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Feature

By Jeffrey Chubak

Orchestrated Involuntary Case Not Dismissed on Bad-Faith Grounds

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In *In re Houston Regional Sports Network LP*,[1] Hon. Marvin Isgur of the U.S. Bankruptcy Court for the Southern District of Texas held that an involuntary case commenced to circumvent a contractual clause requiring unanimous director consent to commence a voluntary case (the "unanimous-consent clause") was not subject to dismissal on bad-faith grounds pursuant to § 1112(b) of the Bankruptcy Code. This holding is significant because, despite the existence of thousands of agreements with unanimous-consent clauses, the two previously reported decisions directly addressing this issue reached opposite conclusions. While it remains to be seen how other courts will rule on this issue, *Houston Regional* may encourage efforts by a debtor's principals to circumvent unanimous-consent clauses by convincing creditors to commence an involuntary case.

Standard for Dismissal

Section 1112(b)(1) provides, subject to certain limitations, that "the court shall … dismiss a case under this chapter … if the movant establishes cause." Section 1112(b)(4), in turn, lists various events that would satisfy "cause." The exact standard for determining whether cause for dismissal exists on the grounds that a case was commenced in bad faith varies somewhat by district. In general, however, cause for a bad-faith dismissal may be established by demonstrating that a reorganization would be "objectively futile" and that the case was commenced in "subjective bad faith" (*i.e.*, as a litigation tactic and not with intent to effect a reorganization).[2]

Kingston Square Associates

In *In re Kingston Square Associates*,[3] the court held that an involuntary case that was commenced to circumvent a unanimous-consent clause is not subject to dismissal on bad-faith grounds where the debtor has a reasonable possibility of reorganizing. In *Kingston Square*, 11 corporations and limited partnerships that owned various apartment complexes issued mortgage-backed securities (MBS), substantially all of which were beneficially owned by Donaldson, Lufkin & Jenrette Securities Corp. and its affiliates (DLJ).[4] To render the borrowers "bankruptcy remote," the corporations' charters and general partners' bylaws were amended to include a unanimous-consent clause, and an independent director selected by DLJ was added to the board of directors of each such corporation and partnership within the general partner to ensure that the unanimous consent that was required to commence a voluntary case would not be obtained without the independent director's vote.[5]

Foreclosure proceedings were subsequently commenced that, if consummated, would have transferred ownership of the borrowers' apartment complexes to DLJ, leaving nothing for unsecured creditors.[6] Believing there to be equity in the apartment complexes and that the independent director was a DLJ pawn who would never approve the commencement of a voluntary case, the borrowers' other directors launched a campaign to find other creditors that would file involuntary petitions against the borrowers.[7]

Following the commencement of the involuntary cases, DLJ and the MBS trustee moved to dis-

1 No. 13-35998, 2014 WL 554824 (Bankr. S.D. Tex. Feb. 12, 2014).
2 *See, e.g., In re Premier Automotive Servs. Inc.*, 492 F.3d 274 (4th Cir. 2007) (citations omitted); *In re Integrated Telecom Express Inc.*, 384 F.3d 108, 119-20 (3d Cir. 2004) (citing *In re SGL Carbon Corp.*, 200 F.3d 154, 165 (1999)) ("Our cases have focused on two inquiries … (1) whether the petition serves a valid bankruptcy purpose … and (2) whether the petition is filed merely to obtain a tactical litigation advantage.").
3 214 B.R. 713 (Bankr. S.D.N.Y. 1997).
4 *Id.* at 715-16.
5 *Id.* at 716-17.
6 *Id.* at 717.
7 *Id.* at 720.

miss the cases on bad-faith grounds, arguing that the filings were orchestrated to circumvent the unanimous-consent clauses.[8] The court noted that the cases were subject to dismissal only "if both objective futility of the reorganization process and subjective bad faith in filing the petition[s] are found."[9] With regard to the former prong, the court held that the borrowers "had a reasonable belief that they could reorganize," and no record was established concerning "the objective futility of reorganization."[10] With regard to the latter prong, the court held that the orchestration of an involuntary filing by itself is "suggestive of bad faith," but that the movants failed to establish that the cases were commenced in furtherance of "a fraudulent deceitful purpose, [such as] avoid[ing] a court order or statutory bar," since the potential for reorganization existed.[11] As a result, the court denied the motion to dismiss.

Global Ship Systems

In *In re Global Ship Systems LLC*, the court held that an involuntary case that was commenced to circumvent a unanimous-consent clause is subject to dismissal on bad-faith grounds, even if the debtor has a reasonable possibility of reorganizing.[12] In this case, to finance its acquisition of a shipyard, Global Ship Systems LLC borrowed approximately $13 million from Drawbridge Special Opportunities Fund LP and granted Drawbridge a 20 percent "class B" equity interest.[13] The borrower's operating agreement provided, among other things, that the class B holder's consent was required for the borrower to commence a voluntary case.[14] The borrower subsequently defaulted on the loan, whereupon Drawbridge commenced foreclosure proceedings.[15] Thereafter, at the class A holder's urging, several creditors commenced an involuntary case against the borrower.[16] As of the date that the involuntary case was commenced, the debt that was owed to Drawbridge had ballooned to approximately $38 million, and the shipyard was estimated to be worth approximately $16 million.[17]

Drawbridge subsequently moved to dismiss the case on bad-faith grounds.[18] The court held that "[i]n circumventing the rights of Drawbridge as shareholder to consent to a bankruptcy filing through the ruse of soliciting an involuntary case and failing to contest the involuntary petition once it was filed, Global engaged in bad faith toward Drawbridge."[19]

The court distinguished *Kingston Square*, by noting that Drawbridge's debt "[f]ar exceed[ed] the value of its collateral and there is simply no basis to believe [that] the unsecured and equity interest holders will be any worse off after a foreclosure than they were before."[20] Notably, the court further held that it was bound by Eleventh Circuit precedent to reject *Kingston Square*'s holding:

> In this Circuit, the fact that there may be prospects for reorganization does not negate a finding of bad faith as a matter of law. *Phoenix Piccadilly*, 849 F.2d at 1395 ("[A] possible equity in the property or potential successful reorganization … cannot transform a bad-faith filing into one undertaken in good faith").… Thus … even if I conclude that a feasible reorganization is in prospect, it would not demand a different conclusion.[21]

Houston Regional Sports Network

In *Houston Regional*, Judge Isgur went one step further than *Kingston Square* court and held that an involuntary case commenced to circumvent a unanimous-consent clause is not subject to dismissal on bad-faith grounds where the debtor has a reasonable possibility of reorganizing, even in situations when the case was commenced by affiliates of the party bound by the unanimous-consent clause.[22] In this case, the debtor was a television network with three limited partners: the Houston Astros, the Houston Rockets and Comcast.[23] The operating agreement of the network's general partner provided that it could not cause the network to commence a voluntary case absent the unanimous consent of the general partner's directors — one of which was selected by the Astros, one of which was selected by the Rockets, and two of which were selected by Comcast.[24] Following payment defaults under a media rights agreement between the network and the Astros, the Astros threatened to terminate the agreement unless the defaults were promptly cured.[25] Thereafter, the four Comcast affiliates commenced an involuntary case against the network, and the two Rockets affiliates and the network's landlord subsequently filed joinders to the involuntary petition.[26]

The Astros moved to dismiss the case on bad-faith grounds, arguing that (1) Comcast's filing of an involuntary petition was done in subjective bad faith to circumvent the unanimous-consent clause in the general partner's operating agreement, and (2) a reorganization of the network would be objectively futile, principally because (a) under the network's partnership agreement, the consent of the Astros-appointed director was required for the network to propose a reorganization plan; (b) the agreement permited the director to vote in the Astros' best interests without regard to his fiduciary duties; and (c) the Astros would instruct such a director to veto any contemplated reorganization plan.[27]

In rejecting the Astros' subjective bad-faith argument, Judge Isgur held that Comcast's "end run" around the unanimous-consent clause did not mean that it acted in bad faith; rather, such action may have subjected it to contract damages, but that was "a far cry from bad faith."[28] Judge Isgur further found that Comcast's involuntary petition had been filed to preserve value and rehabilitate the network, and was therefore consistent with *Kingston Square*'s

8 *Id.* at 723.
9 *Id.* at 734 (citing *In re RCM Global Long Term Capital Appreciation Fund Ltd.*, 200 B.R. 514, 520 (Bankr. S.D.N.Y. 1996)).
10 *Id.* at 734-35.
11 *Id.* at 734.
12 391 B.R. 193 (Bankr. S.D. Ga. 2007).
13 *Id.*
14 *Id.* at 199.
15 *Id.* at 197.
16 *Id.* at 199.
17 *Id.* at 200.
18 *Id.* at 201.
19 *Id.* at 204.
20 *Id.* (citing *Kingston Square*, 214 B.R. at 733-35).
21 *Id.* (quoting *In re Phoenix Piccadilly Ltd.*, 849 F.2d 1393, 1395 (11th Cir. 1988)).
22 2014 WL 554824, at *8-10.
23 *Id.* at *1.
24 *Id.* at *1, 8. Specifically, the operating agreement required unanimous approval for "[a]ny liquidation, dissolution, winding up or voluntary filing of a petition for bankruptcy or receivership," which was interpreted as only barring a voluntary petition. *Id.* at *8.
25 *Id.* at *2.
26 *Id.*
27 *Id.* at *7-9.
28 *Id.* at *9.

holding.[29] In addition, Judge Isgur held that *Global Ship* was inapposite, since in that case, "the petitioning creditors did not intend to promote a legitimate reorganization."[30] Judge Isgur rejected the Astros' argument that reorganizing would be objectively futile, stating that once an order for relief is entered, the general partner is legally required to fulfill its fiduciary obligations, and that the rejection of a viable reorganization plan would result in the Astros' director breaching his fiduciary obligations.[31]

Conclusion

Houston Regional's holding that Comcast's involuntary petition was not filed in bad faith was technically *dicta*, given that the Rockets' affiliates and the network's landlord qualified as petitioning creditors. Nevertheless, the decision is notable for several reasons (aside from the fact that there are few reported decisions addressing whether an involuntary case commenced to circumvent a unanimous-consent clause should be dismissed on bad-faith grounds).

First, *Houston Regional* went further than *Kingston Square* in permitting *affiliated* petitioning creditors to commence an involuntary case to circumvent a unanimous-consent clause. Second, these decisions suggest that in the context of orchestrated involuntary cases, satisfaction of the "subjective bad-faith" prong largely hinges upon satisfaction of the "objective futility" prong: *Kingston Square* held that the orchestration of an involuntary case was "suggestive of bad faith," but declined to dismiss based on the determination that a reorganization was possible; *Houston Regional* held that subjective bad faith does not exist where the potential for reorganization exists, even if orchestration of the involuntary case would result in contract damages.[32] Third, *Houston Regional* confirms that efforts to render an entity "bankruptcy remote" will not necessarily ensure that it is "bankruptcy proof."[33]

While it remains to be seen how other courts will address this issue, when the potential for reorganization exists, *Houston Regional* may embolden parties faced with the challenge of working around a unanimous-consent clause to encourage creditors to commence an involuntary case. abi

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29 *Id.* (citing *Kingston Square*, 214 B.R. at 713) ("[W]hen the petitioning creditors act with the intention of preserving the Estate, the sole fact that a voluntary filing was precluded by state law organizational documents will not make the involuntary petition one filed in bad faith.").

30 *Id.*

31 *Id.* at *11-13 ("With the entry of the order for relief, management became duty-bound to meet fiduciary responsibilities. As fiduciaries, the Court expects that the four directors [of the general partner] will act in the best interest of the network. Although the Astros threaten to have their appointed director veto any arrangement … implementation of such a wholesale threat would be a breach of the Astros-appointed-director's fiduciary duty.… To be sure, the Astros need not ... appoint [an] individual to serve on the board of the General Partner. The Astros may leave a seat vacant, may appoint a third party who will serve as a fiduciary, or may determine an alternative course of action. But, individuals who choose to serve … must honor fiduciary responsibilities.").

32 *See Kingston Square*, 214 B.R. at 734; *id.* at 739 ("[T]he orchestration is not sufficient to warrant the dismissal of the cases without evidence that the Debtors have no chance at rehabilitation."); *Houston Regional*, 2014 WL 55824, at *9.

33 *See generally In re General Growth Properties Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009).