Viii. Bankruptcy Law

BANKRUPTCY LAW

Section 541(c)(2) of the Bankruptcy Act of 1978, 11 U.S.C. section 541(c)(2) (1990) (section 541(c)(2)), enforces applicable nonbankruptcy law that restricts the transfer of a debtor's beneficial interest in a trust. Section 1056(d)(1) of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. section 1056(d)(1) (1990) (section 1056(d)(1)), prohibits a participant in an ERISA qualified pension plan from assigning or alienating the benefits provided under the plan. Until recently, courts have unanimously held that section 1056(d)(1) is not applicable nonbankruptcy law under section 501(c)(2) and, thus, does not prohibit the transfer of a debtor's beneficial interest in an ERISA qualified trust to a bankruptcy trustee.[168]

In *In re Moore*, 907 F.2d 1476 (4th Cir. 1990), the United States Court of Appeals for the Fourth Circuit considered whether the bankruptcy estates of several debtors included the debtors' interests in an ERISA qualified profit sharing and pension plan. The Chapter 7 debtors, employees of Springs Industries, Inc., participated in Springs Industries' retirement plans. The retirement plans contained restrictions that prohibited the alienation of the employees' interests in the plans, and provided for distribution of plan proceeds to a beneficiary only upon retirement, disability, or termination of service. The retirement plans' restriction on assignment is necessary to qualify the plans as ERISA funds and, thus, maintain the retirement plans' tax exempt status under section 501 of the Internal Revenue Code, 26 U.S.C. section 501 (1990).

The trustee for the bankruptcy estates of the debtors in *Moore* sued the administrator of the Springs Industries' plans seeking a turnover of the debtors' interests in the retirement plans. The trustee contended that, because the retirement plans were not spendthrift trusts under South Carolina law, the plans were not subject to a spendthrift trust's enforceable restriction of transfer. The bankruptcy court, however, never addressed the status of the retirement plans under South Carolina law. Instead, the bankruptcy court held that the retirement plans qualified under ERISA, and the ERISA restriction on transfers effectively excluded the debtors' interests in the retirement plans from the debtors' bankruptcy estate. The district court affirmed the decision of the bankruptcy court, and the trustee appealed the affirmation arguing that the term "applicable nonbankruptcy law" in section 541(c)(2) does not include ERISA.

To resolve the issue, the Fourth Circuit analyzed the meaning of the term "applicable nonbankruptcy law" in section 541(c)(2). First, using a

168. *See In re* Daniel, 771 F.2d 1352 (9th Cir. 1985) (stating that § 1056(d)(1) does not constitute "applicable nonbankruptcy law" under § 541(c)(2)); *In re* Lichstrahl, 750 F.2d 1488 (11th Cir. 1985) (same); *In re* Graham, 726 F.2d 1268 (8th Cir. 1984) (same); *In re* Goff, 706 F.2d 574 (5th Cir. 1983) (same). *But see In re* Lucas, 1991 U.S. App. LEXIS 470 (6th Cir. 1991) (stating that plain reading of "applicable nonbankruptcy law" under § 541(c)(2) encompasses § 1056(d)(1)); *In re* Kincaid, 917 F.2d 1162 (9th Cir. 1990) (Fletcher, J., concurring) (same).

plain meaning approach, the Fourth Circuit held that the term encompasses all laws, both state and federal, that provide restrictions on transfers. Furthermore, the Fourth Circuit found no indication in the remainder of section 541(c)(2) suggesting that the term "applicable nonbankruptcy law" refers exclusively to state law or state spendthrift trust law.

Proceeding from this plain language analysis, the Fourth Circuit referred to the occurrences of the term "applicable nonbankruptcy law" in the Bankruptcy Code and to other courts' interpretations of this term. First, the Fourth Circuit cited two bankruptcy decisions that interpreted "applicable nonbankruptcy law" to include pertinent federal law. The Bankruptcy Court for the District of Colorado in *In re Stanley Hotel*, 13 Bankr. 926 (Bankr. D. Colo. 1981), held that the term "applicable nonbankruptcy law," as used in section 1125(d) of the Bankruptcy Code, includes federal securities law. In *In re Ahead By a Length*, 100 Bankr. 157 (Bankr. S.D.N.Y. 1989), the Bankruptcy Court for the Southern District of New York held that the term "applicable nonbankruptcy law," as used in section 108(a) of the Bankruptcy Code, includes the Racketeer Influenced and Corrupt Organizations Act.

The Fourth Circuit then cited *Morrison-Knudsen v. Director, OWCP*, 461 U.S. 624, 633 (1983), in which the Supreme Court held that courts are to presume that a word has the same meaning in all subsections of the same statute. On this basis, the Fourth Circuit held that the term "applicable nonbankruptcy law" in section 541(c)(2) encompasses ERISA. The Fourth Circuit acknowledged that the refusal to narrow the term "applicable nonbankruptcy law" to state law coincided with the Fourth Circuit's decision in *McLean v. Central States, Southeast & Southwest Areas Pension Fund*, 762 F.2d 1204 (4th Cir. 1985). Although in *McLean* the Fourth Circuit did not specifically consider whether ERISA constituted "applicable nonbankruptcy law," the Fourth Circuit held that a court should not confine the recognition of enforceable transfer restrictions under section 541(c)(2) to traditional spendthrift trust transfer restrictions.

Having expressed the rationale for their decision, the Fourth Circuit collectively addressed the cases that interpreted "applicable nonbankruptcy law" narrowly. In *In re Goff*, 706 F.2d 574 (5th Cir. 1983), the United States Court of Appeals for the Fifth Circuit held that section 1056(d)(1) does not constitute "applicable nonbankruptcy law" under section 541(c)(2). The *Goff* court based this holding on an extensive review and analysis of section 541(c)(2)'s legislative history. From this review, the *Goff* court concluded that Congress specifically intended "applicable nonbankruptcy law" to exempt from the bankruptcy estate only spendthrift trusts that pertinent state law placed beyond the reach of creditors. In *In re Graham*, 726 F.2d 1268 (8th Cir. 1984), the United States Court of Appeals for the Eighth Circuit also analyzed section 541(c)(2)'s legislative history and reached the same conclusion as the *Goff* court. The United States Court of Appeals for the Ninth Circuit in *In re Daniel*, 771 F.2d 1352 (9th Cir. 1985), and the United States Court of Appeals for the Eleventh Circuit, in *In re Lichstrahl*, 750 F.2d 1488 (11th Cir. 1985), adopted the holdings in *Goff* and *Graham* and held that section 1056(d)(1) does not constitute "applicable nonbankruptcy law" under section 541(c)(2).

Initially, the Fourth Circuit stated that these decisions involved revocable self settled trusts in which the settlor retained the power to amend or terminate the trust without penalty. In comparison, the ERISA plans at issue in *Moore* provided the beneficiaries with no power to control the plan, make withdrawals from the plan, borrow against the plan, or amend the plan. The Fourth Circuit noted that the courts which opted for a narrow interpretation of "applicable nonbankruptcy law" relied on the legislative history of section 541(c)(2). The Fourth Circuit respectfully declined to follow this course, expressing the view that an appeal to legislative history is inappropriate and irrelevant when the statutory language is clear. Furthermore, the Fourth Circuit's review of the legislative history of section 541(c)(2) revealed only that Congress specifically included state spendthrift trust law within the meaning of "applicable nonbankruptcy law." The Fourth Circuit discovered no indication that Congress intended to restrict the meaning of "applicable nonbankruptcy law" exclusively to state spendthrift trust law.

The Fourth Circuit summarized its decision by stating that including ERISA within the definition of "applicable nonbankruptcy law" gives full effect to both section 541(c)(2) and section 1056(d)(1). This interpretation complies with the Supreme Court mandate in *Morton v. Mancari*, 417 U.S. 535, 551 (1974), that when courts must coordinate the reading of two federal statutes, the courts must give full effect to both statutes. Section 541(c)(2) expressly defers to "applicable nonbankruptcy law" that restricts the transfer of a debtor's beneficial interest in a trust. Section 1056(d)(1) specifically prohibits the transfer of a beneficiary's interest in an ERISA qualified pension plan. This transfer restriction gives effect to the overriding purpose of ERISA to guarantee the security of employees' retirement income.

As additional support, the Fourth Circuit stated that enforcing the ERISA restriction as "applicable nonbankruptcy law" prevents preferring the interests of a bankruptcy trustee over the interests of other relevant parties. Neither plan participants nor general creditors may reach the benefits provided under an ERISA qualified pension plan, and the Fourth Circuit could find no reason to permit interested parties to circumvent this restriction by forcing individuals into involuntary bankruptcy to reach the individuals' interests in ERISA funds. Including ERISA within the meaning of "applicable nonbankruptcy law" provides uniform treatment of ERISA benefit interests throughout the country rather than subjecting these interests to variations in state spendthrift trust law. Furthermore, if courts permit bankruptcy trustees to claim ERISA benefits as part of a debtor's estate, this transfer may subject the entire ERISA pension plan to disqualification under section 1056(d)(1) and under section 401(a)(13) of the Internal Revenue Code, 26 U.S.C. section 401(a)(13) (1990), which conditions the tax exempt status of an ERISA pension fund on the presence of an enforceable transfer restriction. In *McLean v. Central States, Southeast & Southwest Areas Pension Fund*, 762 F.2d 1204 (4th Cir. 1985), the Fourth Circuit recognized that section 401(a)(13) of the Internal Revenue Code requires an anti-assignment clause to maintain the tax exempt status of a qualified pension fund.

Contrary to the Fourth Circuit decision in *Moore*, the majority of circuits that have considered the interaction between section 541(c)(2) and section 1056(d)(1) have held that section 1056(d)(1) does not constitute "applicable nonbankruptcy law" under section 541(c)(2).[169] However, a growing minority of circuit courts that have recently considered the question are in accord with the Fourth Circuit.[170] Like the Fourth Circuit, these circuit courts have realized that the plain meaning of "applicable nonbankruptcy law" encompasses all federal and state laws. Therefore, under this plain meaning, section 541(c)(2) must include section 1056(d)(1) and, thus, prohibit a bankruptcy trustee from reaching a debtor's interest in a qualified ERISA pension plan. Only by adopting this approach can courts give full effect to both statutes and provide uniform treatment to federally sanctioned ERISA pension plans.

* * *

Section 507(a)(7)(E) of the Bankruptcy Act of 1978, 11 U.S.C. section 507(a)(7)(E) (1990) (section 507(a)(7)(E)) establishes priority status for unsecured, governmental claims for excise taxes. Claims with priority status in bankruptcy are paid before all general claims against the bankrupt estate. Courts have employed varying analyses to determine whether a state's workers' compensation premiums fit within section 507(a)(7)(E)'s priority status for excise taxes. Several courts have held that workers' compensation premiums do not constitute excise taxes because the compensation programs

---

169. *See In re* Kincaid, 917 F.2d 1162 (9th Cir. 1990) (stating that, based on legislative history of § 541(c)(2), § 1056(d)(1) does not constitute "applicable nonbankruptcy law" under § 541(c)(2)); *In re* Daniel, 771 F.2d 1352 (9th Cir. 1985) (same); *In re* Lichstrahl, 750 F.2d 1488 (11th Cir. 1985) (same); *In re* Graham, 726 F.2d 1268 (8th Cir. 1984) (same); *In re* Goff, 706 F.2d 574 (5th Cir. 1983) (same).

170. *See In re* Lucas, 1991 U.S. App. LEXIS 470 (6th Cir. 1991) (stating that plain reading of "applicable nonbankruptcy law" under § 541(c)(2) encompasses § 1056(d)(1)); *In re* Kincaid, 917 F.2d 1162 (9th Cir. 1990) (Fletcher, J., concurring) (same). Judge Fletcher concurred in the result because the court held that applicable state spendthrift trust law exempted the debtor's interest from the debtor's bankruptcy estate. *Id.* at 1169. However, Judge Fletcher expressed grave doubts about the majority's reliance on *In re Daniel*, 771 F.2d 1352 (9th Cir. 1985), to dispose of the question whether "applicable nonbankruptcy law" under § 541(c)(2) encompasses § 1056(d)(1). *Id.* Judge Fletcher acknowledged the same concerns that the Fourth Circuit expressed in *In re Moore*, 907 F.2d 1476 (4th Cir. 1990), and stated that a plain reading of § 541(c)(2) encompasses § 1056(d)(1). *Id.* An analysis of the legislative history of § 541(c)(2) is unnecessary because the language of § 541(c)(2) is not ambiguous, and the legislative history of § 541(c)(2) is inconclusive on the point. *Id.* Furthermore, the holding of the majority poses a serious threat to all participants in a qualified pension plan by possibly disqualifying the plan from both ERISA status and tax exempt status. *Id.* This clearly frustrates the purpose of Congress in establishing ERISA protection for qualified pension plans and provides no harmony between federal bankruptcy law and ERISA law. *Id.* at 1170.

more closely resemble insurance than taxes.[171] In other cases, however, courts merely have inquired whether the compensation premiums could be deemed taxes, without considering the insurance attributes of the compensation statutes.[172] In *New Neighborhoods, Inc. v. West Virginia Workers' Compensation Fund*, 886 F.2d 714 (4th Cir. 1989), the Fourth Circuit considered whether premiums levied under the West Virginia Workers' Compensation statute (Compensation statute) were excise taxes for the purpose of priority status in bankruptcy.

In *New Neighborhoods* the plaintiff, a debtor employer, argued that the premiums were not excise taxes under section 507(a)(7)(E). The plaintiff alleged that the Compensation statute established a state system of insurance, the dues to which constituted insurance premiums, not excise taxes. The Compensation statute contains several insurance characteristics. The fact that the Compensation statute refers to the premiums. The statutory premiums, like insurance premiums, fluctuate to reflect each employer's risk of loss. Furthermore, employers may opt out of paying the premiums with the Commissioner's permission. Finally, the purpose of the Compensation fund was to disburse the costs of injured employees among employers in West Virginia, which reflects an insurance pool. Alternatively, the plaintiff alleged that if the Compensation premiums were taxes, the Compensation statute violated the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution. The plaintiff reasoned that this constitutional violation existed because the Compensation statute imposed varying tax rates to reflect factors such as safety records. Consequently, the Compensation statute, according to the plaintiff, established unequal taxation. The plaintiff also asserted that the unequal assessments violated Article X, section 1 of the West Virginia Constitution providing for uniform taxation. The defendant, the West Virginia Workers' Compensation Fund, contended that the premiums were excise taxes and, therefore, entitled to priority status in bankruptcy.

The bankruptcy court held that the Compensation statute's premiums were not excise taxes under section 507(a)(7)(E). On appeal, the United

---

171. *See In re* Smith Jones, Inc., 36 Bankr. 408, 410-11 (D. Minn. 1984) (holding that Ohio's workers' compensation premiums were not taxes because of insurance characteristics of statute); *In re* Payne, 27 Bankr. 809, 817 (D. Kan. 1983) (holding that Kansas' workers' compensation premiums were not taxes because of predominance of non-tax characteristics).

172. *See In re* Metro Transp. Co., 117 Bankr. 143, 152-54 (E.D. Pa. 1990) (holding that Pennsylvania's compensation premiums were not taxes under *Feirling* standard because employers had option whether to join compensation fund); *In re* Primeline Indus., 103 Bankr. 861 (D. Ohio 1989) (holding that Ohio's workers' compensation premiums are taxes because premiums are exacted for public purpose); *In re* E.A. Nord Co., 75 Bankr. 634, 636 (D. Wash. 1987) (holding that Washington's workers' compensation premiums were taxes because premiums were exacted for public purpose); *In re* Tri-Manufacturing and Sales Co., 82 Bankr. 58, 60 (D. Ohio 1983) (holding that Ohio's workers' compensation premiums are taxes because premiums are exacted for public purpose); *In re* Beaman, 9 Bankr. 539, 540-41 (D. Ore. 1980) (holding that Oregon's workers' compensation premiums were taxes because premiums were exacted for public purpose).

States District Court for the Northern District of West Virginia reversed the bankruptcy court's decision, holding that premiums due under the Compensation statute were excise taxes. Accordingly, the district court held that the Compensation statute's premiums were entitled to priority status under section 507(a)(7)(E). New Neighborhoods, Inc. appealed the district court's decision to the United States Court of Appeals for the Fourth Circuit.

The Fourth Circuit first examined an employer's obligations, and the West Virginia State Compensation Commissioner's (Commissioner's) rights, under the Compensation statute. The Compensation statute requires all West Virginia employers either to subscribe to the Compensation fund or, upon demonstration of financial fitness, to opt-out of the fund and become self-insured. Subscribers to the fund must make premium payments. Even a self-insuring employer, however, must post a bond with the fund, attest to the total earnings of its employees, and pay to the fund administrative expenses, costs of a relief fund and payments to cover delinquent employers' non-payments. The Compensation statute empowers the Commissioner to commence a civil action against an employer who fails to make a required payment. The Compensation statute exempts employers who comply with the statute from liability for employee tort suits.

To resolve the issue whether the Compensation statute's premiums constituted taxes, the Fourth Circuit reviewed the Supreme Court's definition of taxes in bankruptcy as expressed in *City of New York v. Feirling*, 313 U.S. 282 (1941). In *Feirling* the Supreme Court defined excise taxes under the Bankruptcy Act as pecuniary burdens for the purpose of defraying authorized governmental undertakings. The Fourth Circuit noted that an excise tax is an indirect tax conditioned on certain acts, occupational performances, or the enjoyment of privileges. In applying the *Feirling* definition, the Fourth Circuit cited three characteristics of the Compensation statute's premiums that were similar to excise taxes. First, the liability for the premiums arose indirectly through the act or transaction of employing. Second, the state compelled payment of the premiums. The Fourth Circuit placed little importance on the fact that employers could opt out of the Compensation fund, apparently because employers can opt out only with the Commissioner's approval. Third, the Compensation statute benefitted the public generally because the system did not burden the public with the costs of injured employees.

The *New Neighborhoods* court rejected the plaintiff's argument that the Compensation statute resembled an insurance program. The court acknowledged that the Compensation statute contained various insurance characteristics. The court, however, found that these insurance attributes of the Compensation statute were not determinative. The court regarded as controlling the fact that the state compelled the premiums for a public purpose. The Fourth Circuit found that the primary distinction between taxes and insurance was that between the power of the state and the rights of citizenry. Furthermore, the court concluded that whether the state legislature enacted the Compensation statute under the police power or revenue raising power, the fact that the state compelled the premiums satisfied the *Feirling* standard. The Fourth Circuit, therefore, concluded that denoting the premiums as excise taxes was permissible.

The Fourth Circuit also recognized, however, the need to limit priority claims in bankruptcy. Priority claims, according to the *New Neighborhoods* court, decrease the funds available to the general creditors, the "little fellows" in a bankruptcy proceeding. The Fourth Circuit, however, found that limiting the Workers' Compensation Fund's priority claim was unnecessary, because the priority claim would benefit injured employees, also the little fellows, in the bankruptcy proceeding. The court concluded that priority status for the premiums would benefit injured employees by helping to ensure the financial soundness of the Fund. Therefore, the court held that the compensation premiums should be classified as excise taxes.

In considering the plaintiff's claim that the differing premium rates violated the equal protection clause, the Fourth Circuit noted the state's need for flexibility in tailoring taxes to local needs and usages. The Fourth Circuit relied on the Supreme Court's holding in *Allied Stores of Ohio v. Bowers*, 358 U.S. 522, 527 (1959), that the equal protection clause requires that taxes have a rational, non-arbitrary basis. Under the Compensation statute, the premiums vary according to the nature of the employer's business, the degree of employee hazard, and the employer's safety record. The Fourth Circuit concluded that the Compensation statute's graduated dues to reflect the risk of employee injury had a sufficiently rational basis to pass the *Bowers* test.

Finally, the *New Neighborhoods* court addressed the plaintiff's contention that the unequal premium rates violated the West Virginia constitutional uniform taxation requirement. While the Fourth Circuit expressed doubt regarding the merit of the plaintiff's allegation, the court refused to rule on the issue, instead leaving the issue for the West Virginia courts and legislature to decide. Accordingly, the Fourth Circuit affirmed the district court's holding that the Compensation statute's premiums were entitled to priority status in bankruptcy.

The Fourth Circuit's opinion comports with many cases in which courts applied the broad *Feirling* definition of excise tax to hold that workers' compensation premiums were excise taxes in bankruptcy.[173] The *New Neighborhoods* court, however, tempered the broad *Feirling* standard by lending credence to the policy of limiting priority claims in bankruptcy. While the facts of *New Neighborhoods* warranted application of *Feirling*, the Fourth

---

173. *See* In re Primeline Indus., 103 Bankr. 861 (D. Ohio 1989) (holding that Ohio's workers' compensation premiums are taxes because premiums are exacted for public purpose); In re E.A. Nord Co., 75 Bankr. 634, 636 (D. Wash. 1987) (holding that Washington's workers' compensation premiums were taxes because premiums were exacted for public purpose); In re Tri-Manufacturing and Sales Co., 82 Bankr. 58, 60 (D. Ohio 1983) (holding that Ohio's workers' compensation premiums are taxes because premiums are exacted for public purpose); In re Beaman, 9 Bankr. 539, 540-41 (D. Ore. 1980) (holding that Oregon's workers' compensation premiums were taxes because premiums were exacted for public purpose).

Circuit expressed some reservation for applying *Feirling* to all government exactions for public purposes.[174]

The *New Neighborhoods* court declined to engage in a comparison between the tax and insurance attributes of the West Virginia Workers' Compensation statute. Accordingly, the Fourth Circuit's *New Neighborhoods* decision is at odds with those cases in which courts inquired whether the compensation statutes contained more insurance attributes than tax attributes.[175] In this latter group of cases, the courts followed a standard that distinguishes between statutes aimed at raising revenue and statutes aimed at regulating an activity.[176] Under this comparison rationale, assessments that are not primarily geared toward raising revenue are not taxes. Although the Fourth Circuit has applied that standard in other contexts, in *New Neighborhoods* the Fourth Circuit held that the *Feirling* definition of excise tax applies in bankruptcy, and refused to give serious consideration to the regulatory aspects of West Virginia's Workers' Compensation statute.

* * *

Section 1112(b) of the Bankruptcy Act of 1978, 11 U.S.C. section 1112(b) (1990) (section 1112(b)), sets out a number of circumstances under which a court may dismiss a Chapter 11 bankruptcy petition.[177] The language

---

174. *See* In re Lorber Indus. of Cal., 675 F.2d 1062, 1068 (9th Cir. 1982) (supporting policy of less expansive interpretation of taxes in bankruptcy); In re Great N.W. Lumber & Millwork Corp., 64 Bankr. 426, 427 (E.D. Pa. 1986) (same); In re Payne, 27 Bankr. 809, 817 (D. Kan. 1983) (same).

175. *See* In re Smith Jones, Inc., 36 B.R. 408, 410-11 (D. Minn. 1984) (holding that Ohio's workers' compensation premiums were not taxes because of insurance characteristics of statute); In re Payne, 27 B.R. 809, 817 (D. Kan. 1983) (holding that Kansas' workers' compensation premiums were not taxes because of predominance of non-tax characteristics).

176. *See* Head Money Cases, 112 U.S. 580, 595 (1884) (distinguishing between taxes used for general support of government and assessments for fund aimed at regulating commerce); Union Pac. R.R. v. Public Utility Comm'n of Or., 899 F.2d 854, 859 (9th Cir. 1990) (distinguishing taxes for purpose of raising revenue and assessments for regulating activities); Brock v. Washington Metro. Area Transit Auth., 796 F.2d 481, 488-89 (D.C. Cir. 1986) (holding that District of Columbia's workers' compensation premiums were not taxes because purpose of assessments was to regulate liability rather than raise revenue); State of S.C. v. Block, 717 F.2d 874, 887 (4th Cir. 1983) (stating that if regulation is primary purpose of statute revenue raised under statute is considered fee rather than tax).

177. *See* 11 U.S.C. § 1112(b) (1988) (listing criteria under which bankruptcy court may dismiss Chapter 11 petition). The relevant part of § 1112(b) states that:

> [T]he [bankruptcy] court may . . . dismiss a case under [Chapter 11] . . . 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 fixed time by the court;
> (5) denial of confirmation of every proposed plan and denial of a request made 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,

of section 1112(b) does not include a good faith requirement for filing a Chapter 11 petition. However, most courts have concluded that, when interpreted in light of established bankruptcy policy considerations, section 1112(b) implicitly includes a good faith filing requirement.[178] The problem these courts have faced, however, is the development of a standard to use to determine whether a debtor filed a Chapter 11 petition in good faith. To find bad faith, some courts demand both evidence of the objective futility of any successful reorganization effort and evidence of the debtor's subjective bad faith in filing the petition.[179] Other courts have determined that a finding of either objective futility or subjective bad faith is sufficient to warrant dismissal of the bankruptcy petition.[180]

In *Carolin Corporation v. Miller*, 886 F.2d 693 (4th Cir. 1989), the United States Court of Appeals for the Fourth Circuit addressed the issue of whether a bankruptcy court may dismiss a voluntary Chapter 11 bankruptcy petition that is not filed in good faith. In *Carolin* the plaintiff, Carolin Corporation (Carolin), filed a Chapter 11 bankruptcy petition fifty minutes before a scheduled foreclosure sale of Carolin's five-and-a-half acre parcel and industrial building in Lexington, North Carolina. The filing automatically stayed the foreclosure proceeding. The defendant, Robert J. Miller, Jr. (Miller), was Carolin's only secured creditor. Miller was the successor beneficiary of a purchase money deed of trust on the Lexington property and successor payee under the purchase promissory note that Carolin executed to finance its original purchase of the land and building. Miller alleged that Carolin's bankruptcy petition was not filed in good faith because Carolin's purpose in filing was to frustrate and delay Miller, not to rehabilitate a distressed business.

The dispute over the valuable Lexington property involved a series of incidents and actors and began nearly four years before Carolin's December

---

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;

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

(10) nonpayment of any fees or charges required under chapter 123 of title 28.

Id.

178. *See In re* Little Creek Development Co., 779 F.2d 1068, 1072 (5th Cir. 1986) (holding that good faith filing requirement is present within the provisions and policies of the Bankruptcy Code); *In re* Winshall Settlor's Trust, 758 F.2d 1136, 1137 (6th Cir. 1985) (same).

179. *See In re* Little Creek Development Co., 779 F.2d 1068, 1072 (5th Cir. 1986) (holding that court must examine debtor's financial condition and motives before dismissing bankruptcy petition for lack of good faith in filing); *In re* Albany Partners, Ltd., 749 F.2d 670, 674 (11th Cir. 1984) (same).

180. *See In re* Phoenix Piccadilly, Ltd., 849 F.2d 1393, 1395 (11th Cir. 1988) (holding that either futility in reorganizing or bad faith in filing is sufficient to dismiss Chapter 11 bankruptcy petition); *In re* North Redington Beach Assoc., 91 Bankr. 166, 169 (Bankr. M.D. Fla. 1988) (same); *In re* Oakgrove Village, Ltd., 90 Bankr. 246, 249 (Bankr. W.D. Tex. 1988) (same); *In re* Markunes, 78 Bankr. 875, 880 (Bankr. S.D. Ohio 1987) (same); *In re* McDermott, 78 Bankr. 646, 651 (Bankr. N.D.N.Y. 1985) (same).

1986 Chapter 11 filing. In March 1983, Steve and Linda Pitchersky purchased the Lexington property from the Miller Tool Company, a business then managed by Miller's mother, Nancy P. Miller (Mrs. Miller). In late 1984, the Pitcherskys defaulted on the promissory note used to purchase the property, and Miller Tool repurchased the property at a foreclosure sale. In January 1985, Carolin purchased the Lexington property from Miller Tool, financing the transaction with a promissory note and deed of trust. Carolin soon leased the property to JMC Furniture Company (JMC), but fires in June 1985 and April 1986 caused extensive damage to the building on the property. A dispute between Carolin and Mrs. Miller over the proceeds from the fire insurance resulted in a failure to completely fix the roof of the building. In the summer of 1986, JMC defaulted on its lease of the Lexington property. Because Carolin was unable to find a new tenant and had no other source of income, it soon defaulted on its promissory note to Mrs. Miller.

The day before Mrs. Miller foreclosed on the property, the Pitcherskys re-entered the picture, incorporated the Benz Holding Company (Benz), and purchased all of Carolin's stock. Benz then forced Carolin to file a Chapter 11 bankruptcy petition less than one hour before the foreclosure. The next day in bankruptcy court, Mrs. Miller filed a motion for relief from the automatic stay, adequate protection, conversion of the case to Chapter 7, or dismissal of the Chapter 11 petition. The bankruptcy court dismissed Carolin's Chapter 11 petition for lack of good faith in filing. The court concluded that Carolin's case was a prime example of what the court termed "the new debtor syndrome," in which a one-asset entity is created shortly before foreclosure to isolate investors from the insolvent property and its creditors. The bankruptcy court also found other indicia of bad faith, including the fact that, other than Mrs. Miller's claim, no other substantial secured or unsecured claims on Carolin's assets existed. Additionally, the court noted that Carolin's chances of finding a new tenant or another source of income were slim, that Carolin had only one employee, and that the Benz principals, the Pitcherskys, had a prior history of default on the same property with the same creditor. The bankruptcy court concluded that the Pitcherskys had created Benz to force Carolin to file its Chapter 11 bankruptcy petition for the sole purpose of acquiring the valuable Lexington property at the existing financing terms without having to pay the fair market price at the foreclosure sale. The court held that Carolin attempted to subvert the purposes of the bankruptcy process by using the system to maximize an investment opportunity without any intention of attempting to reorganize the business.

Carolin appealed to the United States District Court for the Middle District of North Carolina and moved the bankruptcy court to stay the dismissal and to reinstate the Chapter 11 case pending the outcome of the appeal. The bankruptcy court granted the motion on condition that Carolin provide adequate protection to Mrs. Miller's interests while awaiting the district court's resolution of the appeal. The district court affirmed the bankruptcy court's findings and rejected claims that Carolin's compliance with the stay order of the bankruptcy court proved that Carolin had the requisite intent to successfully reorganize while at the same time protecting Mrs. Miller's interests. Carolin appealed the district court's decision to the United States Court of Appeals for the Fourth Circuit.

Pending appeal, Mrs. Miller died and Robert J. Miller became the proper party-in-interest. Carolin ceased giving adequate protection to Miller's interests in violation of the bankruptcy court's stay order, claiming that Mrs. Miller's death permitted Carolin to withhold protection because the stay order required payments to Mrs. Miller only. The bankruptcy court granted Miller's motion requesting his substitution as the proper party-in-interest and ordered Carolin to cure all payments in arrears by September 15, 1988. The bankruptcy court dissolved the original stay order two weeks later after finding that Carolin had not complied with that order, thus clearing the way for a foreclosure sale on the Lexington property. Carolin then filed a motion with the Fourth Circuit seeking a stay of foreclosure proceedings pending a final decision on the appeal from the district court. The Fourth Circuit denied Carolin's motion.

In analyzing the issue of whether the Bankruptcy Code requires that a debtor file a Chapter 11 petition in good faith, the Fourth Circuit in *Carolin* first examined specific provisions and policy considerations of the Code. The court concluded that a good faith requirement for Chapter 11 petitions is implicit in the Code, because such a requirement prevents abuse of the bankruptcy process by compelling the debtor to demonstrate that a realistic possibility of a successful reorganization exists. The Fourth Circuit also noted that its holding was consistent with the Fifth Circuit in *In re Little Creek Development Co.*, 779 F.2d 1068 (5th Cir. 1986), and the Sixth Circuit in *In re Winshall Settlor's Trust*, 758 F.2d 1136 (6th Cir. 1985).

However, the Fourth Circuit did not rely upon broad policy considerations alone in deciding *Carolin*. The court examined several specific provisions of the Code and found that a good faith filing requirement was needed to give meaning to the Code provisions. The court found that section 1112(b) provides three reasons for requiring good faith filings. First, the court stated that section 1112(b) sets out a non-exhaustive list of objective criteria justifying dismissal of a Chapter 11 petition on grounds of the futility of effective reorganization. Second, the court noted that the criteria were consistent with a subjective lack of good faith on the debtor's part in filing a bankruptcy petition. Finally, section 1112(b) permits dismissal for cause, which suggested to the court that lack of good faith might be included as a proper dismissal for cause. The *Carolin* court also noted that section 362(d)(1), which permits a court to lift the automatic stay for cause, in addition to Bankruptcy Rule 9011(a), which discourages frivolous claims, provided additional support for its holding.

After concluding that the Bankruptcy Code demanded good faith filing of Chapter 11 petitions, the *Carolin* court addressed the issue of the standards that a bankruptcy court should use to determine whether a filing is in good faith. The court noted that bankruptcy courts should not casually dismiss a Chapter 11 petition, because denying the debtor access to the

Chapter 11 proceeding is a drastic measure, and creditors can protect themselves through other means. The Fourth Circuit concluded that requiring bankruptcy courts to find evidence of both objective futility of reorganization and subjective bad faith in filing the petition would ensure adequate protection for the diverse and conflicting interests of both the debtor and creditors. The court then concluded that a bankruptcy court must examine the totality of the circumstances to determine whether bad faith is evident under the objective and subjective prongs of the Chapter 11 dismissal inquiry.

After adopting the two-part test for conducting the good faith inquiry, the Fourth Circuit reviewed the district court's dismissal of Carolin's Chapter 11 petition. The *Carolin* court found sufficient evidence to support the district court's conclusion that Carolin did not possess a realistic possibility of successfully rehabilitating itself under the objective prong of the good faith inquiry. First, the Fourth Circuit noted the futility of Carolin's prospects of finding any new tenant that would want to rent a fire-damaged building. The court also found that the Benz principals were unwilling to invest any substantial funds into Carolin for operating or capital needs during the Chapter 11 reorganization. Finally, the court concluded that Carolin was analogous to a shell corporation, because it lacked significant assets other than the Lexington property, and also lacked any indicia of viable business relationships, such as unsecured creditors with substantial claims.

Turning to the subjective prong of the good faith inquiry, the Fourth Circuit found that the record contained direct and circumstantial evidence suggesting that Carolin filed its Chapter 11 petition with subjective bad faith. First, the court noted that the Pitcherskys formed Benz the day before foreclosure on the Lexington property and caused Carolin to file its bankruptcy petition fifty minutes before the foreclosure sale. Although the Bankruptcy Code encourages emergency efforts to forestall imminent financial collapse, the Fourth Circuit concluded that the Bankruptcy Code permits debtors to engage in such efforts only if debtors are willing to provide for the adequate protection of creditors and willing to accept the risk that reorganization might eventually fail. The court stated that the actions of the Benz principals demonstrated that Carolin's purposes were not of an acceptable nature. First, the court recognized that Carolin continuously refused to give adequate protection to Miller's interests throughout the course of the legal proceedings. Second, the court focused on Carolin's failure to make reasonable efforts to find a new tenant for the property. The Fourth Circuit noted that Carolin did not attempt to repair the fire-damaged building to make it more attractive to prospective tenants. Finally, the court concluded that the district court's assessment of the circumstances surrounding the filing of the petition comported with the phenomenon known as the "new debtor syndrome." The "new debtor syndrome," the Fourth Circuit explained, is characterized by the creation of a single-asset entity on the eve of foreclosure for the sole purpose of isolating investors from the insolvent property and its creditors. The *Carolin* court concluded