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Connecticut District Court Breaks New Ground on the Law on Bad Faith Chapter 11 Filings

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Chapter 11 is frequently invoked on the tail-end of a judicial proceeding in order to protect a valuable asset, forestall an adverse judgment or alleviate substantial litigation costs. While such purposes are tolerated and even recognized as consistent with the rehabilitative goals of Chapter 11, a different situation is presented when a Chapter 11 is filed on the eve of trial for the purpose of transferring the venue of a legal dispute from the non-bankruptcy court to the bankruptcy court, thereby serving purely as a tactical advantage for the Debtor. Such was the case in the recent decision in *City Savings Bank v. McKay (In re Sapphire Development, LLC)*, 2016 WL 389961 (D. Conn. Feb. 1, 2016) (Shea, J.), which set some new ground on the standards to be applied for dismissing a Chapter 11 case as a bad faith filing.

Although bad faith is not listed as one of the statutory grounds for dismissal of a Chapter 11 case, which are set forth in 11 U.S.C. §1112(b), the general " for cause" standard in the statute has been held to encompass the filing of a Chapter 11 case in bad faith. *See C-TC 9th Avenue Partnership v. Norton Company (In re C-TC 9th Avenue Partnership)*, 113 F.3d 1304, 1310 (affirming dismissal of case under Bankruptcy Code §1112(b) for bad faith).

The saga that led to the dismissal of Sapphire Development, LLC's ("Sapphire") Chapter 11 case for bad faith began in 1996 when a $3.96 million judgment for fraud was entered in New York state court against its operating manager, Stuart Longman, in favor of Robert McKay. McKay promptly filed certificates of foreign judgment against Longman in Connecticut Superior Court.

Sapphire, formed in 2000, owned a 25-acre property in Ridgefield, Connecticut (the "Property"), where Longman and his wife, Gayla, resided for over 30 years. The Property was originally purchased by Longman in 1985, but title to it was periodically transferred over the years to his wife and several entities controlled by him, until it finally ended up with Sapphire, which itself is owned by the Gayla Longman Family Irrevocable Trust (the "Trust").

The trouble began when McKay instituted an action in Connecticut Superior Court in 2010 seeking three forms of relief: the imposition of a constructive trust on the Property, a finding that it had been fraudulently transferred by Longman to Sapphire, and a piercing of Sapphire's corporate veil. After three years of discovery, and on the day before the trial was to begin, Sapphire filed its Chapter 11 case. The creditor body consisted of three secured creditors with mortgages against the Property, the Town of Ridgefield as the

holder of a tax lien for unpaid real estate taxes and $27,000 in unsecured claims, on which Longman was co-liable with Sapphire.

The ostensible purpose of the Chapter 11 was to subdivide the Property and sell part of it to pay creditor claims, with Longman to retain a portion of the Property as his residence and pay rent to Sapphire. At the time of the filing, however, Sapphire was generating no income and had not employed anyone for almost a decade, and none of the secured creditors was threatening to foreclose, apparently because they were being paid through funds that were periodically transferred to Sapphire from the Trust or other entities controlled by Longman.

McKay promptly filed a motion to dismiss the Chapter 11 case for having been filed in bad faith and a motion for abstention under 11 U.S.C. §305(a)(1), which requires dismissal if it is in "the interests of creditors and the debtor." Before the motions were decided, Sapphire filed an adversary proceeding with the Bankruptcy Court seeking a determination that McKay did not hold any claim against Sapphire and could not otherwise recover anything from the Property. This action essentially sought to eradicate the claims McKay was making in Connecticut state court.

The Bankruptcy Court took up the abstention motion first and, after a three-day evidentiary hearing, granted it based upon what it found was an impermissible purpose for the Chapter 11 filing, *viz.*, to lock McKay out of the Bankruptcy Court and the Connecticut Superior Court "in an effort to avoid paying a judgment Longman owes to McKay for Longman's affirmative fraud." The District Court reversed and remanded, however, because Sapphire and at least one secured mortgage holder had an interest in maintaining the bankruptcy, whereas Bankruptcy Code §305(a)(1) requires that dismissal be in the interests of *all* creditors and the debtor*. In re Sapphire Development, LLC*, 523 B.R. 1, 8, 10 (D. Conn. 2014).

On remand, the Bankruptcy Court took up McKay's motion to dismiss and, after further evidentiary hearings, dismissed the case for bad faith after considering a list of factors set forth by the Second Circuit for determining whether a Chapter 11 case has been filed in bad faith. *See C-TC 9th Avenue Partnership v. Norton Company (In re C-TC 9th Avenue Partnership)*, 113 F.3d 1304, 1311 (2d Cir. 1997). Sapphire appealed.

Under these circumstances, with some color added by the credibility determinations of the Bankruptcy Court, the District Court ruled that Sapphire commenced its Chapter 11 case with subjective bad faith and, in a break from precedent established by other bankruptcy courts in the Circuit, held that either "subjective bad faith or objective futility" in the filing could support dismissal, whereas most courts in the Circuit have held that both of those elements of bad faith must be present in order to dismiss a Chapter 11 case. *See e.g. Davis v. M&M Developer (In re MBM Entertainment)*, 531 B.R. 363, 408 (Bankr. S.D.N.Y. 2015); *In re 300 Washington Street, LLC*, 528 B.R. 534, 551 (Bankr. E.D.N.Y. 2015): *In re General Growth Properties, Inc.*, 409 B.R. 43, 56 (Bankr. S.D.N.Y. 2009).

Connecticut District Court Breaks New Ground on the Law on Bad Faith Chapter 11 Filings

The District Court perceptively noted that the seminal case relied on by most courts for this dual requirement, *In re Cohoes Indus. Terminal, Inc.,* 931 F.2d 222 (2d Cir. 1991), was actually decided under the standards for imposing sanctions under Fed. R. Bankr. P. 9011, and that the passage in the *CT-C Ninth Avenue Partnership* decision that courts have also heavily relied on could fairly be viewed as requiring either subjective bad faith or objective futility, not both.

Citing the equitable purposes of bankruptcy "to facilitate rehabilitation or reorganization" and "to protect creditors and avoid a disorderly dismemberment of the debtors estate," the District Court ruled that Sapphire's reasons for filing Chapter 11 were inconsistent with those purposes, essentially because "the sole motivation for the filing was to stop McKay's State Court Action in its tracks" and not to reorganize or protect its assets from creditor dismemberment.

Carrying the day in that regard was the fact that Sapphire had no employees or business operations, had few unsecured creditors with only $27,000 in claims, other than McKay's claim, and was not experiencing any pressure from the secured mortgage holders on the Property. Under these circumstances, the conclusion was undeniable that the only purpose of Sapphire's filing was to prevent McKay from litigating his claims in state court while disposing of them in the bankruptcy proceeding, all with the ultimate goal of protecting Sapphire's sole asset from McKay.

Although the District Court recognized that many legitimate bankruptcies are filed as creditors are accelerating their collection efforts, it drew the line of legitimacy at the point where the Debtor or one or more of its creditors must actually need the protection of the bankruptcy laws. It found that no such need was present in Sapphire's case.

To perhaps cover the tracks in the event of an appeal, the District Court further ruled that the case was objectively futile as well, because Sapphire did not present evidence that a subdivision of the Property was underway or that a subdivision would actually enhance the Property's value.

Given the facts that were found by the Bankruptcy Court and adopted on appeal by the District Court, the result in *Sapphire* is not surprising. What is perhaps most notable is the District Court's explicit break from a long line of precedent from other courts in the Circuit that both subjective bad faith and objective futility must be found before a Chapter 11 case may be dismissed.

While the issue of whether a district court's decision is binding on a bankruptcy court in the same district remains unsettled, *compare Daly v. Deptula (In re Carrozeella & Richardson)*, 255 B.R. 267, 272 (Bankr. D. Conn. 2000) (decision of one district court judge is not binding on another district judge, even within the same district) with *In re Bruno*, 356 B.R. 89, 91 (Bankr. W.D.N.Y. 2006) (bankruptcy judge bound by district court decision in multi-judge district until another district judge rules the other way), the District Court's decision in *Sapphire* is strong medicine to use when a Chapter 11 is filed for the purpose of usurping litigation that is

Connecticut District Court Breaks New Ground on the Law on Bad Faith Chapter 11 Filings

substantially underway in another court.

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