

Not So Fast! How Poor Planning Can Doom Your Chapter 11 Filing

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A Texas bankruptcy court's decision earlier this year to dismiss the National Rifle Association's ("NRA") chapter 11 bankruptcy case as a bad faith filing illustrates the perils of a poorly planned chapter 11 filing, and highlights the need, even in crisis situations, to establish solid objectives and develop a sound strategy *prior* to seeking relief under the Bankruptcy Code. *In re Nat'l Rifle Ass'n of Am.*, 628 B.R. 262 (Bankr. N.D. Tex. 2021). Unique facts and circumstances notwithstanding, *In re Nat'l Rifle Ass'n of Am.* provides textbook examples of things you should *not* do when filing a corporate chapter 11 case.

In its opinion, the Northern District of Texas Bankruptcy Court highlighted recent events in the history of the NRA prior to the bankruptcy filing, including: (1) the New York Attorney General ("NYAG") opening investigations into the NRA in 2017; (2) the New York Department of Financial Services urging insurers and financial institutions in April 2018, to evaluate whether their relationships with the NRA were harmful to their corporate reputations and jeopardized public safety; (3) multiple whistleblowers notifying the NRA Audit Committee in July 2018 about alleged misconduct by NRA management, including conflicts of interest of senior management and board members and improper reimbursement of living expenses for certain employees; and (4) the NYAG filing a complaint against the NRA in New York state court on August 6, 2020 seeking dissolution of the NRA (the "NYAG Action").

Approximately 3 months after the NYAG Action, on November 23, 2020, the NRA retained counsel to advise them on bankruptcy and restructuring options. The very next day, the entity "Sea Girt, LLC" was formed, as "a transition vehicle to facilitate the NRA's relocation to Texas." *Id.* at 267. At a board meeting on January 7, 2021, the NRA board approved the employment agreement of the NRA's Executive Vice President Wayne LaPierre, which included language allowing Mr. LaPierre to "exercise corporate authority in furtherance of the mission and interests of the NRA, including without limitation to reorganize or restructure the affairs of the Association for the purposes of cost-minimization, regulatory compliance or otherwise." *Id.* at 267-68. There was no discussion of bankruptcy or reorganization at the board meeting, and the board was never informed that the employment agreement authorized Mr. LaPierre to unilaterally file a bankruptcy petition for the NRA. A few days after the board meeting, on Jan. 15, 2021, the NRA and Sea Girt, LLC filed voluntary petitions for relief under Chapter 11.

Approximately one month into the bankruptcy case, multiple parties, including the NYAG, filed dispositive motions seeking various relief that the bankruptcy court categorized as generally falling into three buckets: (1) dismissal; (2) appointment of a chapter 11 trustee; or (3) appointment of an examiner. *Id.* at 270. In adjudicating the motions, the bankruptcy court adopted the Fifth Circuit's flexible view that the term "cause" in Section 1112(b)(4) could include "a finding that the debtor's filing for relief is not in good faith." *Id.* at 270.

The Court's good faith analysis largely focused on the NRA's reasons for filing bankruptcy. After evaluating the relevant arguments and evidence, the Court concluded that the real purpose for the bankruptcy filing was to avoid dissolution in the NYAG Action. The Court noted that although there was "some evidence that the NRA want[ed] to streamline litigation and control litigation costs,..." that did not appear to be "the real purpose" behind the bankruptcy filing. *Id.* at 278. On the contrary, there was testimony that the NRA could afford to pay its legal fees and there had not been any analysis done of the comparative cost of litigation outside of bankruptcy versus the cost of litigation within the bankruptcy case. While the question of "[w]hether the NRA's desire to leave New York and reincorporate in Texas was a true reason for filing bankruptcy [was] a closer call," the Court was not persuaded that the conditions faced by the NRA predating the NYAG Action were an existential threat and reason to file bankruptcy in order to move to Texas. *Id.* at 278. Testimony of the CFO, that "he was not aware of any reasons to file for bankruptcy" was also not supportive of the argument that the bankruptcy was filed for financial reasons. *Id.* at 279. In the Court's view, the other reasons that the NRA gave for filing bankruptcy, such as "preserving the NRA as a going concern" could all be grouped under the general reason of avoiding the dissolution in the NYAG Action. *Id.* at 279.

For its subsequent analysis of whether avoiding the dissolution in the NYAG Action was a valid purpose, the Court conducted the 2-pronged inquiry used by the Third Circuit, namely: "(1) whether the petition serves a valid bankruptcy purpose and (2) whether the petition is filed merely to obtain a tactical litigation advantage." *Id.* at 280. The Court reasoned that a lawsuit seeking a monetary judgment, which could be financially ruinous for a debtor, was different from a state enforcement action specifically seeking dissolution under that state's laws that must satisfy certain requirements. The Court found the NRA case to be a bad faith filing because its purpose was (1) "to deprive the New York AG of the remedy of dissolution, which is a distinct litigation advantage" and "[to deprive] the state of New York of the ability to regulate not-for-profit corporations in accordance with its laws." *Id.* at 281.

In considering whether appointment of a trustee or examiner was in the best interest of creditors, the Court noted "cringeworthy" facts such as the evidence of the NRA's past misconduct, including deficiencies in financial disclosures by senior management. *Id.* at 283. Even more concerning to the Court was the "surreptitious manner in which Mr. LaPierre obtained and exercised authority to file bankruptcy for the NRA," where he had excluded key people such as the CFO and the general counsel from the decision-making process. *Id.* at 284. The determination of whether or not to appoint a trustee or examiner was further complicated because the NRA's mission was, "at times, political and polarizing" and because "[t]he NRA does not sell goods or services" it would be difficult to find the appropriate fiduciary to serve as trustee or examiner. *Id.* at 284. Touting progress the NRA had made in recent years resulting in more disclosure and self-reporting, the Court concluded that, "[o]utside of bankruptcy, the NRA can pay its creditors, continue to fulfill its mission, continue to improve its governance and internal controls, contest dissolution in the NYAG Enforcement Action, and pursue the legal steps necessary to leave New York." *Id.* at 284-85.

In re Nat'l Rifle Ass'n of Am. vividly demonstrates the danger of hastily filing a chapter 11 case, and then formulating a narrative *post-petition* as to the reasons for the filing that are not supported by

evidence. Profoundly damaging to the NRA's position was the inconsistency between the NRA's arguments in bankruptcy court and the NRA's own publicly announced reasons for filing bankruptcy, including a posting on its NRA website which stated, "This action is necessitated primarily by one thing: the unhinged and political attack against the NRA by the New York Attorney General." The Court also expressed frustration at the lack of clarity caused by conflicting testimony of witnesses about the purpose of the bankruptcy filing. When the CFO testifies there is no financial reason to file bankruptcy, how do you argue that the bankruptcy was filed to reorganize the debtor? Also detrimental to the NRA's position were corporate governance failings where there was no vote or even any discussion by the Board about bankruptcy and restructuring options, and it was clear that the decision to file chapter 11 was made by one person. This case shows that, given the significant costs attendant to an imprudent bankruptcy filing that is later dismissed, it is essential to establish clear objectives, articulate a coherent strategy, and practice good corporate governance *prior* to filing a chapter 11 case.

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