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# Will "Good Faith" Keep Solvent Companies From Filing Chapter 11?

In a decision that sets the outer limits of the good faith requirement for filing a chapter 11 petition, the Court of Appeals for the Third Circuit in NMSBPCSLDHB, L.P. v. Integrated Telecom Express, Inc. (In re Integrated Telecom Express, Inc.), 384 F.3d 108 (3d Cir. 2004) recently dismissed a chapter 11 case and held that a solvent debtor with no intent of reorganizing did not file its chapter 11 petition in "good faith" where the debtor filed solely to limit a landlord's claim. Although the Third Circuit reaffirmed that a solvent company may file for bankruptcy protection, its interpretation of the good faith standard leaves little doubt that a solvent company needs more than a desire to take advantage of the Bankruptcy Code's statutory protections to maximize value for equity in order to justify chapter 11 relief.

**Facts**

The debtor, Integrated Telecom Express, Inc. ("Integrated"), was a supplier of software and equipment to the broadband communications industry. After suffering significant losses in 2001, Integrated sought proposals for a sale or merger of its assets. Unable to find an interested buyer, Integrated pursued a plan of liquidation and dissolution under Delaware law. It faced two impediments: (1) the disposition of its intellectual property rights and (2) its remaining obligations to NMSBPCSLDHB, L.P. ("Landlord"), its landlord under a ten year lease. Although Integrated found a buyer for its intellectual property, it was unable to settle its lease obligations. Accordingly, Integrated's Board of Directors authorized a chapter 11 filing if the Landlord would not accept $8 million to settle the lease, and Integrated's bankruptcy counsel sent the Landlord a letter to that effect. The parties did not reach agreement and Integrated filed for chapter 11 relief. At the time it filed, Integrated had $105.4 million in cash and $1.5 million in other assets. Along with Integrated's lease obligations of approximately $26 million, Integrated listed miscellaneous liabilities of approximately $430,000. It was also a defendant in a securities class action lawsuit. The day after Integrated filed its bankruptcy petition, it moved to reject the Landlord's lease. The Landlord opposed the motion, and shortly thereafter moved to dismiss the chapter 11 case on the ground that Integrated did not file its petition in good faith.

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**Procedural History**

After an evidentiary hearing, the Bankruptcy Court denied the Landlord's motion to dismiss on two grounds. First, the Bankruptcy Court found that Integrated had provided a number of reasons for going into chapter 11, including its dramatic financial losses and the "downward spiral" of its business in 2001. The Bankruptcy Court therefore concluded that "the Board had an obligation, and appropriately exercised that obligation, to give the investors their money back." Second, the Bankruptcy Court held that even if Integrated's reasons for filing bankruptcy were not particularly persuasive, Integrated's desire to take advantage of the Bankruptcy Code's cap on landlord claims was, as a matter of law, not sufficient grounds on which to dismiss the petition. The District Court affirmed, holding that the Bankruptcy Court did not abuse its discretion when it denied the Landlord's motion to dismiss.

**The Third Circuit's Decision**

On appeal, the Third Circuit reversed, holding that a chapter 11 petition is not filed in good faith where it is filed by a financially healthy debtor who has no intention of reorganizing or liquidating as a going concern, has no reasonable expectation that chapter 11 will maximize the value of its estate for creditors, and has filed solely to take advantage of the Bankruptcy Code's statutory cap on landlord damages claims. In reaching its conclusions, the Third Circuit identified the two basic purposes of chapter 11 as (1) preserving going concerns and (2) maximizing property available to satisfy creditors. The hallmark of good faith is whether the petition serves these purposes or is filed merely to obtain a tactical litigation advantage. The Third Circuit concluded that because Integrated was highly solvent, had no significant debt, and accordingly, did not face true financial distress, Integrated's bankruptcy would not maximize the value of its estate and therefore, did not meet the good faith standard for chapter 11 relief.

The Third Circuit rejected the Bankruptcy Court's findings that Integrated's downward business spiral and its stated need to resolve the pending securities litigation -- for which Integrated estimated its liability was no more than $25 million -- supported a finding that Integrated's chapter 11 filing benefited creditors given that Integrated was solvent even after accounting for all such liabilities. The Third Circuit also dismissed the argument that Integrated's alleged need to avail itself of chapter 11's distribution scheme and bankruptcy sale procedures established good faith. Whether a debtor's filing serves a valid bankruptcy purpose, the Court reasoned, is a condition precedent -- not a justification for -- a debtor's ability to distribute assets pursuant to the Bankruptcy Code's priority scheme. The Court also found that although Integrated's sale of its intellectual property rights in bankruptcy generated $1 million more than the sale Integrated had negotiated prepetition, the increase in value was a result of Integrated's failure to adequately market the assets, not the bankruptcy sales process itself. Finally, the Third Circuit held that Integrated's desire to take advantage of a particular provision in the Bankruptcy Code -- here, the statutory cap on a landlord's damages claim -- does not on its own establish good faith. The Court held that just as a desire to take advantage of the protections of the Bankruptcy Code cannot establish bad faith as a matter of law, it also cannot establish good faith. Any other rule, the Court reasoned, would eviscerate the good faith requirement.

**Will "Good Faith" Keep Solvent Companies From Filing Chapter 11?**

Although Integrated Telecom reaffirms that a solvent company may file for chapter 11, the decision emphasizes the role "good faith" plays in preventing a healthy company from doing so if it lacks a need to reorganize. Significantly, the decision implicitly rejects the idea that shareholders may use bankruptcy as a means to maximize value for equity holders at the expense of creditors. This result arguably conflicts with a board of directors' fiduciary duties to shareholders, which generally requires the board to maximize value for shareholders, but not creditors, when the company is solvent. By rejecting the lower courts' conclusions that Integrated's board of directors had fulfilled its obligations to shareholders by filing for bankruptcy, the Third Circuit effectively held that this motive alone does not justify a chapter 11 filing.

A recent decision from the District Court for the Northern District of New York echoes the Third Circuit's concerns. In Fraternal Composite Servs., Inc. v. Karczewski, 2004 WL 2106611 (N.D.N.Y. Sept. 21, 2004), the District Court affirmed the Bankruptcy Court's dismissal of a chapter 11 petition on good faith grounds where the corporation was a solvent, profit-earning company facing no immediate financial risk, whose sole goal in filing was to avoid a potential state court judgment. The Court concluded that the purpose of bankruptcy is not to provide an alternate litigation forum for state-court issues where the debtor otherwise has no need for bankruptcy relief.

Taken together, these cases may evidence a trend towards prohibiting companies who do not face immediate financial distress from filing bankruptcy. They may also simply be fall-out from what may be a growing trend to take bankruptcy relief for granted, using it to achieve business goals unrelated to the Bankruptcy Code's underlying rehabilitative objectives. It is too early to make any conclusions one way or another, but Integrated Telecom, and cases like it, put companies and their shareholders on notice that a solvent company does not have unfettered access to chapter 11.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Bankruptcy Group, including:


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