

## **COURT RULES AGAINST A SOLVENT DEBTOR**

**3D CIRCUIT EMPHASIZED THAT BANKRUPTCY PETITION MUST BE FILED IN GOOD FAITH.**

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Insolvency is not a prerequisite for filing for bankruptcy protection. Solvent debtors have, in the past, used bankruptcy as a sword rather than a shield in an effort to enhance their financial position. This practice has now come into question as courts will take a closer look at the debtor's reasons for filing for bankruptcy protection to make certain the bankruptcy process is not being abused.

Recently, the 3d U.S. Circuit Court of Appeals held that a cash-rich debtor that sought to limit a landlord's breach of lease claim by filing for bankruptcy protection failed to prove that the bankruptcy petition was filed in good faith. In *re Integrated Telecom Express Inc.*, 384 F.3d 108 (3d Cir. 2004). The case was remanded to the bankruptcy court with instructions to dismiss the case. The 3d Circuit reinforced the bankruptcy court's role in ensuring that the objectives of rehabilitation and reorganization are balanced against the potential use of bankruptcy law to destroy and undermine the legitimate rights and interests of those intended to benefit from the law.

Integrated Telecom was a supplier of software and equipment to the broadband communications industry. In early 2001, Integrated signed a 10-year lease for space in Silicon Valley. Shortly thereafter, Integrated Telecom's business began to deteriorate, resulting in a net operating loss of \$36.2 million in fiscal 2001. To make matters worse, at the end of 2001, Integrated was named as a defendant in a \$93 million securities lawsuit.

Integrated sought the advice of a technology consultant and retained the services of an investment banker to investigate the potential sale or merger of the business. Unable to formulate an alternative business plan, Integrated chose to close its doors and liquidate its assets.

Integrated Telecom immediately entered into an agreement to sell its assets for \$1.5 million and contacted its landlord to discuss terminating the lease. Although the landlord's breach of lease claim would total about \$26 million, Integrated offered to pay the landlord \$8 million in full satisfaction of the balance due on the lease. To convince the landlord that the offer was reasonable, Integrated's counsel sent the landlord a letter advising that Integrated was prepared to

file for bankruptcy protection to "avail itself of various provisions of the Bankruptcy Code, including the cap on landlord's claims set forth in 11 U.S.C. § 502(b)(6)." 384 F.3d at 114.

Under Bankruptcy Code § 502(b)(6), a landlord's claim for damages for termination of a lease of real property is limited to the greater of one year's rent or 15% of the balance due on the lease, not to exceed three years' rent. 11 U.S.C. 502(b)(6). Integrated's attorneys attempted to convince the landlord that if Integrated was forced to file for bankruptcy protection, the claim would be capped at \$4 million, and that therefore Integrated's offer of \$8 million was very reasonable. The landlord rejected Integrated's offer, and the company filed a petition under Chapter 11 on Oct. 8, 2002, less than two years after the signing of the 10-year lease.

#### **STILL IN THE BLACK**

On its bankruptcy schedules, Integrated listed assets totaling \$107 million, including \$105.4 million in cash. On the debt side of the equation, Integrated owed \$26 million to the landlord, which was the presented discounted value of the balance of the lease obligation, \$5 million as the estimated exposure on the securities litigation and \$430,000 of miscellaneous debt. Although Integrated believed the securities action would settle for \$25 million, there was insurance coverage of \$20 million, leaving Integrated exposed for about \$5 million.

Integrated was solvent from a balance-sheet point of view to the tune of \$75 million. However, if the landlord's claim could be capped under bankruptcy law in the amount of \$4.3 million, the net equity would jump to about \$96 million, which, at the conclusion of the bankruptcy case, would be paid to the shareholders. To no surprise, the landlord aggressively opposed the bankruptcy case to avoid having Integrated redistribute \$21.7 million of its damage claim to the shareholders through the bankruptcy case.

Immediately after filing for bankruptcy protection, Integrated filed a motion to approve the sale of its intellectual property assets for \$1.5 million, filed a motion to reject the lease with the landlord and started formulating its bankruptcy plan. The plaintiffs in the securities lawsuit agreed to limit any judgment against Integrated to \$25 million. Since Integrated had \$20 million of insurance coverage for the claim, Integrated's exposure was reduced to \$5 million. The bankruptcy court approved the sale of the intellectual property rights which, after the initial objections to the sale were resolved, sold for \$2 million (\$500,000 above the original offer).

In response to the motion to reject its lease, the landlord filed a motion to dismiss the bankruptcy case on the ground that the bankruptcy case was not filed in good faith and, as the debtor, Integrated had the burden of proving good faith. Integrated responded to the landlord's motion to dismiss the bankruptcy case by arguing that there is no requirement that a debtor be insolvent to avail itself to bankruptcy protection and, more important, it had numerous valid reasons to file for bankruptcy protection.

Integrated argued that it was a financially distressed company and bankruptcy would enable it to sell its assets at a public auction with court oversight, resulting in a quick, orderly and efficient winding down of its business. Additional benefits of the bankruptcy included the increased offer

for Integrated's intellectual property rights by \$500,000 as well as assistance in negotiating a deal with the securities claimants who agreed to limit Integrated's exposure to \$5 million from a \$93 million claim. Integrated argued that, without a settlement with the securities claimants, any state court liquidation would be held up for years.

The bankruptcy claim procedures allowed Integrated to set a claims bar date and permit it to identify the universe of claims against its business. Finally, Integrated argued that the lease damage cap was expressly incorporated into the Bankruptcy Code and reflects a "Congressional determination that landlords stand to receive a windfall in a bankruptcy, and that landlord claims are inherently speculative." 384 F.3d at 128.

Looking at the totality of the circumstances, Integrated argued it met its burden of proving that its bankruptcy petition was filed in good faith. The bankruptcy court agreed, and the district court affirmed the bankruptcy court's decision.

The landlord appealed to the 3d Circuit. The 3d Circuit started by noting that Integrated bears the burden of proving good faith in a very fact-sensitive inquiry requiring the court to review the totality of the facts and circumstances surrounding the bankruptcy case. The court must make a determination as to where the bankruptcy falls along the spectrum ranging from the clearly acceptable to the patently abusive.

#### **THE 3D CIRCUIT'S ANALYSIS**

In framing the issue, the 3d Circuit restated the two basic purposes of Chapter 11: "(1) preserving going concerns and (2) maximizing property available to satisfy creditors." 384 F.3d at 119. These two purposes, the 3d Circuit noted, guide the court in its application of the doctrine of good faith. The 3d Circuit found that courts focus "on two inquiries that are particularly relevant to the question of good faith: (1) whether the petition serves a valid bankruptcy purpose, e.g., by preserving a going concern or maximizing the value of the debtor's estate, and (2) whether the petition is filed merely to obtain a tactical litigation advantage." *Id.*

Since Integrated ceased all operations, the court concluded there was no going-concern value to preserve. Therefore, the inquiry turned on whether Integrated's petition might reasonably have maximized the value of the bankruptcy estate.

In order to establish that the bankruptcy petition maximizes the value of the bankruptcy estate, there must be proof of some value that would be lost outside of bankruptcy. The court focused on "value"-inside and outside of bankruptcy. What assets are threatened outside of bankruptcy that could be "preserved or maximized in an orderly liquidation under Chapter 11"? 384 F.3d at 122. What was being done before bankruptcy that was jeopardizing the value of Integrated's assets? Keep in mind that Integrated's assets included \$105.4 million in cash and \$2 million in intellectual property rights.

The 3d Circuit reviewed the record and concluded that there was no proof that the value of Integrated's assets was being threatened outside of bankruptcy, but could be preserved by a

bankruptcy filing. The financial problems causing it to close its business had no relation to the debts it owed to its creditors. Some level of financial distress must be present and capable of being relieved by the bankruptcy filing. Merely going out of business and losing money is not enough.

The 3d Circuit next distinguished the two main cases relied upon by the bankruptcy court: PPI Enterprises Inc., 228 B.R. 339 (Bankr. D. Del. 1998), aff'd 324 F.3d 197 (3d Cir. 2003), and Sylmar Plaza L.P., 314 F.3d 1070 (9th Cir. 2002). The 3d Circuit found compelling the fact that in both cases the debtor was insolvent or there was no proof that the debtor would have emerged from bankruptcy solvent without bankruptcy protection. As a result, the 3d Circuit concluded that the debtors in PPI and Sylmar were able to prove that Chapter 11 was being used to maximize value for creditors as a whole.

The 3d Circuit quickly rejected many of the other reasons advanced by Integrated. With regard to the securities litigation, the 3d Circuit found that the litigation did not threaten the value of Integrated's assets since there appeared to be ample insurance coverage to satisfy \$20 million of the estimated \$25 million claim. The record also did not support Integrated's allegation that the bankruptcy forced the securities claimants to agree to a cap of \$25 million, with \$20 million being covered by insurance. The 3d Circuit concluded that Integrated filed its petition, in part, to gain a litigation advantage over the securities claimants, which is not a valid bankruptcy purpose. The court also did not believe the \$500,000 increase in the sale price of the intellectual property right was significant in light of Integrated's \$104 million in cash, or that Integrated needed to invoke the bankruptcy claim procedures.

Integrated's final argument was that the goal of using Bankruptcy Code § 502 establishes good faith in and of itself. Although the 3d Circuit agreed that seeking to avail oneself of a particular Bankruptcy Code section does not establish bad faith, likewise, it does not, "standing alone, establish[] good faith." 384 F.3d at 128. Simply put, one needs additional factors to meet the burden of good faith. To get to Bankruptcy Code § 502, the debtor must first hurdle the good-faith challenge.

#### **SERVING A PURPOSE OF CHAPTER 11**

Although the 3d Circuit reaffirmed that a solvent debtor may file for bankruptcy protection and that seeking to invoke a single bankruptcy code section is not per se bad faith, solvent debtors must still convince the court that their bankruptcy plans are consistent with the purpose of Chapter 11. Before a debtor unsheathes its sword to strike at creditors, it must prove it belongs in the bankruptcy arena. The analysis is very fact sensitive, and Integrated failed to meet its burden of proof.

Companies facing a similar situation must be prepared to create a record before the bankruptcy court that leads to the conclusion that bankruptcy protection is required to preserve value for creditors that would be lost outside of bankruptcy. The record clearly showed that outside of bankruptcy, Integrated would merely have to pay its debt in full and the value of its assets (primarily cash) was not in jeopardy. Inside of bankruptcy, the record established that the value

to Integrated's shareholders would be preserved and maximized at the expense of Integrated's creditors, a result which does not further the purpose of Chapter 11.

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