplicitous and bordering on sanctionable. For this reason, *Malden Mills* is an unusual case.

That is not to say that the ultimate outcome of the venue transfer motion would have been different, but it might have been a closer call. Moreover, absent vacatur of the final decree, any venue transfer request would have been properly addressed to the Delaware, rather than the Massachusetts, bankruptcy court. The Massachusetts court expressed confidence that the Delaware court would have ruled the same way, given Malden's lack of any meaningful contact with Delaware, other than a Delaware certificate of incorporation, and the existence of a proactive creditor group voicing vigorous opposition to Malden's choice of venue.

Malden's underlying strategy in filing for bankruptcy again as a way of facilitating a sale of the company was ultimately successful. The bankruptcy court approved the sale of substantially all of Malden's assets to Chrysalis Capital Partners, on February 26, 2007 for approximately $44 million. On March 7, 2007, Malden filed a motion seeking to convert its chapter 11 cases to a chapter 7 liquidation. The new textile manufacturing entity is called Polartec LLC.

In re Malden Mills Industries, Inc., 2007 WL 140818 (Bankr. D. Mass. Jan. 22, 2007).