Bankruptcy Alert

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The NRA's Chapter 11 Filing Takes Aim at the State of New York: Is it off Target?

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by Irve J. Goldman

The National Rifle Association (commonly known as the NRA), a New York not-for-profit corporation with its principal place of business in Virginia, has tested the limits of how accommodating Chapter 11 can be to a solvent company that faces a dissolution action in its state of incorporation and seeks to relocate its corporate domicile to a more hospitable state.

Despite having no corporate presence in Texas, the NRA filed its Chapter 11 petition in the U.S. Bankruptcy Court for the Northern District of Texas shortly after forming a wholly-owned subsidiary, Sea Girt, LLC, as a Texas limited liability company and first filing a Chapter 11 petition for Sea Girt in the Texas Bankruptcy Court. The NRA engaged in this Texas two-step in order to establish "affiliate venue" for itself in this preferred district, and has reported in its Chapter 11 filing that it has total assets of $203 million and aggregate liabilities of approximately $153 million, making it highly solvent. So, what's the deal?

Since August 2020, the NRA has been embroiled in litigation with the State of New York, which is seeking to dissolve the NRA's corporate existence based on what it alleges is the looting and waste of corporate assets, fraud and breaches of fiduciary duty by its CEO, Wayne LaPierre, and those under his control. There are companion claims to recover from the individuals who are alleged to be responsible for the corporate wrongdoing. The NRA's motion to dismiss the action was denied by the New York Supreme Court on January 21, 2021.

The NRA's Chapter 11 filing in Texas raises a number of vexing problems. First, is Texas a proper venue for the case? Second, would the New York dissolution action be automatically stayed by the filing? And third, is the NRA's Chapter 11 case subject to dismissal as a "bad faith" filing?

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VENUE IN TEXAS IS NOT GUARANTEED

The proper venue for a corporate Chapter 11 case such as the NRA's can be the corporation's domicile, which is considered its state of incorporation, *In re Dunmore Homes, Inc*¸ 380 B.R. 663, 670 (Bankr. S.D.N.Y. 2008), or the state(s) in which its principal place of business or principal assets are located. 28 U.S.C. §1408(1). For the NRA, that would mean New York or Virginia. But under 28 U.S.C. §1408(2), a corporation can also file for Chapter 11 in a district in which venue would be proper for the Chapter 11 filing of a corporate affiliate, such as a wholly-owned subsidiary. Because Sea Girt is a Texas LLC, its Chapter 11 filing is proper in the Northern District of Texas, and because Sea Girt is the NRA's "affiliate," the NRA can file there too. But not so fast.

Although the formation of a subsidiary in a particular state for the purpose of creating bankruptcy venue is not prohibited, it can result in a transfer of venue of the case to a district which is considered more appropriate for the Chapter 11 case. A case in point is *In re Patriot Coal Corp.*, 482 B.R. 718 (Bankr. S.D.N.Y. 2012), where the principal debtor, Patriot Coal Corp., formed two subsidiaries in New York for the admitted purpose of creating venue, and after the two subsidiaries filed for Chapter 11 in New York, Patriot Coal filed Chapter 11 for itself and over 90 of its related companies in New York as affiliates. *Id.* at 728. The Bankruptcy Court found that while venue in New York was proper based on the venue statute, it transferred venue of all the Chapter 11 cases under 28 U.S.C. §1412 – which allows transfer "in the interest of justice or for the convenience of the parties" – to the Bankruptcy Court in St. Louis, Missouri, because the debtors' corporate headquarters and executive offices were there and many of the key corporate functions, as well as books and records, were there as well. *Id.* at 754. Based on *Patriot Coal*, the NRA could find itself back in New York for the administration of its Chapter 11 case.

THE AUTOMATIC STAY MAY NOT APPLY TO THE DISSOLUTION ACTION

Regardless of where the NRA's case gets administered, the New York dissolution action will likely not be "centralized" in the Bankruptcy Court with other creditor actions, but will proceed unabated by the automatic stay that is normally imposed upon a Chapter 11 filing. That is because of what is known as the "police power" exception to the automatic stay, which provides that actions to enforce the government's police or regulatory power are not subject to the automatic stay. 11 U.S.C. §362(b)(4). Bankruptcy case authority holds that actions like the New York dissolution action are not subject to the automatic stay based on this exception. *See e.g. In re Universal Life Church, Inc.*, 128 F.2d 1294, 1298 (9th Cir. 1997) (IRS's revocation of debtor's tax-exempt status was within the police power exception to the automatic stay); *In the Matter of Jesus Loves You, Inc.*¸ 40 B.R. 42 (Bankr. M.D. Fla. 1984) (State of Florida's action to revoke debtor's corporate charter was not automatically stayed based on police power exception). *But see Hillis Motors, Inc. v. Hawaii Automobile Dealers' Association*, 997 F.2d 581 (9th Cir. 1993) (state's dissolution of debtor corporation for failing to file annual reports and pay filing fees violated automatic stay and was not covered by police powers exception).

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THE NRA'S BANKRUPTCY MAY BE A BAD FAITH FILING

Courts are generally in agreement that a Chapter 11 case may be dismissed if it has not been filed in good faith. *See e.g In re 15375 Memorial Corp.*, 589 F.3d 605, 618 (3d Cir. 2009); *In re C-TC 9th Avenue Partnership,* 113 F.3d 1304, 1310 (2d Cir. 1997); *Matter of Little Creek Development Co.*¸ 779 F.2d 1068, 1072 (5th Cir. 1986). The filing of a Chapter 11 petition in order to obtain a tactical litigation advantage or when the debtor is not in financial difficulty has been held to be in bad faith. *See In re SGL Carbon*, 200 F.3d 154, 166-67 (3d Cir. 1999) (filing of chapter 11 case by financially healthy company to gain leverage against civil antirust judgment creditors and claimants was held to be in bad faith because of "[t]he absence of a valid reorganization purpose"); *Investors Group, LLC v. Pottorff*¸ 518 B.R. 380, 384-85 (N.D. Tex. 2014) (Chapter 11 filing to avoid impending state court trial in a $5 million derivative suit, when the debtor was solvent on a balance sheet basis, was filed in bad faith). *See generally In re Rent-A-Wreck of America, Inc.*, 580 B.R. 364, 375 (Bankr. D. Del. 2018) (ability to use the Bankruptcy Code "assumes the existence of a valid bankruptcy, which, in turn, assumes a debtor in financial distress").

The NRA itself has stated that the purpose of its Chapter 11 proceeding is to allow it to reincorporate in Texas because it believes it is being unfairly persecuted by the State of New York. Whether that is in fact the case, however, can of course be decided in the pending litigation in New York. In effect, therefore, the NRA is seeking the imprimatur of a Bankruptcy Court to escape the consequences that led to the New York dissolution litigation and give it the stamp of approval to simply start anew in Texas. In other words, its case is a litigation tactic that is not in accord with a valid reorganization purpose, especially when you consider that the NRA is solvent.

It also bears mention that if the NRA was dissolved as a result of the litigation in New York, it might not even be eligible to file for Chapter 11 relief. In *In re Cedar Tide Corp.*, 859 F.2d 1127 (2d Cir. 1988), the Second Circuit Court of Appeals held that a for-profit New York corporation that was dissolved for nonpayment of franchise fees was eligible to file for Chapter 11 relief because New York law allowed it to be reinstated *nunc pro tunc* upon the filing of a certificate indicating that all taxes, interest and fees had been paid. *Id.* at 1132. If not for the ability to reinstate itself, the corporation was obligated to wind up its affairs and most likely would have been found to be ineligible to file for Chapter 11 relief or, if permitted to file, would have its activities limited to winding up or liquidating. *See e.g. In re Superior Boat Works, Inc.*¸ 438 B.R. 878 (Bankr. N.D. Miss. 2010) (dissolved Wyoming corporation could file Chapter 11 for purposes of liquidating).

If the NRA was dissolved for the reasons stated in the New York Attorney General's complaint, it would not seem logical or permissible for the NRA to be able to reinstate itself, as the debtor in *Cedar Tide* was able to do by simply paying its past due taxes. Although the NRA is not currently dissolved, its Chapter 11 case seems to account for that possibility, or seeks to simply end-run a dissolution, by putting forth a plan for its incorporation anew in Texas. If a New York dissolution would render the NRA ineligible to be a Chapter 11

debtor, or would limit its activities to liquidating in Chapter 11, it would hardly seem permissible for the NRA to make itself eligible for Chapter 11 relief and continue operating by the simple expedient of becoming a Texas non-profit corporation after it has been dissolved in New York.

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