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Good-Faith Filing in Chapter 11

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The question of when a corporate debtor can initiate chapter 11 proceedings has taken on renewed importance in the wake of high-profile judicial rulings and a congressional proposal. This paper addresses that question, proposing a rule that dismissal for improper filing requires a showing that the proceedings are objectively futile. This proposal is supported by both policy and statute. Ideally, the bankruptcy and appellate courts (and ultimately the Supreme Court of the United States) would announce the rule. It could alternatively be implemented by statutory amendment to the United States Bankruptcy Code. At the very least, Congress should not enact any legislation that moves the law in the opposite direction.

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The question of when a corporate debtor can initiate chapter 11 proceedings has taken on renewed importance in the wake of high-profile judicial rulings and a congressional proposal. This paper addresses that question, proposing a rule that dismissal for improper filing requires a showing that the proceedings are objectively futile. This proposal is supported by both policy and statute. Ideally, the bankruptcy and appellate courts (and ultimately the Supreme Court of the United States) would announce the rule. It could alternatively be implemented by statutory amendment to the United States Bankruptcy Code. At the very least, Congress should not enact any legislation that moves the law in the opposite direction.

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I. INTRODUCTION

When can a corporate debtor initiate chapter 11 bankruptcy proceedings? The United States Bankruptcy Code does not provide a clear answer to this question. Nowhere does it set forth a list of requirements for a debtor to qualify for chapter 11. Nor does it specify what factors render a filing improper. Courts, nonetheless, require that a debtor has acted in good faith in filing its petition. These courts suggest that a good-faith-filing requirement is both implied by the Code and required by the concept of "equity."

While courts have broadly adopted the good-faith-filing requirement, they have not agreed on a test for identifying good faith or its absence. Some courts apply a totality-of-circumstance test. Others look for subjective bad faith of the debtor and ask whether the proceedings are objectively futile. Most recently, the United States Court of Appeals for the Third Circuit broke new ground by requiring that a chapter 11 debtor show immediate financial distress to establish its good faith in initiating a case. That ruling, along with proposed legislation currently before the United States Senate, has brought renewed attention to the good-faith-filing question.

This paper addresses the question head on, proposing a rule that chapter 11 cases should only be dismissed for improper filing upon a showing that the proceedings are objectively futile. This proposal is supported by both policy and statute. Ideally, the bankruptcy and appellate courts (and ultimately the Supreme Court) would announce this rule, but it could also be implemented by a simple statutory amendment to the Code. At the very least, Congress should not enact the proposal that is now before the Senate, as that would move the law in the opposite direction.

II. THE ISSUE

What is the optimal rule for when a corporate debtor can initiate chapter 11 proceedings?

As a practical matter, this question arises when a party moving to dismiss the case "for cause" argues that the debtor lacked good faith in filing its chapter 11 petition. Section 1112(b) of the Code, which provides for dimissal for cause, provides the statutory framework. Courts have generally read a good-faith-filing requirement into that for-cause provision. Thus, a chapter 11 proceeding will be dismissed for cause when it is shown that the debtor lacked good faith in filing its petition. On that the courts agree. But they have split on the question of what it means for a debtor to lack good faith.[1]

Because the good-faith-fiing requirement originated in the courts, the question is first one of judicial action. I frame the proposal accordingly. In the absence of explicit statutory guidance, defining the good-faith-filing requirement is largely a question of the overall purpose and policy behind the Bankruptcy Code. The rule proposed in this paper is consistent with and faithful to the Code and could be implemented by the courts without going outside the bounds of its language. Still, in the absence of judicial resolution, the proposal could also be implemented by statutory clarification from Congress. I address that path as well.

Finally, this paper addresses only the issue of good-faith filing. It takes everything else about U.S. bankruptcy law—such as the debtor-in-possession rules, the voting rules, the automatic stay, and the debtor's exclusive right to file a plan of reorganization—as static. From a broader view, an initiation rule is a part of the overall design of a bankruptcy system, entertwined with questions about control, priority, voting, and the like. The optimal initiation rule for a

[1] The phrase "lack good faith" may seem cumbersome as compared to "in bad faith." I avoid the latter because some couts have made a (somewhat confusing) distinction suggesting that lacking good faith is meaningfully different from acting in bad faith. The distinction is unimportant for my proposal, but I will conform to the terminology used by the courts to avoid confusion.

debtor-in-possession system will be distinctly different from the optimal rule in a creditor-in-posession or administrator-in-posession system. The United States, however, has the most well-functioning corporate bankruptcy system in the world and is not likely to redesign its debtor-in-possession, priority, or voting rules from scratch. And so, I take those and other core rules as given.

III. SUMMARY OF PROPOSAL

The proper rule for initiation of chapter 11 would allow a debtor broad discretion in deciding whether and when to file its petition. The courts should only dismiss a chapter 11 case as improperly filed upon a showing that the proceedings are objectively futile.

Objective futility is a precise term meaning that there is no realistic possibility that a confirmable plan of reorganization will preserve value for the debtor's estate. If the debtor is seeking a reorganization plan that will arguably preserve value for the estate (as compared with what will happen outside of bankruptcy), the case should not be dismissed. This rule allows debtors to file their cases early enough to preserve value and minimizes protracted litigation over filing rules at the outset of the case.

The proposal could be implemented in one of three ways. First, if courts are true to statutory language and follow the Supreme Court's guidance in interpreting that language, they will conclude that there is no good-faith-filing requirement in the Code. In fact, that judge-made requirement conflicts with several other provisions and the overall structure and history of the Code. The courts should abandon the good-faith-filing rule and find the authority to dismiss cases for objective futility under separate provisions of the Code (discussed below).

Second, if—as is likely—courts continue to require good-faith at filing, they should define good faith as requiring only that the reorganization is not objectively futile.[2] This is the only good-faith rule that is consistent with the structure and policy of the Code. It also minimizes conflicts between a good-faith-filing requirement and other provisions of the Code.

Third, if courts do not act, Congress should. A simple clarification to the Code could resolve the split among courts. Section 1112(b)(4) could be amended to change the word "include" to "means" and the list of causes for dismissal could be amended to add "or (Q) objective futility of the proceedings at the time of filing." (See Appendix for the current verison of the statute.). These changes would clarify the grounds on which a court may dismiss a case for cause, specifying that the only cause for dismissal based on the filing itself is objective futility. That would simplify litigation over filing and achieve the appropriate filing incentives for the United States corporate bankruptcy regime.

Unfortunately, the most recent Congressional proposal for bankruptcy reform moves the law in the opposite direction by providing for dismissal for bad faith and creating several vague triggers for presuming bad faith. Congress should abandon this proposal to avoid making things worse.

IV. BACKGROUND

While United States Courts are generally permissive when it comes to good-faith filing, they are far from uniform. The tests for good faith vary across courts, and that variation has grown in recent years. The differences are unsurprising given the lack of statutory guidance. The Code includes no language about good-faith filing. On the contrary, the rule is judge-made,

[2] Optimally, the burden would be on the movant to show objective futility by clear and convincing evidence. But courts are more likely to plae the burden on the debtor to show by a preponderance of the evidence that the case is not futile. The difference is likely to be small in practice, affecting a small number of cases.

arguably resulting from judicial overreach in violation of the statute. The courts, however, view the requirement as an implied standard, the substance of which Congress left to them to develop by case law. With that view, each court has fashioned its its own definition of good faith. The result is a far-from-uniform patchwork of good-faith-filing tests.

To give the reader a sense of that patchwork, this section provides a general background on the supposed statutory basis for the good-faith-filing requirement and then turns to a review of case law that demonstrates how courts have implemented the requirement.

a. Statutory Framework

On the statutory note, there are strong arguments that the Code does not provide any good-faith-filing rule and that it even prohibits such a rule. Section 1112(b) provides a list of sixteen things that constitute "cause" for dismissal. This list is non-exhaustive as indicated by its introductory language: "For the purposes of this subsection, the term 'cause' *includes*:" Thus, courts interpet 1112(b) as providing examples of the things that constitute cause for dismissal.

From there, the courts have made the unjustified leap to concluding that lack of good faith is one of the unlisted but implied causes for dismissal. This reading is suspect for several reasons. To start, it contradicts established methods of statutory interpretation. Each of the sixteen items listed as cause in 1112(b) involves actions that a debtor would take *after the case has already commenced.* The list sets forth examples only of post-petition misbehavior that would require dismissal. Good-faith filing, on the other hand, involves exclusively prepetition behavior. As a result, it is meaningfully different from the category that encompasses the examples. The most sensible textual reading is that all implied causes fall into the same category as all the examples. If all explicit examples are of a certain type, the implied items are also of that type.

Notably, the Supreme Court of the United States embraced this method of interpretation in its most recent decision involving the Bankruptcy Code. In issuing its ruling in the *Purdue Pharma* case, the Supreme Court noted that examples on a list must indicate something about the implied but unlisted items. *Harrington v. Purdue Pharma L. P.*, 144 S. Ct. 2071 (2024).

The existence of a good-faith rule is further undermined by the legislative history of the Code. Prior to the enactment of the current Code in 1978, the relevant statutes—going back to 1898—included a good-faith-filing requirement. Congress made the conscious decision to remove that requirement from the 1978 Code. Indeed, the Congressional record shows that the question of initiation was fully considered and the lawmakers opted to adopt the most liberal filing requirements:

> Access to collective relief should be similarly open except for safeguards against fraudulent use. *There should be no legal barrier to voluntary petitions*. …
> Belated commencement of a case may kill an opportunity for reorganization or arrangement.

Report of the Commission on The Bankruptcy Laws of the United States, H.R.DOC. No. 137, 93d Cong., 1st Sess., Pt. 1 at 75 (1973) (emphasis added).

Finally, the structure and other provisions of the Code strongly contradict any inference of a good-faith-filing requirement. Perhaps the strongest evidence against a chapter 11 good-faith filing is the requirement in Section 109(c)(3) that a chapter 9 debtor "is insolvent." This is a clear statement of a filing requirement. There is no similar requirement of any kind for chapter 11 debtors. Had Congress intended to establish a good-faith rule or any financial requirement, it would have included a provision similar to 109(c)(3) for chapter 11 debtors.

Additionally, Section 1129(a)(3) requires that a chapter 11 plan be "proposed in good faith." This language demonstrates how Congress communicates a good-faith requirement and is absent from the sections of the code that address initiation requirements. Structurally, this backend requirement of good faith at confirmation but not filing is consistent with a Code designed to allow liberal initation and minimize upfront litigation while still preventing abusive plans from being confirmed.

Despite these arguments against reading a good-faith-filing requirement into the code, lower courts (all courts other than the Supreme Court), are unlikely at this point to jettison the good-faith-filing requirement altogether.

Similarly, Congress is unlikely to clarify the absence of such a requirement. The recent proposal currently before the Senate would take the law in the opposite direction by adding "bad faith" to the list of causes and adding a series of triggers that create a presumption of bad faith. These factors inclue "manufacturing" venue, filing to "gain a tactical litigation advantage," filing to "impose an undue delay upon creditors," filing to cap liabilities, and engaging in certain capital structure transactions. The vagueness of these triggers is likely to increase litigation at the outset of most chapter 11 cases.

b. CASE LAW

Three cases, two recent and one from 2009, demonstrate the varied contexts in which the good-faith-filing question arises. The first is the bankruptcy of the National Rifle Association and provides a prototypical example of a chapter 11 case that should be dismissed as objectively futile; the second is the bankruptcy of a subsidiary of Johnson & Johnson involving a legal maneuver referred to as the Texas Two-Step; the third is the bankruptcy of General Growth Properties and the motion to dismiss the bankruptcy cases filed by dozens of its subsidiaries.

i. National Rifle Association

The bankruptcy of the National Rifle Association of America raised traditional questions about when a debtor can initiate chapter 11 proceedings. The National Rifle Association, a non-profit entity registered in New York, filed for chapter 11 with the exclusive purpose of evading the regulatory power of the New York Attorney General.

At the time of filing, the Attorney General was pursuing claims that the debtor had violated state law. The Attorney General ultimately sought to dissolve the debtor's operations. The debtor freely admitted that it was filing a chapter 11 petition to hinder the Attorney General in that pursuit. More importantly, the debtor disclaimed any financial reason to initiate the bankruptcy proceedings as well as any argument that it was entering bankruptcy to address a collective action problem among its stakeholders. In the end, the only reason the debtor credibly put forward for its filing was to circumvent the Attorney General's exercise of regulatory authority.

This is a clear example of an objectively futile case. The power of bankruptcy courts is limited and cannot interfere with state regulatory action. As such, there was nothing that the debtor could include in a confirmable plan of reorganization that would further its professed goal. In other words, the case was objectively futile because the debtor had not stated a cognizable bankruptcy purpose.

ii. LTL Management LLC and The Texas Two-Step

The United States Court of Appeals for the Third Circuit announced a new test for good-faith filing in *In re LTL Management LLC*. In that case, Johnson & Johnson had sought to use the bankruptcy process to assist in reaching a global settlement of tort litigation related to its manufacturing and sale of Baby Powder and related products containing talc. Tens of thousands

of cases had been brought against Johnson & Johnson ("J&J") alleging a link between the talc in its product and ovarian cancer and mesothelioma.

The primary defendant in the talc litigation was J&J's subsidiary Johnson & Johnson Consumer Inc. ("Old JJCI"). Complicating things, Old JJCI also produced dozens of other consumer products totally unrelated to Baby Powder, including Band-Aids, Tylenol, and Neutrogena. A bankruptcy of Old JJCI would have been one of the largest and most complicated bankruptcy filings in history, and so, J&J took a different path. Rather than putting Old JJCI into bankruptcy, it created a new entity (LTL Management LLC) through a process known as a Texas Divisive Merger and then immediately caused LTL to initiate chapter 11 proceedings. The key characteristic of LTL was that it was essentially a shell housing the talc liabilities of Old JJCI. At the same time, the Divisional Merger placed the assets of Old JJCI into a new entity referred to as New JJCI. To ensure that this transaction was not a fraudulent transfer and did not reduce the potential recoveries of talc claimants, New JJCI and J&J executed a funding agreement promising that each would cover LTL's ultimate talc liabilities up to (and beyond) the value of Old JJCI at the time of the divisive merger.

This maneuver, pejoratively referred to as the "Texas Two-Step," had been used three other times in attempts to resolve mass-tort litigation related to asbestos. Like the debtors in those other cases, LTL initiated its chapter 11 proceedings in the Western District of North Carolina. But the case did not remain there, as the court—on its own motion—transferred venue to the District of New Jersey. This transfer turned out to be hugely consequential when the United States Court of Appeals for the Third Circuit (in which the District of New Jersey sits) ordered the case dismissed as not being filed in good faith.

In the bankruptcy court, the talc claimants moved to dismiss the case, attacking J&J's use of the Texas Two-Step. The bankruptcy court denied the motion, finding that LTL was spending over a billion dollars in litigation fees, faced tens of thousands of alleged claims, and had been ordered to pay hundreds of millions of dollars to some claimants. The court reasoned that those facts added up to financial distress and that chapter 11 was uniquely capable of resolving the complex collective action problems posed by mass-tort litigation.

On appeal, the Third Circuit reversed ordering the case dismissed for lack of good faith. In doing so, it announced a new rule that good-faith filing requires the debtor to show it is facing financial distress "immediate enough to justify filing." *In re LTL Mgt., LLC* ("*LTL I*"), 64 F.4th 84 (3d Cir. 2023). This rule is untethered from the Texas Two-Step and appears to apply broadly to all chapter 11 cases.

Essentially, the court ruled that LTL couldn't justifiy its filing because the funding agreement with J&J and New JJCI had made too much money available for the claimants against LTL. This presents the perverse outcome that the debtor was found to lack good faith because it had proactively structured things *to preserve value* for its creditors. Preserving value is, of course, the very thing that the Code was created to do.

The Third Circuit's immediate-financial-distress test—which creates a vague near-insolvency requirement for filing—directly conflicts with the tests applied in other courts. Starkest is the contrast with the Fourth Circuit's test. Noting that "[d]ecisions denying access at the very portals of bankruptcy, before an ongoing proceeding has even begun to develop the total shape of the debtor's situation, are inherently drastic and not lightly to be made," the Fourth Circuit has announced a rule that "require[s] that both objective futility and subjective bad faith

be shown in order to warrant dismissals for want of good faith in filing." *Carolin Corp. v. Miller,* 886 F.2d 693, 700–01 (4th Cir. 1989).

iii. General Growth Properties

Good-faith filing was also at issue in the bankruptcy of General Growth Properties in 2009. Creditors had required the General Growth enterprise to adopt structures that they thought would prevent the subsidiaries of the General Growth parent entity from filing bankruptcy. These "bankruptcy remote" structures included independent board members, a unanimous consent requirement for filing, and a financial structure that reduced the arguments that the subsidiary would have an estate that bankruptcy law could preserve.

Despite those structures, and despite being solvent, the subsidiaries filed for bankruptcy along with the parent entity. The secured creditors of the subsidiaries moved to dimiss the subsidiary filings as not filed in good faith. The bankruptcy court, located in the Southern District of New York, denied the motion. The court noted that in the Second Circuit—like in the Fourth Circuit—dismissal for lack of good faith requires a finding of both subjective bad faith of the debtor and objective futility of the proceedings. The main question in the case was whether the interests of the entire enterprise were relevant in determining whether the subsidiary filings served a bankruptcy purpose. The court answered that question in the affirmative. Notably, far from being a litigation or stalling tactic, at the end of the day, the General Growth bankruptcy was a success story for chapter 11, returning full value to all stakeholders.

V. ANALYSIS

The good-faith-filing requirement should be replaced by an objective-futility test. This can be done by judicial ruling or by Congressional act. The cleanest, but least likely, path is for

courts to abandon the good-faith-filing requirement because it is not authorized by the Code.[3] The courts would then look to 1112(b)(4)(j) for the objective-futility test. Under that section, cause for dismissal includes "failure…to file or confirm a plan, within the time fixed by this titled or by order of the court." When a case is objectively futile, the debtor will, by definition, be unable to confirm a plan. As soon as the futility is evident, 1112(b)(4)(j) therefore provides cause to dismiss the case.

Alternatively, courts could maintain the good-faith-filing requirement but define good faith to encompass the objective-futility test. This approach reaches the same result while maintaining some continuity with judicial precedent. The test is not far from the current approach in the Second and Fourth Circuits. Those courts dismiss cases where the court finds both objective futility and subjective bad faith. In theory, that test is even more permissive than the rule I propose. But it is unlikely that there will be a large number of cases where the proceeding is objectively futile but the debtor is acting in good faith. More importantly, once the court finds that a case is objectively futile, it is unclear why the case shouldn't be dismissed. Dropping the subjective bad faith element likely affects very few cases, but it does streamline the task of the judge and reduce litigation. Subjective bad faith is—as the term suggests—subjective and will require the judge to engage in the murky task of deciding the mental state of a corporate debtor at the time of filing.

In the absence of judicial action, Congress could clarify the statute to explicitly reject the good-faith-filing requirement or equate it to an objective-futility test. This could be achieved by a statutory amendment changing the word "include" in section 1112(b)(4) to "means," deleting the word "and" after subsection (O), and adding "or (Q) objective futility of the proceedings at

[3] I am not alone in this view. See Brook Gotberg, The Burden of Financial Distress, (work in progress).

the time of filing" to the end of the list of causes. This small change would limit the grounds for dismissal of a bankruptcy filing to those explicitly listed, eliminate the amorphous and unproductive doctrine of good-faith filing, and clarify that objective futility is grounds for dismissal.[4]

However it is implemented, the objective-futility test simply asks if the debtor can articulate some realistic possibility that it can propose a confirmable plan that preserves some value for the estate. If a movant can show that no such possibility exists, the court should dismiss the case.

The objective-futility test is preferable because it limits dismissal to the most egregious cases and eliminates costly upfront litigation over the debtors' motives and financial condition. Objective futility allows for the dismissal of cases where it is clear that the debtor is filing (as the NRA did) to evade state regulatory power, is plainly engaging in stalling tactics, or is using the filing solely to gain litigation leverage. But cases like *LTL* and *General Growth Properties*, where chapter 11 can preserve value for stakeholders, will go forward. Meanwhile, the objective futility test will reduce litigation costs for solvent firms attempting to access the collective restructuring process available in theCode and allow most most other cases to proceed.

In contrast, a vague good-faith-filing rule inserts a litigation-intensive decision into the very beginning of the bankruptcy process. This will result in delays and consume estate resources. For instance, the Third Circuit's near-solvency requirement invites ambiguity. For any company not clearly insolvent, stakeholders have an incentive to litigate over just how close to

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[4] Thus, section 1112(b)(4) would read as follows:

> For purposes of this subsection, the term "cause" <u>means</u>—
> [(A)-(P)]<u>; or</u>
> <u>(Q) objective futility of the proceedings at the time of filing;</u>

insolvency the debtor is, and whether that is close *enough* to satisfy the test. The threat of such litigation provides hold-out opportunities that often lead to bargaining failure.

As in all of law, the choice here boils down to one between rules and standards. A broad standard allows courts to exercise discretion to weed out bad-faith filings, but it invites excessive litigation. This is especially true of a standard like the one announced by the Third Circuit, which provides no fixed point or objective fact on which to anchor the inquiry. By focusing on the "immediacy" of financial distress, the court ensures that solvent debtors will be drawn into lengthy future litigation over what qualifies as immediate. The test requires a factual inquiry into the value of assets and the value of claims followed by a discretionary judgment about how accessible the value is and how immediate the claims are. That inquiry will be long, detailed, and unpredictable. And it will occur before the bankruptcy proceedings even get started.

Moreover, at the time of initiation, courts have limited information. Rules that turn on financial distress or on the totality of circumstances of a case take the filing decision out of the hands of the debtor and place it in the hands of the bankruptcy judge. To be sure, by the end of a case when it comes to confirmation, the bankruptcy judge has to dive into the weeds. That often requires complex valuation of assets and an affirmative finding that the plan was proposed in good faith. By that time, however, the parties have been heard, the judge has had time to get up to speed, and many of the disputes have been settled through the chapter 11 bargaining process. The same is not true on the first day. For that reason, the Code's structure explicitly moves the good-faith inquiry and the many difficult judicial decisions to the end of the process.[5]

[5] Of course, some critical decisions, like debtor-in-posession financing, cannot be pushed back. In those cases, the Code allows imperfect upfront litigation. But, where an opportunity for more informed decisionmaking exists, courts should cease it.

The objective-futility test is consistent with the current text of the Code – which makes no mention of a good-faith-filing requirement – and could be adopted tomorrow by any court willing to do so. In contrast, the Third Circuit's immediate financial distress test is in direct conflict with the Code, which provides an explicit insolvency requirement for chapter 9 cases and no financial requirement of any sort for chapter 11 cases.

The test is also consistent with the requirements of the Bankruptcy Clause of the United States Constitution, which provides that "Congress shall have the Power … To establish … uniform Laws on the subject of Bankruptcies throughout the United States." One litigant has recently argued, that the Bankruptcy Clause includes a financial requirement of some sort for chapter 11 cases. That litigant has not explained what that test would be or how it would be implemented. Nor has it explained the source of its interpretation of the Constitution, which is inconsistent with an unbroken line of Supreme Court precedent since the 19th century adopting an extremely broad reading of the Bankruptcy Clause. Most recently the Court explained,

> This Court has repeatedly emphasized that the Bankruptcy Clause's language, embracing laws on the subject of Bankruptcies, is broad. For example, the Court has recognized that the subject of bankruptcies is incapable of final definition, and includes nothing less than the subject of the relations between a debtor and his creditors.

Siegel v. Fitzgerald, 596 U.S. 464, 473-74 (2022).

Critics might object that the proposal in this paper allows debtors to abuse the iniation power. This raises a fundamental question about the design of any corporate bankruptcy regime. Because bankruptcy law alters parties' substantive and procedural rights, those parties have divergent incentives in deciding whether to initiate proceedings. An initiation rule must account for these incentives to prevent stakeholders from destroying value. Overly permissive rules

produce too many bankruptcies and premature filings; overly strict rules produce too few case and filings that come too late; vague standards and murky rules lead to uncertainty and litigation.

As a starting point, equityholders and management have a disincentive to file for bankruptcy. Bankruptcy shuts down future gambles that a debtor might take in the hopes of turning things around. Chapter 11's priority rules collapse all future possibilities into an immediate valuation. In this way, even though the business continues, equity's interests are valued as if the company is being sold. The result is that equity is often wiped out and managers are often replaced.

Secured creditors also have an incentive to oppose bankruptcy. Outside bankruptcy, they have strong enforcement rights, including the right to foreclose. Inside bankruptcy, those rights are stayed and may even be eliminated through cramdown.

Chapter 11 is designed primarily to preserve value for unsecured creditors. And so, they are the stakeholders with the most to gain from a filing. But, as a general matter, they are the least coordinated and possess the least information. This may explain why involuntary chapter 11s—which are filed by unsercured creditors—are rare.

Certain provisions of chapter 11 intentionally modify these incentives. The debtor-in-possession regime in the United States consciously transfers an enormous amount of power to the debtor upon filing. It allows management to maintain control and provides it with the exclusive right to propose a plan. This provides a carrot to draw debtors in. Similarly, the automatic stay allows a debtor to block creditor enforcement measures. Debtors can abuse this power, and sometimes use chapter 11 as a litigation tactic or stalling mechanism. In this way, the debtor's control rights give management the ability to gain bargaining leverage.

But that is not all bad. The leverage transferred to the debtor upon filing facilitates a system that relies on initiation by a party that would otherwise be the most disadvantaged by the filing. The debtor is offered these rights to overcome its baseline tendency to avoid bankruptcy. As Randy Picker has pointed out, "The debtor's right to file a voluntary petition and to invoke the holdup power conferred on the debtor by the automatic stay and the exclusivity period operates as a mechanism for compensating the debtor for filing a voluntary petition." See Randal C. Picker, *Voluntary Petitions and the Creditors' Bargain,* 61 University of Cincinnati Law Review 519, 524 (1992). If that leverage were transferred to any other stakeholder, the debtor would lose all incentive to file.

Another important consideration is that a debtor's legal power to initiate a case does not always translate to real power. It is commonly recognized that banks exercise power over a debtor's prefiling decisions through the acceleration of debt and the enforcement of covenants. In recent years, other players, including private credit funds, have also entered the arena.

Parties with leverage stemming from other sources can bargain with the debtor to trade their leverage for promises on how the debtor will exercise its legal control. The result is a complicated dance among creditors and debtors on the eve of bankruptcy that often results in complex deals. Examples of such deals can be observed in forbearance agreements, restructuring support agreements, debtor-in-posesssion financing, and liability management exercises. All of this is to say that the debtor's legal power is often tempered by the real-world leverage of other stakeholders.

Finally, if the initiation rule transfers too much power to the debtor, there are other ways to shift the balance without jettisoning the case altogether. For example, the court might consider lifting the exclusivity for cases where the debtor is shown to be comfortably solvent. Or a court

could consider limiting the scope of the automatic stay and preliminary injunctions. These proposals all reduce leverage without cutting off the avenue of value preservation altogether.

VI. CONCLUSION

Consistent with the statutory text, courts should replace chapter 11's good-faith-filing requirement with an objective-futility test. That can be done either by abandoning the good-faith-filing requirement or adopting a test that equates lack of good faith with objective futility. Alternatively, Congress should clarify the statute to accomplish the same outcome.

This proposal will allow more chapter 11 cases to proceed earlier and with less upfront litigation. That is a feature and not a bug. There is asymmetry between the cost of cases that file too early and those that file too late. Premature cases invoke unnecessary procedures while delayed cases result in the failure of othwersie viable businesss. Recogizing this, the Code provides for liberal initiation. This is one of the most important innovations of United States corporate bankruptcy law. While other jurisdictions around the world require a debtor to show actual insolvency or meet other strict requirements to initiate judicial proceedings aimed at collectively restructuring its debts, the United States corporate bankruptcy regime encourages debtors to initiate chapter 11 proceedings with a minimum showing that chapter 11's collective process might preserve estate value. That approach encourages debtors to address problems before they get out of hand and to enlist the Code's collective proceedings before value has been irretrievably destroyed. To use a common metaphor, chapter 11 encourages a debtor to call the fire department before the house has burned down.

Appendix

11 U.S.C § 1112(b):

(1) Except as provided in paragraph (2) and subsection (c), on request of a party in interest, and after notice and a hearing, the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause unless the court determines that the appointment under section 1104(a) of a trustee or an examiner is in the best interests of creditors and the estate.

…

(4) For purposes of this subsection, the term "cause" includes—

(A) substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation;
(B) gross mismanagement of the estate;
(C) failure to maintain appropriate insurance that poses a risk to the estate or to the public;
(D) unauthorized use of cash collateral substantially harmful to 1 or more creditors;
(E) failure to comply with an order of the court;
(F) unexcused failure to satisfy timely any filing or reporting requirement established by this title or by any rule applicable to a case under this chapter;
(G) failure to attend the meeting of creditors convened under section 341(a) or an examination ordered under rule 2004 of the Federal Rules of Bankruptcy Procedure without good cause shown by the debtor;
(H) failure timely to provide information or attend meetings reasonably requested by the United States trustee (or the bankruptcy administrator, if any);
(I) failure timely to pay taxes owed after the date of the order for relief or to file tax returns due after the date of the order for relief;
(J) failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court;
(K) failure to pay any fees or charges required under chapter 123 of title 28;
(L) revocation of an order of confirmation under section 1144;
(M) inability to effectuate substantial consummation of a confirmed plan;
(N) material default by the debtor with respect to a confirmed plan;
(O) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and
(P) failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.