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Good Faith in Chapter Eleven Reorganizations

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NOTE

GOOD FAITH IN CHAPTER ELEVEN REORGANIZATIONS

I. INTRODUCTION

Although not expressly required by statute, good faith has been established as a prerequisite for Chapter 11 reorganizations under the Bankruptcy Reform Act of 1978. The most commonly cited statutory authority for the good faith requirement is section 1112(b) of Title 11 of the United States Code,[1] which provides for the conversion or dismissal of a case for "cause" and includes nine specific situations that qualify as "causes." Several bankruptcy courts have concluded that the list of causes is not exclusive and that a lack of good faith is an additional cause for dismissal or conversion.[2] The legislative history of section

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1. 11 U.S.C. § 1112(b) (Supp. IV 1980) provides:

(b) Except as provided in subsection (c) of this section, on request of a party in interest, and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 7 of this title or may dismiss a case under this chapter, whichever is in the best interest of creditors and the estate, *for cause, including—*

(1) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation;

(2) inability to effectuate a plan;

(3) unreasonable delay by the debtor that is prejudicial to creditors;

(4) failure to propose a plan under section 1121 of this title within any time fixed by the court;

(5) denial of confirmation of every proposed plan and denial of additional time for filing another plan or a modification of a plan;

(6) revocation of an order of confirmation under section 1144 of this title, and denial of confirmation of another plan or a modified plan under section 1129 of this title;

(7) inability to effectuate substantial consummation of a confirmed plan;

(8) material default by the debtor with respect to a confirmed plan; and

(9) termination of a plan by reason of the occurrence of a condition specified in the plan.

(emphasis added).

2. *See, e.g., In re* McLaury, 25 B.R. 30 (Bankr. N.D. Tex. 1982); *In re* Pappas, 17

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1112(b) supports this conclusion; Congress did not intend for the list of "causes" in section 1112(b) to be exhaustive and, in fact, encouraged the courts to consider individual facts in every case.[3] Congress also emphasized that the courts have broad discretion to determine whether "cause" for dismissal or conversion exists.[4]

A second provision cited for a good faith requirement is section 362(d)(1) of Title 11 of the United States Code, which allows a court to grant relief from an automatic stay "for cause, including lack of adequate protection."[5] Bankruptcy courts have found a lack of good faith to be "cause" enough for relief, independent of the lack of adequate protection specified in section 362(d)(1).[6] The legislative history[7] of section 362(d) shows that Congress shared this nonrestrictive view of the term "cause."[8]

B.R. 662 (Bankr. D. Mass. 1982); *In re* Northwest Recreational Activities, Inc., 4 B.R. 36 (Bankr. N.D. Ga. 1980); *In re* Dutch Flat Inv. Co., 6 B.R. 470 (Bankr. N.D. Cal. 1980).

3. S. REP. No. 989, 95th Cong., 2d Sess. 117, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5903 states:

> [11 U.S.C. § 1112(b)] gives wide discretion to the court to make an appropriate disposition of the case *sua sponte* or upon motion of a party in interest, or the court is permitted to convert a reorganization case to a liquidation case or to dismiss the case, whichever is in the best interest of creditors and the estate, but only for cause. Cause may include [the nine specific factors enumerated in § 1112(b)]. This list is not exhaustive. The court will be able to consider other factors as they arise, and to use its equitable powers to reach an appropriate result in individual cases. The power of the court to act *sua sponte* should be used sparingly and only in emergency situations.

See also H.R. REP. No. 595, 95th Cong., 1st Sess. 405, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 6361, 6362 (employs language virtually identical to that quoted above); *Analysis of the Bankruptcy Reform Act of 1978*, 1979 *Ann. Surv. of Bankr. L.* 197, 352.

4. S. REP. No. 989, *supra* note 3, at 5903; H.R. REP. No. 595, *supra* note 3, at 6361.

5. 11 U.S.C. § 362(d)(1) (Supp. IV 1980) provides:

> (d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—
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> (1) *for cause*, including the lack of adequate protection of an interest in property of such party in interest. . . .

(emphasis added).

6. *In re* Victory Constr. Co., 9 B.R. 549, 558-60 (Bankr. C.D. Cal. 1981). *See also In re* Hewitt, 16 B.R. 973 (Bankr. D. Alaska 1982); *In re* Beach Club, 22 B.R. 597 (Bankr. N.D. Cal. 1982); *In re* Lotus Invs., Inc., 16 B.R. 592 (Bankr. S.D. Fla. 1981).

7. "[T]he lack of adequate protection of an interest in property of the party requesting relief from the stay is one cause for relief, but it is not the only cause." H.R. REP. No. 595, *supra* note 3, at 6300.

8. At least one court has recognized 11 U.S.C. § 305(a) as authority for dismissal of a case when the debtor acts in bad faith. *See In re* Matchup, Inc., 13 B.R. 147 (Bankr.

McColl: Good Faith in Chapter Eleven Reorganizations

This Note examines the nature of the good faith requirement in Chapter 11 cases. In particular, it discusses situations in which a good faith challenge may arise and the various factors a court might consider in assessing a debtor's good faith.

II. JUSTIFICATIONS FOR THE GOOD FAITH REQUIREMENT

Since the question of whether authority exists within the Bankruptcy Code for a good faith requirement has been settled, the courts have begun to advance various justifications for its use. A common justification is the protection of the bankruptcy court's jurisdictional integrity. "Good faith . . . [has] merged into the power of the court to protect its jurisdictional integrity from schemes of improper petitioners seeking to circumvent jurisdictional restrictions and from petitioners with demonstrable

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S.D. Fla. 1981). Section 305(a) allows the court to abstain from a case if "the interests of creditors and the debtor would be better served by such a dismissal. . . ." In *In re Matchup, Inc.*, the court held that dismissal would best serve the interests of both the creditors and the debtor because the schedules were incomplete, the corporate debtor's president was incapable of representing the debtor itself, the president's assertion that counsel could not be afforded conflicted with representations in the schedules, the debtor had no income for at least two years, there was no ongoing business to rehabilitate, and the debtor was partially owned by another corporation.

Since *all* creditors and the debtor must benefit from the court's refusal to hear the case, most bankruptcy courts will not use § 305(a) to dismiss a petition, even when the debtor's conduct indicates a lack of good faith. *See, e.g., In re* Mineral Hill Corp., 16 B.R. 687 (Bankr. D. Md. 1982); *In re* WPAS, Inc., 6 B.R. 44 (Bankr. M.D. Fla. 1980). Although § 305(a) has been interpreted as an enlargement of, rather than a restriction upon the court's power to dismiss, *see In re* Fast Food Properties, Ltd. No. 1, 5 B.R. 539 (Bankr. C.D. Cal. 1980), the majority of bankruptcy courts use § 305(a) sparingly and not as a substitute for a bad faith dismissal under § 1112(b) or § 362(d)(1). *See, e.g., In re* Pine Lake Village Apt. Co., 16 B.R. 750, 754 (Bankr. S.D.N.Y. 1982); *In re* Mineral Hill Corp., 16 B.R. 687, 688 (Bankr. D. Md. 1982). *See also In re* Luftek, 6 B.R. B.R. 539, 548 (Bankr. E.D.N.Y. 1980), in which the court stated:

> [C]ourts will have to exercise great care in using the discretion granted by section 305(a) to dismiss a case. To be sure, it could be said that dismissal would be in the interests of creditors and the debtor in many of the proceedings commenced under the Bankruptcy Code; this Court could dispose of much of its calendar if its discretion was unbridled. There is an inherent risk to our system of jurisprudence in any Act of Congress which gives the courts such broad powers to refuse jurisdiction over a case. This risk is compounded by the finality and non-appealability of an order entered under this section. Indeed, by giving an example of a situation in which abstention or dismissal would be appropriate, Congress has indicated that it intended section 305(a) dismissals to be the exception rather than a rule.

[sic] frivolous purposes absent any economic reality."[9] This inherent power of the bankruptcy court was considered by Congress when the new Bankruptcy Code was enacted. The House Report on section 1112(b) states that "[t]he court will be able to consider other factors as they arise, and to use its equitable power to reach an appropriate result in individual cases."[10]

Clearly, good faith is a condition necessary to prevent improper imposition on the bankruptcy courts' jurisdiction. It is crucial to the courts' integrity that petitioners be prevented from using the Bankruptcy Code as "part and parcel of a scheme whereby the form of a judicial remedy . . . [supplies] a protective cover for a fraudulent design."[11]

A second justification for the good faith requirement advanced by the bankruptcy courts is that the debtor's legal status and economic condition must fall within the purpose of Chapter 11. The filing of a Chapter 11 petition is intended to provide relief from financial distress by facilitating the "rehabilitation of an ongoing business."[12] The goal of reorganization is to preserve the debtor's assets by saving them from premature sales, such as foreclosures, so that the interests of both the debtor and its unsecured creditors will not be completely extinguished. While the debtor is allowed to restructure his debts to achieve a "fresh start,"[13] the creditors are permitted to avoid foreclosure actions to achieve a greater return on their claims. The tension between the competing goals of the debtor and the creditor has resulted in a balancing of interests by the bankruptcy courts.[14]

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9. *In re* Northwest Recreational Activities, Inc., 4 B.R. 36, 39 (Bankr. N.D. Ga. 1980). *See also In re* Levinsky, 23 B.R. 210 (Bankr. E.D.N.Y. 1982); *In re* Sung Hi Lim, 7 B.R. 316 (Bankr. D. Hawaii 1980).

10. H.R. REP. No. 595, *supra* note 3, at 6362.

11. Shapiro v. Wilgus, 287 U.S. 348, 355 (1932). *See also* Tucker v. Texas Am. Syndicate, 170 F.2d 939 (5th Cir. 1948). *But see In re* World of English, 16 B.R. 817 (Bankr. N.D. Ga. 1982) in which the court said that it is "better able to protect its jurisdictional integrity in situations in which debtors are before it," than it is by dismissal of the case for lack of good faith. *Id.* at 821.

12. *In re* Spenard Ventures, Inc., 18 B.R. 164, 167 (Bankr. D. Alaska 1982).

13. *In re* Alison Corp., 9 B.R. 827, 829 (Bankr. S.D. Cal. 1981).

14. This balancing was described by one bankruptcy court as follows:

> The provisions of the Code dealing with rehabilitation and reorganization must be viewed as direct lineal descendents of a legal philosophy solidly embedded in American bankruptcy law. . . . [The origins of this law] disclose a common theme and objective: avoidance of the consequences of economic dismemberment and liquidation, and the preservation of ongoing values in a man-

A third justification is the apparent absence of any congressional intent to do away with a good faith test. Although not included as an express safeguard in Chapter 11 of the 1978 Bankruptcy Code, good faith has been an integral part of bankruptcy philosophy for almost a century. It was an express condition of confirmation under the 1898 Act.[15] Good faith was also stipulated for both the filing and confirmation of proposed compositions or extensions under the 1933 Act.[16] The 1933 Act also required good faith for the confirmation of a farmer's proposal for composition or an extension of time[17] and for the approval of a plan for railroad reorganization.[18] Under Section 77B of the 1934 Act, good faith was an express prerequisite to court approval of a petition for the reorganization of a corporation[19] and confirmation was allowed only after the judge was satisfied that good faith accompanied the proposal.[20] Similarly, Chapter X of the 1938 Act made good faith an express condition both to filing of the petition for reorganization by a corporate debtor and to confirmation of the plan.[21] Chapters XI,[22] XII,[23] and XIII[24] of

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ner which does equity and is fair to rights and interests of the parties affected. But the perimeters of this potential mark the borderline between fulfillment and perversion; between accomplishing the objectives of rehabilitation and reorganization, and the use of these statutory provisions to destroy and undermine the legitimate rights and interests of those intended to benefit by this statutory policy. That borderline is patrolled by courts of equity, armed with the doctrine of good faith. . . .

In re Victory Constr. Co., 9 B.R. 549, 558 (Bankr. C.D. Cal. 1981). *See also* American United Mut. Life Ins. Co. v. Avon Park, 311 U.S. 138, 145 (1940); SEC v. United States Realty & Improvement Co., 310 U.S. 434, 435 (1940); *In re* First Dade Corp., 17 B.R. 887, 890 (Bankr. N.D. Fla. 1982). *Cf.* Louisville Title Co.'s Receiver v. Crab Orchard Banking Co., 249 Ky. 736, 61 S.W.2d 615 (1933)(recognition of equitable principles in state receivership proceedings). *See also* Gaffney, *Bankruptcy Petitions Filed in Bad Faith: What Actions Can Creditor's Counsel Take?*, 12 U.C.C. L.J. 205 (1980).

15. Section 12(d)(3) of the Bankruptcy Act of 1898 provided that an offer of composition could not be confirmed by the court unless "the offer and its acceptance [were] in good faith. . . ." Ch. 541, 30 Stat. 544, 550 (1898).

16. Section 74(a) of the 1933 amendments to the Bankruptcy Act of 1898 required the judge to approve the petition if it complied with the section and had "been filed in good faith." Pub. L. No. 72-420, 47 Stat. 1467 (1933). In addition section 74(g)(4) required the court to confirm the proposal if "the offer and its acceptance [were] in good faith, and [were] not . . . made or procured except as herein provided, or by any means, promises or acts herein forbidden." Pub. L. No. 72-420, 47 Stat. 1467, 1468 (1933).

17. Pub. L. No. 72-420, § 75(i)(3), 47 Stat. 1467, 1472 (1933).

18. Pub. L. No. 72-420, § 77(g)(3), 47 Stat. 1467, 1479 (1933).

19. Pub. L. No. 73-296, § 77B, 48 Stat. 911, 912 (1934).

20. Pub. L. No. 73-296, § 77B(f)(6), 48 Stat. 911, 919 (1934).

21. Pub. L. No. 75-696, 52 Stat. 840, 887, 897 (1938).

the 1938 Act also prohibited confirmation of arrangements with creditors unless the court was satisfied that the debtor's good faith existed.

The current rehabilitation and reorganization provisions of the 1978 Code are viewed by the courts as "direct lineal descendents of a legal philosophy solidly embedded in American bankruptcy law."[25] Good faith is considered an inseparable component of that philosophy.[26] Many bankruptcy courts utilize the following reasoning:

> It would be more than anomalous to conclude that in consolidating the provisions of Chapters X, XI, and XII in Chapter 11 of the Code, Congress intended to do away with a safeguard against abuse and misuse of process which had been established and accepted as part of bankruptcy philosophy (either by statute or decisional law) for almost a century. "Good faith" must therefore be viewed as an implicit prerequisite to the filing or continuation of a proceeding under Chapter 11 of the Code.[27]

This rationale is further supported by the lack of any evidence in the legislative history or in the Code itself of congressional intent to eliminate the good faith safeguard from bankruptcy law.[28]

A fourth justification for the good faith requirement is its practicality. At least one court has announced that "power must exist 'in every court to control the disposition of the causes on its docket with economy of time and effort for itself, for counsel and for litigants.' "[29] Dismissal or relief from an automatic stay for lack of good faith is believed to be an appropriate exercise of a court's inherent power to control its case load.

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22. Pub. L. No. 75-696, §§ 361, 366(5), 52 Stat. 840, 911-12 (1938).

23. Pub. L. No. 75-696, §§ 467, 472(4), 52 Stat. 840, 923 (1938).

24. Pub. L. No. 75-696, 52 Stat. 840, 934 (1938).

25. *In re* Victory Constr. Co., 9 B.R. 549, 558 (Bankr. C.D. Cal. 1981). *Victory Construction* contains an unusual but useful Appendix which lists by Code section topic numerous cases dealing with the good faith standard. *Id.* at 565-69.

26. *E.g., In re* Mogul, 17 B.R. 680 (Bankr. M.D. Fla. 1982); *In re* FJD, Inc., 24 B.R. 138 (Bankr. D. Nev. 1982).

27. *In re* Victory Constr. Co., 9 B.R. 549, 558. *See also* cases cited *supra* note 26.

28. *In re* First Dade Corp., 17 B.R. 887, 891 (Bankr. M.D. Fla. 1982).

29. *In re* 299 Jack-Hemp Assocs., 20 B.R. 412 (Bankr. S.D.N.Y. 1982)(quoting Landis v. North Am. Co., 299 U.S. 248, 254 (1936)).

III. TYPICAL FACT PATTERNS

Three basic fact situations give rise to good faith challenges. None are exclusive and elements of each are frequently present in a given case. The most common is an attempt by the debtor to fraudulently invoke the jurisdiction of the bankruptcy court. *In re Nancant, Inc.*,[30] provides a typical example of this situation. In *Nancant* the debtor was a dummy corporation to which property was transferred immediately prior to the corporation's filing for Chapter 11 reorganization. The amount of secured indebtedness and real estate taxes due greatly exceed the value of this transferred property, which was the corporation's only asset. Only one general unsecured creditor for a nominal amount existed, and the debtor had never operated a business on the property. If the debtor had followed normal procedures, it would have had to pay the taxes due before seeking an abatement. By filing for reorganization, the debtor hoped to avoid selling the property to prepay the taxes and to have a bankruptcy court determine its tax liability.

The court focused on the debtor's purpose for invoking the bankruptcy court's jurisdiction and dismissed the case for lack of good faith. Although no single factor was deemed conclusive, the court considered the following facts: the paucity of unsecured creditors, for whom business reorganization was principally created; the absence of an operating company with a business and economic history; the lack of a proposal for future operations of the debtor corporation, except for a vague development plan concerning the transferred property; and the a transfer of that asset to the newly-formed corporation on the eve of bankruptcy.[31] The putative need for reorganization was apparently created by the debtor for the sole purpose of bringing the encumbered property under the protection of the bankruptcy court.

Other attempts to fraudulently invoke the jurisdiction of the bankruptcy court have ranged from the creation of a dummy entity[32] to the submission of false material statements to the

30. 8 B.R. 1005 (Bankr. D. Mass. 1981).

31. *Id.* at 1009.

32. *In re* G-2 Realty Trust, 6 B.R. 549 (Bankr. D. Mass. 1980); *In re* Dutch Flat Inv. Co., 6 B.R. 470 (Bankr. N.D. Cal. 1980).

court.[33] In *In re Verrazzano Towers, Inc.*,[34] an officer of the debtor corporation falsely stated in a certificate to the court that a special meeting of the debtor's board of directors had been held, that the board had resolved to file for relief under Chapter 11, and that the officer himself was both president and secretary of the corporation. The imposter filed the Chapter 11 petition without knowledge or consent of the two other directors of the debtor. The court found the false material statements to be aimed at achieving an improper commencement of the Chapter 11 proceeding, held the improper conduct dispositive of the good faith issue, and dismissed the case.[35]

A second fact pattern which has arisen in Chapter 11 proceedings is an attempt by a debtor to shield his assets from the jurisdiction of the bankruptcy court. In *In re Eden Associates*,[36] the debtor corporation was created and property was conveyed to it by an individual from his more affluent, closely held corporation. The debtor corporation was a shell with no assets other than the transferred property, no bona fide creditors, and no ongoing business. Thus, there was no business enterprise to rehabilitate. The individual had attempted to shield the assets of his wealthier corporation by allowing the bankruptcy court to reach only the assets held by the dummy corporation. The court concluded that the debtor had impermissibly abused the court's jurisdiction and dismissed the case for lack of good faith.[37]

A third fact situation involves the filing of a Chapter 11 petition by the debtor on the eve of foreclosure proceedings. In *In re Lotus Investments, Inc.*,[38] the debtor corporation was created and the purchaser's interest in certain property transferred to it after a mortgagee commenced foreclosure action but before the ordered foreclosure sale. The property was the sole asset of the debtor. The debtor did not give any consideration for the property, and there was no evidence that the conveyance was for legitimate business purposes. The property was not proved necessary for an effective reorganization of the debtor. Further, the

33. *In re* Verrazzano Towers, Inc., 10 B.R. 387 (Bankr. E.D.N.Y. 1981).
34. *Id.*
35. *Id.* at 408-09.
36. 13 B.R. 578 (Bankr. S.D.N.Y. 1981).
37. *Id.* at 585.
38. 16 B.R. 592 (Bankr. S.D. Fla. 1981). *See infra* text accompanying note 61.

debtor did not provide, nor offer to provide, any additional payments or substitute liens to adequately protect the mortgagee's interest. Consequently, the court held that the mortgagee was entitled to relief from the automatic stay with respect to the property scheduled for sale because the debtor had not filed his petition in good faith.[39]

Frequently, the relief sought by the petitioner in Chapter 11 cases is the automatic stay itself and not the opportunity to reorganize its debts to stay in business. This motive is exemplified by *In re 299 Jack-Hemp Associates*[40] in which a partnership filed for relief after a mortgagee had obtained a foreclosure judgment on property that was part of a decedent's estate. The co-executors under the will had created the partnership to qualify as a debtor under the Bankruptcy Code.[41] The court reasoned that the co-executors were trying to circumvent administration of the property by the probate court.[42] Since the co-executors were merely seeking an automatic stay which would prevent the impending foreclosure sale of the property, the debtor's petition was dismissed for lack of good faith.[43]

IV. DEFINING THE GOOD FAITH STANDARD

Although the bankruptcy courts agree that a good faith standard exists and is justified, various interpretations of the standard are used. *In re Victory Construction Co., Inc.*[44] illustrates the "new debtor syndrome" definition of the good faith standard. In finding a lack of good faith, the court in *Victory* emphasized that the a debtor entity was created shortly before it filed a Chapter 11 petition. Other factors, such as the lack of an ongoing business to protect, were noted by the court, but creation of the debtor on the eve of filing was apparently dispositive of the good faith issue.

Several bankruptcy courts have not been satisfied with the *Victory* approach[45] and have applied the standard suggested in

39. *Lotus Invs., Inc.* 16 B.R. at 596.
40. 20 B.R. 412 (Bankr. S.D.N.Y. 1982).
41. *See* 11 U.S.C. § 109(b), (d).
42. *Jack-Hemp. Assocs.*, 20 B.R. at 413.
43. *Id.*
44. 9 B.R. 549 (Bankr. C.D. Cal. 1981).
45. *E.g., In re* The Beach Club, 22 B.R. 597 (Bankr. N.D. Cal. 1982); *In re* Levinsky,

Shapiro v. Wilgus.[46] The *Shapiro* test focuses on whether "any of the substantive or procedural rights of any of the creditors to assets, available prior to the transfer of property, have been altered or eroded by the transfer and subsequent Chapter 11 filing."[47] This approach seeks to avoid a bar to legitimate reorganization attempts which involve the creation of a new debtor immediately prior to filing. "The timeliness of the change of entity and/or transfer of property is not controlling."[48] With the *Shapiro* approach, the courts' main concern is the presence or absence of a detriment to the creditors rather than an advantage to the individual(s) or business(es) that created the new debtor entity. If no fraud is perpetrated upon any creditor and no creditor is hindered in the collection of a claim, then the delay is considered procedural, not substantive; and the court will allow the debtor's petition to stand.

At least one court has found the *Shapiro* standard unacceptable because it places "undue emphasis on the 'intent to use Chapter 11 to delay the secured creditors in the enforcement of their rights.' "[49] According to the court in *In re Eden Associates*, the preferred method is to probe for good faith on a case by case basis with emphasis on the debtor's intent to abuse the judicial process rather than to delay creditors.[50] In theory, this approach is broader since many debtor manipulations, such as the shielding of unencumbered assets from the jurisdiction of the bankruptcy court, are abuses of the judicial process, but may not cause delay to creditors.

V. FACTORS CONSIDERED

Regardless of which standard is used, the concept of good faith requires that a court's analysis be highly factual. Too many

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23 B.R. 210 (Bankr. E.D.N.Y. 1982); *In re* Nancant, 8 B.R. 1005 (Bankr. D. Mass. 1981).

46. 287 U.S. 348 (1932). *See also In re* Mallard Assocs., 463 F. Supp. 1259, 1260 (S.D.N.Y. 1979); *In re* Northland Constr. Co., 560 F.2d 756, 758 (7th Cir. 1977); *In re* Metropolitan Realty Corp., 433 F.2d 676, 677-78 (5th Cir. 1970).

47. *In re* Northwest Recreation Activities, Inc., 4 B.R. 36, 42 (Bankr. N.D. Ga. 1980). *See also In re* Levinsky, 23 B.R. 210, 218 (Bankr. E.D.N.Y. 1982).

48. *In re* Northwest Recreational Activities, Inc., 4 B.R. 36, 42 (Bankr. N.D. Ga. 1980).

49. *In re* Eden Assocs., 13 B.R. 578, 584 (Bankr. S.D.N.Y. 1981)(quoting *In re* Victory Constr. Co., 9 B.R. 549, 564-65 (Bankr. C.D. Cal. 1981)).

50. *In re* Eden Assocs., 13 B.R. at 578, 584 (Bankr. S.D.N.Y. 1981).

variables are involved in the typical debtor's case to avoid considering factors ranging from the debtor's motive to his prospects of economic success. Although it is possible to isolate several factors that are commonly examined by the bankruptcy courts, these are in no way exclusive. Further, no single factor is usually determinative of the good faith issue.

Last minute changes in form by the debtor, such as the creation of a "new debtor" entity, will trigger close scrutiny by bankruptcy courts. These transformations may indicate an attempt to manufacture a jurisdictional basis or to shield certain assets, but the courts "will not blindly impute bad faith under such circumstances."[51] If the "new debtor" entity has no assets except a single piece of property acquired shortly after its creation, the courts have frequently found it to be a mere shell or front for the true debtor.[52] If the debtor can establish a legitimate business purpose for creating the new entity, however, the courts have concluded that the true debtor acted in good faith.[53] Conversely, the lack of a valid reason for formation of the "new debtor" has been interpreted as an indication of bad faith.[54] Legitimate business motives recognized by the courts include the conservation of debtors' investments,[55] the uncertain state of a debtor's health,[56] a liquidation through sale of assets,[57] and the addition of managerial experience coupled with the potential for greater financial resources.[58] A few courts have found no evidence of bad faith when the true debtor could have filed the Chapter 11 petition himself, even though he created a new entity to do so.[59] These courts have reasoned that formation of the new debtor in such instances was unnecessary for filing and did not hinder the creditors' recourse to their collateral.

Another question asked by the bankruptcy courts is

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51. *In re* Levinsky, 23 B.R. 210, 218 (Bankr. E.D.N.Y. 1982).

52. *See, e.g., In re* Eden Assocs., 13 B.R. 578 (Bankr. S.D.N.Y. 1981); *In re* Lotus Invs., Inc., 16 B.R. 592 (Bankr. S.D. Fla. 1981).

53. *E.g., In re* The Beach Club, 22 B.R. 597 (Bankr. N.D. Cal. 1982).

54. *In re* FJD, Inc., 24 B.R. 138 (Bankr. D. Nev. 1982).

55. *In re* The Beach Club, 22 B.R. 597, 599 (Bankr. N.D. Cal. 1982).

56. *In re* Spenard Ventures, Inc., 18 B.R. 164, 167 (Bankr. D. Alaska 1982).

57. *Id.*

58. *In re* Northwest Recreational Activities, Inc., 4 B.R. 36, 43 (Bankr. N.D. Ga. 1980).

59. *In re* The Beach Club, 22 B.R. 597 (Bankr. N.D. Cal. 1982); *In re* Spenard Ventures, Inc., 18 B.R. 164 (Bankr. D. Alaska 1982).

whether the debtor filed the petition on the eve of foreclosure.[60] Last minute filing is frequently an attempt by the debtor to delay enforcement of the creditors' rights, especially when accompanied by the transfer of assets from an entity ineligible for bankruptcy relief and an absence of a legitimate business purpose for the transfer.[61] Courts have refused to find bad faith despite a late filing date when the petition was "filed with honesty of purpose and with a reasonable hope of success."[62] If the debtor can establish that the late filing was the only available mechanism for preserving his troubled, but viable, business, then the court may overlook the timing of his effort. When foreclosed property is necessary to the debtor's successful reorganization, the impact of filing immediately prior to the sale is lessened. At least one court has emphasized that the "preeminent purpose of Chapter 11 is to give a debtor an extension of time to restructure debts" so a late filing does not violate the spirit of Chapter 11 unless concrete evidence of bad faith is present.[63]

The bankruptcy courts will also consider the presence of unsecured creditors since a major objective of Chapter 11 business reorganization is the protection of such creditors.[64] "If virtually all of the indebtedness runs to secured creditors, and there is no equity in the property which would benefit unsecured creditors, the invocation of Chapter 11 proceedings is an abuse of the Bankruptcy Court's jurisdiction."[65] Yet, the lack of unsecured creditors should not outweigh other competing factors and require a finding of bad faith.

The reasonable probability of submission and confirmation of a plan of reorganization is another element considered by the bankruptcy courts. Most courts will examine both the potential for proposal of a plan and the economic feasibility of the plan once submitted.[66] However, one court has refused to consider

60. *E.g.*, *In re* Dolton Lodge Trust No. 35188, 22 B.R. 918, 923 (Bankr. N.D. Ill. 1982); *In re* Hewitt, 16 B.R. 973, 981 (Bankr. D. Alaska 1982).

61. *In re* Lotus Invs., Inc., 16 B.R. 592, 595 (Bankr. S.D. Fla. 1981). *See supra* note 38 and accompanying text.

62. *In re* Hewitt, 16 B.R. 973, 981 (Bankr. D. Alaska 1982).

63. *In re* Levinsky, 23 B.R. 210, 221 (Bankr. E.D.N.Y. 1982).

64. *E.g.*, *In re* Spenard Ventures, Inc., 18 B.R. 164, 168 (Bankr. D. Alaska 1982); *In re* FJD, Inc., 24 B.R. 138, 141 (Bankr. D. Nev. 1982).

65. *In re* FJD, Inc., 24 B.R. 138, 141 (Bankr. D. Nev. 1982).

66. *E.g.*, *In re* Pappas, 17 B.R. 662, 668 (Bankr. D. Mass. 1982); *In re* Dolton Lodge Trust No. 35188, 22 B.R. 918, 923 (Bankr. N.D. Ill. 1982).

whether reorganization is reasonably possible until after the debtor actually files a plan.[67] This court reasoned that, in all fairness, the debtor must be given an opportunity to establish good faith by filing a plan.[68] The likelihood of submission of a plan is ordinarily an important factor, especially when the sole creditor is fully secured, has refused to consent to the plan, and has opposed the proceeding by moving for a dismissal.[69] Unfavorable economic circumstances may indicate that the entire proceeding is just a stalling device utilized by the debtor to harass his creditors. In addition to the financial aspects of any proposed plan for the debtor's business operation, the courts also consider the degree of protection provided for the creditors.[70] Lack of adequate protection indicates a likelihood that confirmation of an acceptable plan will not occur.

Bankruptcy courts also regularly dismiss cases for lack of good faith when the debtor entity is not an ongoing business.[71] The primary purpose of Chapter 11 as reflected in its legislative history is to provide for the rehabilitation of troubled business.[72] Thus, the reorganization proceeding is unnecessary if there is no viable business to protect. Frequently a debtor entity will file for relief, even though it is not a bona fide business organization, in an attempt to shield other wealthier entities from the court's jurisdiction.[73] If the debtor can convince the court however that

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67. *In re* Weathersfield Farms, Inc., 11 B.R. 148 (Bankr. D. Vt. 1980).

68. *Id.* at 153.

69. *In re* Dutch Flat Inv. Co., 6 B.R. 470, 471 (Bankr. N.D. Cal. 1980).

70. *E.g., In re* Andrews, 17 B.R. 515, 519 (Bankr. C.D. Cal. 1982); *In re* The Beach Club, 22 B.R. 597, 600 (Bankr. N.D. Cal. 1982).

71. *E.g., In re* Mogul, 17 B.R. 680 (Bankr. M.D. Fla. 1982); *In re* Eden Assocs., 13 B.R. 578 (Bankr. S.D.N.Y. 1981).

72. H.R. REP. No. 595, *supra* note 3, at 6179 states:

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business' [sic] finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. Often, the return on assets that a business can produce is inadequate to compensate those who have invested in the business. Cash flow problems may develop, and require creditors of the business, both trade creditors and long-term lenders, to wait for payment of their claims. If the business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.

73. *E.g., In re* FJD, Inc., 24 B.R. 138, 141 (Bankr. D. Nev. 1982); *In re* Eden Assocs.,

the petition was filed to preserve its status as an ongoing concern, thereby protecting its employees and creditors, good faith will usually be found.[74]

Another factor considered by the bankruptcy courts is the debtor's conduct. In *In re Andrews*,[75] the court focused on the debtor's motive for filing his Chapter 11 petition. The debtor was trying to preserve the low interest rate on foreclosed property as a means of financing the acquisition with a minimum of front money. The court concluded that the debtor did not act with "that candor, frankness, sincerity and willingness to do equity which are the indicia of good faith."[76] False material statements to the court,[77] failure to maintain books or records,[78] an asserted ignorance of the contents of financial statements signed by the debtor,[79] unexplained absences from court hearings,[80] and failure to list substantial assets, liens, or unsecured debts in the Chapter 11 schedules[81] have been considered evidence of a debtor's lack of good faith.[82]

VI. CONCLUSION

Good faith has remained an integral part of our bankruptcy law despite its deletion as an express prerequisite for Chapter 11 reorganizations under the Bankruptcy Reform Act of 1978. Although still a viable mechanism available to creditors for dealing with bad faith debtors, what debtor conduct constitutes a lack of good faith is not always certain. Attempts to fraudulently invoke the court's jurisdiction, to shield assets from the bankruptcy court, or to obtain relief on the eve of foreclosure should signal

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13 B.R. 578, 584 (Bankr. S.D.N.Y. 1981).

74. *E.g., In re* Spenard Ventures, Inc., 18 B.R. 164 (Bankr. D. Alaska 1982); *In re* Alton Tel. Printing Co., 14 B.R. 238 (Bankr. S.D. Ill. 1981).

75. 17 B.R. 515 (Bankr. C.D. Cal. 1982).

76. *Id.* at 518.

77. *In re* Verrazzano Towers, Inc., 10 B.R. 387 (Bankr. E.D.N.Y. 1981).

78. *In re* Pappas, 17 B.R. 662, 667 (Bankr. D. Mass. 1982).

79. *Id.*

80. *Id.*

81. *Id.*

82. In *In re* McLaury, 25 B.R. 30 (Bankr. N.D. Tex. 1982), arguments at a hearing cast doubt on the accuracy of the schedules of assets filed by the debtor, but the court assumed that the schedules were substantially correct. *Id.* at 32. This assumption suggests that alleged discrepancies in the debtor's filings must be proved with concrete evidence before they will be considered indicative of bad

to the courts and creditors that bad faith may be present. The very nature of good faith precludes more precise guidelines, but if creditors can demonstrate that the debtor's actions have abused the judicial process or infringed on creditors' rights, then dismissal for lack of good faith is a realistic possibility.

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