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## BANKRUPTCY LAW

# Third Circuit Limits Use of Strategic Bankruptcy Filings

To enjoy the protections of Chapter 11, a solvent debtor must file in good faith

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A recent Third U.S. Circuit Court of Appeals decision limits the use of strategic bankruptcy filings by solvent companies. *In re Integrated Telecom Express Inc.*, 384 F.3d 108, reh'g denied, 389 F.3d 423 (3d Cir. 2004). The decision has significant impact on commercial tenants considering Chapter 11 filings as well as landlords dealing with unreasonable settlement demands from tenants.

In *Integrated*, the court ruled that a debtor's use of Chapter 11 to limit liability under a lease of real property pursuant to the statutory "cap" on lease rejection damages provided by 11 U.S.C. § 502 (b)(6), was not a good faith filing. While good faith in this context may be narrowly construed, *Integrated* further refined an issue previously addressed by the Third Circuit.

In *Integrated*, the debtor supplied

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software and equipment to the broadband communications industry. The debtor leased commercial space in Silicon Valley under a long-term lease. When the broadband communications industry collapsed, the debtor began to wind down its business and liquidate its assets outside of bankruptcy. In furtherance of that process, the debtor surrendered its premises to its landlord and attempted to negotiate a reduction of its remaining obligations. Specifically, the debtor proposed to reduce its obligations from more than \$26 million over the duration of the lease, to \$8 million. The landlord, however, was unwilling to accept the proposed reduction and rejected the debtor's settlement offers.

As a result of the landlord's recalcitrance, the debtor filed a Chapter 11 petition. The debtor sought to reject the unexpired lease of nonresidential real property under 11 U.S.C. § 365, and take advantage of the limitations of 11 U.S.C. § 502(b)(6) concerning the landlord's lease rejection claim. Generally, under 11 U.S.C. § 502(b)(6), a landlord's claim for damages resulting from the termination of a real property lease would be

limited to the obligations due under the lease for the greater of one year or 15 percent, not to exceed three years, of the remaining term of the lease, plus amounts due under the lease on the earlier of the bankruptcy filing date or the date the property was surrendered.

The debtor's motivation for its Chapter 11 filing was evident from both its negotiations with the landlord and its own internal discussions. Minutes from a meeting of the board of directors and prior correspondence to the landlord revealed that the principal, if not sole reason, for the debtor's Chapter 11 filing was to reject the lease and limit the landlord's lease rejection claim. *Integrated*, 384 F.3d at 112-15. At the time of its Chapter 11 filing, the debtor had ceased all business operations and held sufficient cash (\$105 million) to pay its creditors in full. The only claims that existed belonged to an unliquidated class action claim and the landlord's lease claim.

In response to the debtor's motion to reject the lease, the landlord moved to dismiss the debtor's bankruptcy case pursuant to 11 U.S.C. § 1112(b). The landlord's motion was based on the

debtor's alleged lack of good faith in filing its Chapter 11 petition. The landlord argued that the sole reason for the filing was to unfairly and abusively take advantage of the statutory cap provided by 11 U.S.C. §502(b)(6). The landlord argued that its claim for more than \$26 million would be unfairly capped at \$4.3 million.

The bankruptcy court granted the debtor's motion to reject the lease, capped the landlord's rejection damage claim at \$4.3 million, and denied the landlord's motion to dismiss the Chapter 11 case. *Integrated*, 384 F.3d at 115. Thereafter, the debtor sold its remaining assets for \$2.5 million and obtained approval of a liquidating plan that addressed and capped its liability in the class action suit.

On appeal, the district court affirmed the bankruptcy court, reasoning that the lower court had not abused its discretion in determining the debtor's Chapter 11 was filed in good faith, and that the bankruptcy court's determination was supported by the Third Circuit's earlier decision of *In re PPI Enters. (U.S.) Inc.*, 324 F.3d 197 (3d Cir. 2003), where the court held that bad faith is not established per se where a debtor files a Chapter 11 case for the purpose of utilizing provisions that alter prepetition rights. *Integrated*, 384 F.3d at 117-18.

The Third Circuit reversed. The Third Circuit specifically found that the lower courts erred in concluding that the debtor had filed its Chapter 11 in good faith. Relying upon standards previously articulated in *In SGL Carbon Corp.*, 200 F.3d 154, 159-62 (3d Cir. 1999), the Third Circuit stated:

We conclude that the collapse of Integrated's business model does not support a finding of good faith. Integrated was not suffering financial distress when it filed its petition and the rulings of the Bankruptcy Court and the District Court to the contrary constitute legal error. Failure of Integrated's business did not subject the company to any pressure on the value of its assets that could be reduced or

avoided in an orderly liquidation under chapter 11. Because Integrated's economic difficulties do not establish that Integrated was suffering from financial distress, they do not, standing alone, establish that Integrated's petition was filed in good faith. *Integrated*, 384 F.3d at 123.

The Third Circuit distinguished its ruling in *PPI*, by noting that when the debtor in *PPI* filed its Chapter 11, it was arguably insolvent. *Integrated*, 384 F.3d at 122-23. In contrast, the debtor in *Integrated* held more than \$105 million in cash and was solvent. Moreover, although the debtor-tenant in *PPI* specifically sought to limit the landlord's claim for future rent, the Third Circuit, in that case, determined that the debtor's intended use of 11 U.S.C. §502(b)(6) was the express purpose for which the section was enacted. In short, the Third Circuit in *PPI* affirmed the notion that an insolvent debtor can target its landlord and avail itself of the statutory damage cap in an effort to maximize the benefit to the estate. *PPI*, 324 F.3d at 200-01; see *Integrated*, 384 F.3d at 123-24. The court in *PPI* further reasoned that the debtor's financial condition and its ability to maximize the value of its estate through a Chapter 11 filing are critical components of a good faith finding. *PPI*, 324 F.3d at 200-01; see *Integrated*, 384 F.3d at 122-23.

The debtor in *Integrated*, however, was not insolvent and was forced to advance three additional arguments that its petition was filed in "good faith." The debtor argued that: (a) the sale of its assets was enhanced by bankruptcy court oversight; (b) the establishment of a bar date was beneficial to address unknown and inchoate claims; and (c) Chapter 11 provided an efficient procedure to distribute assets. *Integrated* 384 F.3d at 126-27. The Third Circuit rejected each of these arguments and specifically held that facilitating a liquidation of assets that was favorable to equity holders, at the expense of the debtor's creditors, was not a valid purpose of Chapter 11. Id. at 127-28. The

use of the bankruptcy forum was inappropriate in *Integrated* to resolve the landlord's claim because the Third Circuit determined there was no support for allowing tenants to avoid lease obligations, pursuant to 11 U.S.C. §502(b)(6), whenever the landlord's state law remedy would exceed the statutory cap by an amount greater than the cost of proceeding through a Chapter 11 reorganization or liquidation. Id. at 128-29.

The Third Circuit's analysis in *Integrated* was influenced by the board resolution authorizing the Chapter 11 filing if major concessions could not be obtained from the landlord. Id. at 129. This "smoking gun" was a crucial fact allowing the Third Circuit to determine that the filing was being used primarily to limit the landlord's claims and increase potential distributions to equity holders. Id.

Through its decision in *Integrated*, the Third Circuit has signaled that the proper function of a Chapter 11 filing is to create or preserve some value that would otherwise be lost, and not simply to distribute assets pursuant to a statutory scheme. Id. at 129. The debtor in *Integrated* failed to identify any value that would be preserved or maximized in an orderly liquidation under Chapter 11, which value was otherwise threatened outside of the bankruptcy process by the collapse of Integrated's business model. Consequently, the Third Circuit reversed the lower courts' rulings and remanded the *Integrated* case to the bankruptcy court with instructions to dismiss the debtor's petition.

The lesson to be drawn from *Integrated* is that Chapter 11 filings in the Third Circuit will be scrutinized when the facts demonstrate that an arguably solvent debtor has sought to abuse the bankruptcy process by unfairly targeting landlords. Therefore, a debtor in the Third Circuit must be prepared to address whether its petition was filed to serve one of the overriding purposes of Chapter 11, i.e., maximizing value to the estate and the debtor's creditors; reorganization and rehabilitation of the debtor's business; and the preservation of a going

concern. Ultimately, while the Third Circuit affirmed that it is not unfair to seek a tactical advantage by filing a

Chapter 11 petition and utilizing the provisions of the bankruptcy code to preserve value, the advantages enjoyed

by the debtor must only be a collateral benefit of an otherwise good faith filing. ■