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WHEN A SOLVENT DEBTOR FILES FOR REORGANIZATION, IS THE FILING “PER SE” BAD FAITH?

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In their article, *Courts Reign in Solvent Debtor Bankruptcies by Handing Landlords Significant Victories*, 5 NORTON BANKR. L. ADVISER 3 (2005), John D. Fredericks and Eric E. Sagerman argue that *In re Liberate Technologies*, 314 B.R. 206 (Bankr. N.D. Cal. 2004), and *NMSBPCSLDHB, L.P. v. Integrated Telecom Express, Inc.* (*In re Integrated Telecom Express, Inc.*), 384 F.3d 108 (3d Cir. 2004), *cert. denied*, 2005 WL 544094 (June 6, 2004), reflect a trend away from prior cases that allowed solvent debtors to reorganize. As explained here, these recent decisions depart from a long line of cases holding that a debtor's good faith should be determined from a “totality of circumstances”—including solvency of the debtor—but not determined exclusively by

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the debtor's solvency. Further, this excessive focus on the debtor's solvency creates an additional eligibility requirement not found in 11 U.S.C. § 109(d) or (e). It is too soon to declare that the courts have shifted away from or abandoned the "totality of circumstances" approach and instead adopted the holdings in *Liberate and Integrated*.

Good Faith in the Code

The requirement that a plan be filed in "good faith" is mentioned in both § 1129 and § 1325 of the Bankruptcy Code (Chapter 12 also has a good faith requirement in § 1225(a)(3) that is identical to § 1325(a)(3)).

Section 1129(a) states in part that a court shall confirm a plan only if, among other things, "the plan has been proposed in good faith and not by any means forbidden by law." 11 U.S.C. § 1129(a)(3). Section 1325(a)(3) similarly provides that plan confirmation requires that the plan be proposed in good faith and not by any means forbidden by law.

Lack of good faith is conspicuously absent from the Code sections describing appropriate "cause" to dismiss or convert a Chapter 13 or Chapter 11 filing. *See* 11 U.S.C. §§ 1112(b) and 1307(c). Courts have generally found that a petition must be filed in good faith whenever a debtor is seeking the rehabilitative goals of Chapter 11, and require that a debtor show that its filing presupposes a "valid reorganizational purpose." *In re SGL Carbon Corp.*, 200 F.3d 154, 164 (3d Cir. 1999). Even though "good faith" is not listed in § 1112 or § 1307, courts have found an implicit requirement that petitions be filed in good faith and that a court may use its equitable power to prevent a misuse or abuse of the rehabilitative provisions of Chapters 11 and 13. *Alt v. United States (In re Alt)*, 305 F.3d 413 (6th Cir. 2002); *In re Adell*, 310 B.R. 460, 465 (Bankr. M.D. Fla. 2004). (There are several cases which have found that Chapter 7 does not have a similar good faith requirement. *See Neary v. Padilla (In re Padilla)*, 222 F.3d 1184, 1193 (9th Cir. 2000).) Courts have generally employed a "to-

talities of circumstances" test when determining whether a petition has been filed in good faith. *See generally Leavitt v. Soto (In re Leavitt)*, 171 F.3d 1219 (9th Cir. 1999) (Chapter 13); *Finney v. Smith (In re Finney)*, 992 F.2d 43 (4th Cir. 1993) (Chapter 11); *In re Love*, 957 F.2d 1350, 1357 (7th Cir. 1992) (rejected by, *In re Lilley*, 91 F.3d 491 (3d Cir. 1996) (Chapter 13)); *Winslow v. Williams Group (In re Winslow)*, 949 F.2d 401 (10th Cir. 1991) (Chapter 11).

Two recent courts have dismissed petitions not based on a "totality of circumstances" analysis, but instead dismissed petitions as bad faith filings on the sole ground that a debtor is solvent. Are these decisions creating a "per se" rule that a solvent debtor is precluded from filing a good faith petition for reorganization, creating an additional eligibility requirement for reorganization under Chapter 11 or Chapter 13?

Chapter 11 Cases—A Differing View on Solvency

It is well established that a debtor need not be insolvent before filing for bankruptcy protection. *SGL Carbon*, 200 F.3d at 163. The Code does not require specific evidence of insolvency for a voluntary Chapter 11 filing. *In re Mid-Valley, Inc.*, 305 B.R. 425, 430 (Bankr. W.D. Pa. 2004). In the past, courts have considered a debtor's solvency as a factor in determining whether or not a petition is filed in good faith. *See, e.g., SGL Carbon*, 200 F.3d at 163. Recently, two courts have abandoned the "totality of circumstances" test and focused on a debtor's solvency exclusively to determine whether or not a petition is filed in good faith.

Liberate and Integrated Telecom—Solvency Precludes a Finding of Good Faith

In the case of *Liberate Technologies*, the debtor had over \$212 million of unrestricted cash on hand at the time it filed its Chapter 11 petition. The debtor sought to cap a landlord's claim at \$8 million from the \$45 million scheduled claim pursuant to

§ 502(b)(6). The court, analyzing whether the petition was filed in good faith, stated that the most conspicuous prerequisite for obtaining Chapter 11 bankruptcy relief is that the debtor need Chapter 11 relief. *Liberate*, 314 B.R. at 211. It further held that a case could not be found to have been filed in good faith if the sole purpose of the solvent debtor's filing was to take advantage of a particular section of the Code (here, § 502(b)(6)). *Liberate*, 314 B.R. at 216.

The Third Circuit reached a similar conclusion in *Integrated Telecom*. In that case, the debtor had over \$105 million in cash which exceeded its liabilities by over \$70 million. Again, the debtor sought to cap a landlord's claim under § 502(b)(6), reducing the claim from \$26 million to \$4.3 million. The Third Circuit found that the bankruptcy filing was in bad faith because the debtor did not have any financial distress; it was solvent. *Integrated Telecom*, 384 F.3d at 122. The court further based its conclusion on the fact that the filing of the petition did not maximize value for creditors as a whole, but instead facilitated dissolution on terms favorable to equity interests. *Integrated Telecom*, 384 F.3d at 126. Lastly, the court stated "[t]o be filed in good faith, a petition must do more than merely invoke some distributional mechanism in the Bankruptcy Code. It must seek to create or preserve some value that would otherwise be lost—not merely distributed to a different stakeholder—outside of bankruptcy." *Integrated Telecom*, 384 F.3d at 129.

Solvency is a Factor in Determining Good Faith, but Not a Bar to Filing

The *Liberate* and *Integrated Telecom* decisions remain the minority decisions, with other courts continuing to allow solvent debtors to seek bankruptcy protection to reorganize under the Code.

In the case of *In re Chameleon Systems, Inc.*, 306 B.R. 666, 672 (Bankr. N.D. Cal. 2004), the court held that a solvent debtor (with enough cash to cover its liabilities) could file a bankruptcy petition to cap a

landlord's claim under § 502(b)(6), noting that "there is no reason [the debtor] should remain in operation for the sole purpose of servicing this lease."

The court in *Solow v. PPI Enterprises (U.S.), Inc. (In re PPI Enterprises (U.S.), Inc.)*, 324 F.3d 197 (3d Cir. 2003) discussed the relevancy of the solvency of a Chapter 11 debtor that sought to limit a landlord's claim under § 502(b)(6). The Third Circuit, which later decided *Integrated Telecom*, found in this case that a debtor's solvency was not relevant to an application of § 502(b)(6) and that there was no requirement in the Code that a debtor be insolvent. The court affirmed the bankruptcy court's decision that it is not bad faith for debtors to file for bankruptcy in order to take advantage of a particular provision of the Code. *In re PPI Enterprises (U.S.), Inc.*, 228 B.R. 339, 345 (Bankr. D. Del. 1998), *aff'd*, 324 F.3d 197 (3d Cir. 2003). The bankruptcy court further held that the debtor was using § 502(b)(6) for exactly its intended purpose. *PPI*, 228 B.R. at 345. The *PPI* court relied on a "totality of the circumstances" test and found that in evaluating a debtor's good faith, the court's only inquiry is to determine whether the debtor seeks to abuse the bankruptcy law by employing it for a purpose for which it was not intended. *PPI*, 228 B.R. at 345.

In *In re Federated Dep't Stores, Inc.*, 131 B.R. 808, 813 (S.D. Ohio 1991), the court did not prohibit a debtor from filing Chapter 11, instead finding that a "debtor's duty to unsecured creditors who happen to be lessors does not include the performance of an otherwise useless act for the sole purpose of helping the lessor to avoid the statutory cap of § 502(b)(6)."

Other Chapter 11 Cases Raising Solvency of the Debtor

Cases discussing a solvent Chapter 11 debtor's good faith are not limited to instances where the debtor seeks to utilize § 502(b)(6).

The Ninth Circuit in *Platinum Capital, Inc. v. Sylmar Plaza, L.P. (In re Sylmar Plaza, L.P.)*, 314 F.3d 1070 (9th Cir. 2002),

cert. denied, 538 U.S. 1035, 123 S. Ct. 2097, 155 L. Ed. 2d 1065 (2003), ruled in favor of a debtor and held it was not per se bad faith to file a bankruptcy plan solely to use the cure and reinstatement provisions of § 1124(2). The debtor owned a shopping center that was subject to a secured loan. The debtor ultimately defaulted on the loan. The debtor sold the shopping center free and clear of the bank's lien. The secured lender objected to the debtor's plan that allowed the debtor to pay the lender's claim at the nondefault interest rate. The Ninth Circuit found that insolvency is not a prerequisite to a finding of good faith, and that a creditor's contractual rights are adversely affected by a bad faith filing. *Sylmar Plaza*, 314 F.3d at 1074-75.

Chapter 13 Cases

Chapter 13 debtors may also take advantage of particular Code sections that may adversely impact a single creditor. Consider the following hypothetical. A Chapter 13 debtor owns real estate which is not his primary residence. He is current on the mortgage obligation on the property and has no other debt (either secured or unsecured). The value of the property is less than the amount of the mortgage. The debtor files Chapter 13 for the sole purpose of bifurcating his mortgage obligation under § 506(a) into secured and unsecured portions with the intent of paying the secured portion and paying a percentage of the unsecured portion over the life of the Chapter 13 plan. Would this filing be a good faith filing?

Under the holdings of *PPI*, *Chameleon* and *Sylmar Plaza*, the hypothetical case would survive a good faith inquiry because the debtor was using the Code "for a purpose for which it was intended." The *Liberate* and *Integrated Telecom* courts would reach a different result. Which result is correct? As stated previously, courts have held that solvency is not a prerequisite to filing either a Chapter 11 or 13 petition. The *Liberate* and *Integrated Telecom* courts have become gatekeepers, preventing a certain class of debt-

ors, namely those that are solvent, from filing petitions to reorganize. However, it is unclear what section of the Code these courts rely on to reach a determination that solvency is a barrier to a good faith filing and why they have abandoned a "totality of the circumstances" test. Clearly, they are not relying on § 109 that governs a debtor's eligibility.

Eligibility Under § 109

Section 109(d) states:

Only a railroad, a person that may be a debtor under Chapter 7 of this title (except a stockbroker or a commodity broker), and an uninsured State member bank, or a corporation organized under section 25A of the Federal Reserve Act, which operates, or operates as, a multi-lateral clearing organization pursuant to section 409 of the Federal Deposit Insurance Corporation Improvement Act of 1991 may be a debtor under Chapter 11 of this title.

11 U.S.C. § 109(d).

Section 109(e) states:

Only an individual with regular income that owes, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts of less than \$307,675 and noncontingent, liquidated, secured debts of less than \$922,975, or an individual with regular income and such individual's spouse, except a stockbroker or a commodity broker, that owe, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts that aggregate less than \$307,675 and noncontingent, liquidated, secured debts of less than \$922,975 may be a debtor under Chapter 13 of this title.

11 U.S.C. § 109(e).

Solvency is conspicuously absent as a factor to determine a debtor's eligibility under Chapter 11 or 13. By requiring a debtor to be insolvent, the *Liberate* and *Integrated Telecom* courts are adding an additional re-

quirement of eligibility that is not found in the Code.

If Congress had intended solvency to be a requirement for filing Chapter 11 or Chapter 13, it would have written it into § 109(d) or (e). Indeed, Chapter 9 eligibility requires that a debtor under that chapter be insolvent. 11 U.S.C. § 109(c)(3).

Conclusion

Based upon a literal reading of the Code, if a debtor meets the eligibility requirements found in § 109, it should be able to attempt to propose a plan of reorganization. Courts should employ a "totality of the circumstances" test to each case to determine whether a particular debtor has filed its petition in bad faith, considering a debtor's solvency as a factor (not the only factor). As stated earlier, Fredericks and Sagerman's article which heralded a shift from the "totality of circumstances" may be premature. Further, the holdings in *Liberate* and *Integrated Telecom* ignore the plain language of § 109(d) and (e) which allow a solvent debtor to file a petition to reorganize. As the Supreme Court has held in *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290 (1989), when a statute is unambiguous on its face, it must be read literally.

The mere fact that a debtor is solvent should not cause a case to lack good faith "per se." A debtor may file for the sole purpose of taking advantage of certain Code sections such as § 502(b)(6) or § 506(a). To preclude a solvent debtor from filing for reorganization when it seeks to take advantage of certain sections of the Code creates an additional requirement of eligibility. If Congress had intended that debtors seeking reorganization be insolvent, it would have drafted such language into § 109(d) or (e), as it did in § 109(c). In its present form, that language is not included in § 109 and this author believes that the courts seeking to add this additional eligibility requirement are thwarting congressional intent by limiting Chapter 11 or Chapter 13 filings to insolvent debtors.



From the Appellate Courts

RECENT DECISIONS FROM THE APPELLATE COURTS

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FIRST CIRCUIT

Boston Reg'l Med. Ctr., Inc. v. Reynolds (In re Boston Regional Medical Center, Inc.), 410 F.3d 100 (1st Cir. 2005). In the context of a liquidating plan of reorganization, bankruptcy court's related-to jurisdiction does not diminish postconfirmation to the same degree it would in a viable, reorganized debtor case.

Research References: Norton Bankr. L. & Prac. 2d § 95:6

West's Key Number Digest,
Bankruptcy ⇨ 3570

Hannigan v. White (In re Hannigan), 409 F.3d 480 (1st Cir. 2005). Debtor cannot amend schedules to take full advantage of homestead exemption when debtor intentionally undervalued his home.

Research References: Norton Bankr. L. & Prac. 2d § 46:33; Bankr. Serv., L Ed §§ 26:380, 26:1050

West's Key Number Digest,
Bankruptcy ⇨ 2796, 2798

SECOND CIRCUIT

Pereira v. Farace, 413 F.3d 330 (2d Cir. 2005). Standing in the shoes of the debtor corporation, Chapter 7 trustee cannot maintain "due care" claim against debtor's directors, when exculpatory language in the corporate charter would preclude the debtor from bringing such claims. Trustee argued un-