ALERT MEMORANDUM

Texas Bankruptcy Court Dismisses the NRA's Chapter 11 Filing for Lack of Good Faith

May 18, 2021

On May 11, 2021, a Bankruptcy Court in the Northern District of Texas dismissed the bankruptcy petitions filed by the National Rifle Association ("NRA") and certain of its affiliates.[1] Judge Harlin D. Hale determined that the primary purpose of the NRA's filing was not to preserve itself as a going concern but to gain an improper litigation advantage in response to a regulatory action filed in New York by the state's Attorney General seeking its dissolution. Accordingly, the court determined that the Chapter 11 filing was not "an appropriate use of bankruptcy."

The ruling sheds useful light on pitfalls to avoid for debtors that may be contemplating a petition that could be contested by creditors. While the facts at issue for the NRA are extreme, the case underscores the importance of debtors clearly enunciating consistent and proper purposes for any bankruptcy filing and following adequate corporate governance when making the decision to file for bankruptcy. Finally, the case highlights the strategic importance of selecting the best venue given the different standards that courts use in evaluating bad faith.

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[1] *In re: National Rifle Association of America and Sea Girt LLC*, Case No. 21-30085, D.I. 740 (Bankr. N.D.Tex. May 11, 2021) (the "NRA Opinion").

Background

While its profile and reputation likely require no introduction, the NRA was chartered as a New York not for profit in 1871. Today, the organization has approximately five million members, almost 500 employees, and annual revenue of approximately $300 million. The organization is supported by member dues and private donor contributions. It is presently led by executive vice president Wayne LaPierre.[2]

In 2017, the New York Attorney general opened an investigation into the NRA for potential non-compliance with New York State not-for-profit law.[3] In 2020, the same office sued the NRA in state court for "violating numerous state and federal laws" as a result of self-dealing and other improper acts.[4] The lawsuit sought dissolution of the NRA and named several individual defendants as well, including Mr. LaPierre. The lawsuit also sought restitution, removal of Mr. LaPierre and another associate from the organization, and a prohibition on all individual defendants from serving on nonprofit boards in New York again.[5]

On January 15, 2021, the NRA filed for bankruptcy under Chapter 11 in the Northern District of Texas.[6] At the time of filing, the Mr. LaPierre announced in a statement that the organization was "dumping New York" and pursuing reincorporation in Texas because it "value[d] the contributions" of the organization and would be a friendlier host to it.

The filing prompted a response from several parties. On February 10, Ackerman McQueen, Inc., a former vendor that had handled public relations for the NRA for decades and more recently had been pursuing litigation against it, filed a motion to dismiss the Chapter 11 filing or, in the alternative, appoint a trustee pursuant to section 1104(a) of the Bankruptcy Code.[7] The New York and District of Columbia Attorneys General, as well as other parties, followed with their own motions.[8] On April 5, the Court commenced a twelve-day trial.

The Court's Decision

Under section 1112(b) of the Bankruptcy Code, a court shall dismiss a Chapter 11 case 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."[9] "Cause" is not defined in the Bankruptcy Code, but the Fifth Circuit Court of Appeals has held that the term provides "flexibility to the bankruptcy courts" and includes the debtor's filing for relief not being "in good faith."[10]

Courts around the country differ in the standards they use for evaluating good faith and on whom they place the burden. In the Third Circuit, which hosts Delaware (an important forum for bankruptcy filings), the burden is on the bankruptcy filer to establish good faith.[11] This makes the Third Circuit's standard easier to satisfy for creditors seeking dismissal. In contrast,

[2] As the Bankruptcy Court found, the "executive vice president" in the NRA is the organizational equivalent of a chief executive officer.
[3] NRA Opinion, at 3.
[4] *Id.* at 6.
[5] *Id.*
[6] The NRA filed for bankruptcy along with Sea Girt, LLC, a transition vehicle formed by the NRA to facilitate its relocation to Texas. The two cases were jointly administered and the Bankruptcy Court also focused on the NRA rather than Sea Girt because it was "formed to accomplish a shared bankruptcy purpose."
[7] *Ackerman McQueen, Inc.'s Motion to Dismiss the Chapter 11 Bankruptcy Petition, or, in the Alternative, Motion for the Appointment of a Chapter 11 Trustee, and Brief in Support* [Docket No. 131].
[8] *The State of New York's Motion to Dismiss, or, in the Alternative, to Appoint a Chapter 11 Trustee* [Docket No. 163]; *The District of Columbia's Motion in Support in the State of New York's Motion to Dismiss* [Docket No. 429]. Judge Journey, a longtime member and director of the NRA had also filed a motion seeking the appointment of an examiner under section 1104(c) of the Bankruptcy Code. The Court set all these motions for trial together due to the "overlapping facts and interrelated relief."
[9] 11 U.S.C. § 1112(b)(1) (2016).
[10] *In re Little Creek Dev. Co.*, 779 F.2d 1068, 1072-73 (5th Cir. 1986); *In re Humble Place Joint Venture*, 936 F.2d 814, 816–17 (5th Cir. 1991).
[11] *In re 15375 Mem'l Corp. v. Bepco, L.P.*, 589 F.3d 605, 618 (3d Cir. 2009).

the Fifth Circuit requires the party moving for dismissal to make a "prima facie showing of a lack of good faith," *after* which the burden shifts to the debtor to demonstrate such faith.[12] The Fifth Circuit, like almost every other federal Circuit, follows a "totality of the circumstances" approach to evaluating good faith.[13] A Chapter 11 petition is not filed in good faith if it does not "serve a valid bankruptcy purpose."[14]

If lack of good faith is found, a court must dismiss the filing unless appointing a trustee or examiner is "in the best interests of creditors and the [debtor's] estate." Upon the request of any party or the United States Trustee, the Court may appoint such a trustee to handle the debtor's estate or an examiner to investigate the debtor's handling of the estate.

The Court structured its analysis in this way: first, it reviewed the record to determine the NRA's primary purpose for the bankruptcy filing. Second, it examined whether this purpose was a valid use of the Bankruptcy Code or presented cause for dismissal. Then, it examined whether it needed to appoint a trustee or examiner or merely dismiss the bankruptcy filing.

The Court found that the NRA's "primary purpose" for filing the Chapter 11 was to evade the regulatory action brought by the New York Attorney General. To reach this determination, the Court examined the NRA's proffered reasons for its petition from its public statements and trial testimony. The Court noted that the NRA was solvent and had no "financial reason" to file for bankruptcy. The NRA contended that it sought to reorganize to streamline litigation costs and to modernize its 150-year-old charter, but the Court found them to be merely ancillary benefits of reorganization. The Court dismissed stated concerns about the appointment of a receiver, noting that the New York Attorney General had not sought the appointment of a receiver. The Court highlighted its concerns about the lack of internal deliberation within the NRA before the filing and the executive power vested in Mr. LaPierre,[15] and thus treated his testimony as most revealing, because he had authorized the filing without discussing it with the full Board. In trial testimony, Mr. LaPierre had stated that the NRA was reorganizing because New York state wanted to dissolve the organization and seize its assets, and the Court found that conclusive.

Then, the Court evaluated whether avoiding such regulatory action by a state was a valid use of the Bankruptcy Code. Because the NRA's conduct was trying to gain an "unfair advantage in litigation," the Court determined that the filing was not in good faith.

In doing so, the Court stated that it was not announcing a "*per se* rule" that a pending dissolution action renders a potential filer ineligible for bankruptcy, but only making a totality-of-the-circumstances judgment based on the specific facts. The Court also found that the judiciary has a duty to conduct a fact-intensive inquiry to check for avoidance of *any* exercise of police power, not just avoidance of one section of the Securities Act of 1933 (which is specifically carved out in Section 1129) as the NRA had contended.

Having found cause for dismissal, the Court held that appointment of a trustee or examiner was not necessary at this time. The NRA had started correcting its organizational controls; was solvent and could pay its creditors outside of bankruptcy; and could continue to fulfill its organizational mission. Thus, the Court dismissed the filing without prejudice.

[12] *In re Mirant Corp.*, 2005 Bankr. LEXIS 1686, at *27 n.20 (Bankr. N.D. Tex. Jan. 26, 2005).
[13] NRA Opinion, at 27 (citing *In re 15375 Mem'l Corp.*, 589 F.3d 605, 618 n.7 (3d Cir. 2009)).
[14] *Id.* at 12 (quoting *Off. Comm. of Unsecured Creditors v. Nucor Corp.* (*In re SGL Carbon Corp.*), 200 F.3d 154, 165 (3d Cir. 1999)).
[15] Indeed, the NRA"s general counsel only learned of the bankruptcy filing after the fact, *id.* at 19, and the board members were not apprised that a bankruptcy filing was being considered when they granted Mr. LaPierre the broad executive authority he ultimately used to authorize the filings.

Implications of the Case

The decision by the Bankruptcy Court means that the NRA must either file a Chapter 11 petition again — opening itself up to appointment of a trustee or examiner this time — or resolve its issues with the New York Attorney General outside of bankruptcy.

While the Court stated that the factual context made this an "odd twist for a bankruptcy case," its ruling still holds several takeaways for third parties.

Ensure Consistent Message about Valid Purpose of Bankruptcy Filing

First, the ruling underscores the importance of clearly articulating valid bankruptcy purposes when commencing a Chapter 11 case. Debtors considering bankruptcy due to anticipated losses in litigation must be cognizant that courts have dismissed cases intended to confer an unfair advantage in the litigation. Consistent communication, whether in court pleadings or public relations materials, is important. Most sophisticated Chapter 11 debtors develop press materials, frequently-asked-questions guides for their vendors, customers, and employees, and even websites devoted to the bankruptcy filing. In the NRA's case, several of these publicity materials had inflammatory language that the Bankruptcy Court relied on in reaching its decision that the Chapter 11 case was not filed in good faith. Parties using press materials, particularly in the context of a hotly contested proceeding, must remain aware that their statements — even rhetoric in internal documents — can be analyzed to evaluate the "good cause" of their eventual filing. Entities should consider involving counsel earlier in the process and having them vet such communications in order to avoid creating damaging evidence.

Importance of Good Corporate Governance

Second, entities considering a bankruptcy filing — and especially any anticipating challenges to such a filing — must ensure they have adequate corporate governance mechanisms and internal deliberative processes for making such decisions. The immense power the NRA's structure placed in Mr. LaPierre and the lack of any organizational votes or even deliberation weighed heavily in the Court's analysis.

The Critical Choice of Venue

Third, because jurisdictions have different standards for "bad faith" dismissal, venue is important. In the Fifth Circuit, the initial burden is on the party moving for dismissal to demonstrate lack of good faith. The Second Circuit goes one step beyond the Fifth Circuit, requiring the movant to demonstrate both subjective *and* objective bad faith.[16] In the Third Circuit, however, the burden is on the bankruptcy filer to establish good faith.

All State Police Power Actions Matter

Fourth, the Fifth Circuit's ruling emphasized that the judiciary has a duty to thoroughly analyze any bankruptcy filing for attempts to evade *any* exercise of police power. The NRA unsuccessfully made the novel argument that the judiciary's obligation was limited to analyzing attempts to evade Section 5 of the Securities Act of 1933. The NRA developed this argument based on the negative inference that Section 1129(d) prohibits confirmation of a plan whose principal purpose is the avoidance of Section 5 of the Securities Act of 1933. The Court disagreed, reasoning that Congress would not have made such a sweeping endorsement of using bankruptcy to evade police power through this one provision.

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[16] *In re RCM Glob. Long Term Capital Appreciation Fund, Ltd.*, 200 B.R. 514, 520 (Bankr. S.D.N.Y. 1996).