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Delaware District Court Sheds Light on Standards for Dismissal of Chapter 11 Case Based on Bad Faith

By Robert Klyman and Scott C. Shelley*

In this article, the authors discuss a decision by a Delaware district court that provides useful guidance for future courts adjudicating disputes over whether a bankruptcy filing was undertaken in bad faith.

Judge Gregory B. Williams of the U.S. District Court for the District of Delaware (the District Court) has issued a ruling in *AIG Financial Products Corporation* affirming an order on appeal from the Delaware bankruptcy court (the Bankruptcy Court) that denied a motion to dismiss a Chapter 11 petition as a bad faith filing.[1]

The *AIG Financial* ruling – which follows the recent ruling by the U.S. Court of Appeals for the Third Circuit in *In re LTL Management, LLC*[2] for the propositions that "for a bankruptcy case to be filed in good faith, the debtor needs to be in "some degree of financial distress," the petition needs to "serve[] a valid business purpose," and it cannot have been filed "merely to obtain a litigation advantage" – constitutes the first order from a Delaware district court after *LTL Management* that synthesizes existing case law under Bankruptcy Code Section 1112, and provides useful guidance for future courts adjudicating disputes over whether a bankruptcy filing was undertaken in bad faith.[3]

THE DEBTOR'S RELATIONSHIP WITH AIG

AIG Financial Products Corporation (the Debtor) was a wholly owned subsidiary of AIG International Group (AIG). The Debtor was created to

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[1] See In re AIG Financial Products Corp., Case No 23-573 (GBW) (D. Del Aug. 28, 2024), Memorandum Opinion (Opinion).

[2] 64 F.4th 84, 101 (2023).

[3] Opinion at 10, 19 (holding that "filing a petition 'merely to obtain tactical litigation advantages' in ongoing litigation provides grounds to dismiss the petition for lack of good faith," but clarifying that "if the filing serves multiple valid bankruptcy purposes, it, by definition, could not have been 'filed merely to obtain a tactical litigation advantage.'").

permit AIG to access capital markets and generate revenue from complex derivatives transactions. AIG generally agreed to guarantee all of the Debtor's monetary obligations.[4]

THE DEBTOR'S DEFERRED COMPENSATION PROGRAM

Prepetition, the Debtor established a deferred compensation program (DCP) for its executives. The deferred compensation was not held in trust or segregated from the Debtor's general funds, but instead was reflected in a ledger of accounts. Significantly, the DCP expressly stated that the benefits owed to plan participants did not have the benefit of the AIG payment guaranty.[5]

By the terms of the DCP, amounts in any plan participant's account were subject to (a) reduction if the Debtor suffered certain losses and applied the DCP funds to cover those losses, and (b) replenishment by the Debtor from future profits. In addition, by the terms of the DCP, claims in respect of the DCP were subordinate to all general unsecured claims of the Debtor.[6]

THE GREAT FINANCIAL CRISIS' IMPACT ON THE DEBTOR AND THE DCP

As a consequence of the 2008 financial crisis in the United States, the Debtor suffered a severe liquidity crisis and incurred tens of billions of dollars in liabilities. AIG, the Debtor's corporate parent, obtained loans from the Federal Reserve Bank of nearly $100 billion, and extended a $65 billion revolving line of credit to the Debtor (the AIG Revolver).

Over the subsequent 14 years, the Debtor drew approximately $92 billion on the AIG Revolver and repaid approximately $59 billion. The Debtor used these funds to avoid defaulting on its derivatives transactions and began efforts to unwind its portfolio.[7]

Notably, the Debtor used funds previously allocated to the DCP to satisfy some of its obligations, but the Debtor never recouped tens of billions of dollars it lost as a result of the financial crisis.[8]

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[4] Id. at 1-2.

[5] Id.

[6] See Disclosure Statement for the Plan of Reorganization for AIG Financial Products Corp. Under Chapter 11 of the Bankruptcy Code, Docket No. 7, Case No. 22-11309 (MFW) (Bankr. D. Del.) at 10.

[7] Opinion at 3.

[8] Id.

Moreover, because the Debtor thereafter never generated "distributable income," the Debtor did not restore those funds to DCP plan participants' accounts.[9] In addition, by its terms, the AIG Revolver could not be used to fund any money owed under the DCP Plan.[10]

THE PRE-BANKRUPTCY LAWSUIT BY FORMER EXECUTIVES

In December 2019, a group of former executives (the Former Executives) filed a complaint in Connecticut state court seeking $640 million in damages arising from the Debtor's alleged breach of the DCP related to the Debtor's failure to restore the money under the DCP. On December 14, 2022 – the eve of a discovery deadline – the Debtor filed a Chapter 11 petition (the Bankruptcy Case) rather than producing the required documents.[11]

THE BANKRUPTCY CASE

Concurrently with filing a bankruptcy petition, the Debtor filed a proposed plan of reorganization and disclosure statement. The plan provided for the termination of the AIG Revolver in exchange for which AIG would retain its equity interest in the Debtor, and the establishment of a cash pool of $1 million for the pro rata benefit of DCP participants if that class voted to accept the plan. The Debtor also represented that if the Debtor failed to confirm a plan, it would pursue a sale of its assets under Section 363 of the Bankruptcy Code.[12]

THE FORMER EXECUTIVES' MOTION TO DISMISS THE BANKRUPTCY CASE

On January 13, 2023, the Former Executives moved to dismiss the Chapter 11 case under 11 USC Section 1112(b), because the Bankruptcy Case was not filed in good faith. Among other issues, the Former Executives argued that the Debtor was not experiencing financial distress because the Debtor was "flush with cash, no creditor was pressuring it for payment, and its obligations to counterparties were guaranteed by AIG which had billions of dollars in cash reserves."[13] The Former Executives also moved to dismiss the Bankruptcy Case

[9] Id. at 4.

[10] Id. at 14.

[11] Id. at 4-5.

[12] Id. at 6.

[13] Id. at 6-7.

by asking the Bankruptcy Court to abstain under 11 USC Section 305, arguing that the interests of stakeholders would be better served by dismissal.[14]

BANKRUPTCY COURT DENIED THE MOTION TO DISMISS

The Bankruptcy Court denied the motion to dismiss, and found the Debtor filed the Bankruptcy Case in good faith. Among other reasons, the Bankruptcy Court held that the Debtor:

(a) Faced sufficient financial distress as it had "no prospect" of ever satisfying its liabilities;

(b) Faced mounting legal bills to defend against the Former Executives' litigation;

(c) Was preserving value by stopping the accrual of interest and the cost of the foregoing litigation;

(d) Was not suffering substantial losses because the Debtor had sufficient liquidity to pay its administrative expenses; and

(e) Would be able to rehabilitate either through a plan or a bankruptcy sale process.[15]

ON APPEAL, THE DISTRICT COURT AFFIRMED THE BANKRUPTCY COURT RULING

On appeal, the Former Executives argued that the Debtor did not file the Bankruptcy Case in good faith because the Debtor was not experiencing the financial distress required by the Third Circuit, and the Bankruptcy Case did not serve a valid reorganization purpose. The District Court rejected both of these arguments and affirmed the Bankruptcy Court.[16]

THE DEBTOR FACED SUFFICIENT FINANCIAL DISTRESS

In the Third Circuit, a finding of good faith requires "some degree of financial distress" because "bankruptcy is designed to handle the distribution problems arising when the system of individual creditor remedies harms the creditors as a group and there are not enough assets to go around."[17]

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[14] Id. at 7.

[15] Id.

[16] Id. at 10.

[17] Id. at 11.

In affirming the Bankruptcy Court order, the District Court found that the record reflected that the Debtor, as of the commencement date of its Bankruptcy Case:

(i) Was balance sheet insolvent by more than $37 billion even *before* taking into account the Former Executives' claim for $640 million;

(ii) Was incurring significant expenses associated with the Connecticut litigation;

(iii) Was party to a credit facility under which more than $100 million in interest was accruing each month; and

(iv) Had no ability to pay a significant judgment entered in the Connecticut litigation, which would make a bankruptcy filing "inevitable."[18]

The court stated that "a debtor need not be *in extremis* in order to file," and pronounced that the Bankruptcy Code envisions the need for early access to bankruptcy before a situation is hopeless.[19] Because AIG Financial was already deeply insolvent, faced mounting legal costs associated with the Connecticut litigation – and the prospect of a judgment it could never pay – the court found that the Debtor "had no obligation to wait for that to happen."[20] The court thus concluded that AIG Financial was in financial distress sufficient to support good faith in seeking bankruptcy protection.[21]

The Former Executives also pointed to the AIG guarantee to justify the conclusion that the Debtor was not facing sufficient financial distress – citing the *LTL Management* decision, where the debtor's corporate parent provided a funding backstop for all of the debtor's liabilities. The District Court distinguished LTL Management because AIG's guarantee was by its terms limited and did not cover the Debtor's obligations under the DCP Plan, and AIG could refuse to fund the Debtor's other obligations in its sole discretion.[22]

THE BANKRUPTCY CASE SERVED A "VALID" PURPOSE

The District Court observed that "[f]inancial distress is necessary but not sufficient to establish good faith," and that good faith also requires a "valid bankruptcy purpose" and that the case was not filed *merely* to obtain a "tactical

[18] Id. at 11-13.

[19] Id. at 15.

[20] Id. at 16.

[21] Id.

[22] Id. at 14.

litigation advantage."[23] Had the Debtor filed the Bankruptcy Case for the "primary, if not sole purpose" of "orchestrating litigation," the District Court likely would have dismissed the Bankruptcy Case as a bad filing.[24]

In contrast, however, the District Court rejected the argument that the Bankruptcy Case was "merely a litigation tactic." According to the District Court and as described above, the Bankruptcy Case served "multiple valid bankruptcy purposes." As a consequence, "by definition" the filing "could not have been 'filed *merely* to obtain a tactical advantage.'"[25]

REJECTION OF OTHER ARGUMENTS BY THE FORMER EXECUTIVES

The Former Executives also argued that the Bankruptcy Case should be dismissed under Bankruptcy Code Section 1112(b)(4)(A) based on substantial or continuing loss to the estate and the absence of any prospect for rehabilitation. The District Court rejected this argument.

In so doing, the District Court noted that the Debtor was not suffering substantial losses in the Bankruptcy Case and had sufficient liquidity to meet its administrative obligations. The District Court reinforced its conclusion by pointing to the significant savings realized by the Debtor from the stay on the accrual of interest under the AIG Revolver.[26]

Finally, with regard to the Former Executives' request that the Bankruptcy Court abstain, the District Court noted that abstention is "an extraordinary remedy that should be used sparingly and not as a substitute for a motion to dismiss under other sections of the Bankruptcy Code."[27]

The District Court concluded that the Bankruptcy Court had not abused its discretion in holding that the interests of the Debtor and its stakeholders would be better served by denying the request to dismiss the case under Bankruptcy Code Section 305.[28]

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[23] Id. at 16.

[24] Id. at 19.

[25] Id. at 19 (citing In re SGL Carbon Corp., 200 F.3d 154, 165 (3d Cir. 1999)).

[26] Id. at 21.

[27] Id.

[28] Id. at 22.

KEY TAKEAWAYS OF *AIG FINANCIAL*

The District Court shed further light on the standards for good faith bankruptcy filings recently enunciated in *In re LTL Management, LLC*.[29] LTL Management stressed that a bankruptcy petition could not be filed in good faith unless the debtor was in financial distress, the debtor filed the case to pursue a valid bankruptcy purpose, and the bankruptcy case was not filed merely to obtain a tactical litigation advantage.

In sum, the District Court clarified that a bankruptcy case could be a good faith filing even if a goal – but not the primary goal – was to obtain a tactical litigation advantage. As long as a debtor had other valid reasons to seek bankruptcy protection, a court should deny a motion to dismiss a bankruptcy case as a bad faith filing if the bad faith allegations are premised on the fact that the debtor would gain a tactical litigation advantage. This makes sense, as a debtor almost always obtains some tactical advantage from a bankruptcy filing, by virtue of the automatic stay of Bankruptcy Code section 362.

AIG Financial also clarified that "financial distress" does not mean a debtor must be "*in extremis*" in order to file a bankruptcy case in good faith. Where a debtor is insolvent and facing mounting liabilities it is unable to pay, a bankruptcy filing may become inevitable, and the debtor has no obligation to delay its Chapter 11 filing.[30]

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[29] In re LTL Management, LLC, 64 F.4th 84 (3d Cir. 2023).

[30] Opinion at 16.