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FICKLE GATEKEEPERS: APPLICATION OF THE "GOOD FAITH" DOCTRINE IN *SYLMAR PLAZA* AND *PPI ENTERPRISES* INSPIRES LITTLE FAITH IN THE INTEGRITY OF THE CHAPTER 11 SYSTEM

By A. Kenneth Hennesay, Jr.[1]

I. Introduction

Chapter 11 is a comprehensive system that has the sweeping power to alter or dispose with contracts and delay and reduce the payment of debts. Bankruptcy courts, as courts of equity, are the gatekeepers of that system,[2] charged with maintaining its integrity against those who would abuse the system to gain an illegitimate windfall. Courts may bar the chapter 11 gates by denying confirmation of a chapter 11 plan that is not filed in good faith or by dismissing the case outright if the debtor's purpose in filing the chapter 11 petition was not grounded in good faith.[3]

Not surprisingly, without any statutory guidance, courts have developed a "good faith" body of law that is amorphous and malleable – derided by some as nothing more than a "smell test." In the Ninth Circuit's most recent application of the doctrine, *In re Sylmar Plaza*, the court missed a prime opportunity to add some measure of certainty to the good faith analysis. In that case, a secured creditor asked the court to declare that a chapter 11 plan lacked good faith, as a matter of law, where the sole purpose of the chapter 11 filing was to take advantage of the Bankruptcy Code so that the debtor's equity holder could profit personally at the expense of a single creditor.[4] The Ninth Circuit refused the bait.

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[2] Hon. Edith H. Jones, *The Good Faith Requirement in Bankruptcy*, 1988 ANN. SURVEY OF BANKR. L. 45.

[3] Both the "bad faith" doctrine for dismissal for cause and the court's good faith review of a proposed plan under 11 U.S.C. § 1129(a)(3) require an analysis of the totality of circumstances, conducted on a case by case basis. *See*, *In re* SGL Carbon Corp., 200 F.3d 154 (3d Cir. 1999); Marsch v. Marsch (*In re* Marsch), 36 F.3d 825, 828-29 (9th Cir. 1994); Platinum Capital, Inc. v. Sylmar Plaza, L.P. (*In re* Sylmar Plaza, L.P.), 314 F.3d 1070 (9th Cir. 2002) *cert. denied* 123 S. Ct. 2097 (2003).

[4] *Sylmar Plaza*, 314 F.3d at 1074.

Even accepting that the purpose of the chapter 11 case was as alleged by the secured creditor, the court could not bring itself to issue a per se rule. Instead, it left future good faith determinations in this Circuit to an unbound "totality of the circumstances" analysis.[5]

The *Sylmar Plaza* decision is disappointing not only because it failed to establish a bright line on the outside edge of the good faith doctrine, but also because the Ninth Circuit's good faith analysis was less than strenuous. Incredibly, the opinion fails to reference any purpose or policy supporting the Bankruptcy Code, even while deciding whether the debtor's plan was "consistent with the objectives and purposes of the Code."[6] Instead, following the bankruptcy court in *PPI Enterprises,*[7] the Ninth Circuit held that if the Bankruptcy Code provides for certain relief from the debtor's contractual obligations, then the debtor cannot lack good faith when it files for the purpose of seeking such relief. This holding begs the ultimate question of good faith -- does the chapter 11 case (or plan) fulfill a legitimate bankruptcy purpose. The purported answer to this ultimate question offered by the *Sylmar Plaza* and *PPI Enterprises* courts is a classic example of circular reasoning. Indeed, following this logic to its ultimate conclusion, the good faith requirement would never be imposed. Every bankruptcy filing is for the purpose of obtaining relief under some provision of the Code. The fact that the Code provides relief the debtor seeks is not, a priori, an answer to the question of whether the debtor's resort to such relief is in good faith.

Additionally, the *Sylmar Plaza* decision reflects a double standard in the good faith analysis, when considered in light of other Ninth Circuit decisions. On the one hand, where the debtor illegitimately seeks bankruptcy as a forum to delay or obtain advantage in litigation with a creditor, the Ninth Circuit stands firm to deny access and impose sanctions. On the other hand, where a debtor seeks bankruptcy solely as a forum to reform its contract with a creditor, to profit interest holders at the expense of the creditor, the Ninth Circuit is a more reluctant gatekeeper. There should be no discrepancy in the courts' treatment of strategic litigation filings and strategic commercial filings in bankruptcy,[8] as the results of either can be equally offensive to the purposes of the Bankruptcy Code.

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[5] *Id*. at 1074-75.

[6] *Id.* at 1074.

[7] *In re* PPI Enters. (U.S.), Inc., 228 B.R. 339 (Bankr. D. Del. 1998) *aff'd* 324 F.3d 197 (3d Cir. 2003).

[8] Of course, nearly all bankruptcy filings are strategic in some regard, and nearly all involve issues that must be litigated as well as the commercial dealings of the debtor. It is necessary for

II. The Good Faith Filing Doctrine

A. A Brief Statement of the Good Faith Doctrine's Long History

Whether expressed in statute or developed in case law, good faith has been a condition of maintaining a bankruptcy case for the past century.[9] Chapter X of the Bankruptcy Act actually included a nonexclusive set of bad faith indicia, providing for dismissal of a case where (1) equity holders planned retention of their equity without any capital contributions; (2) there exists a pending foreclosure proceeding; (3) a plan of reorganization could not reasonably be expected; and (4) a prior proceeding is pending in another court and it appears that the interests of creditors and equity holders would be best served in the existing, nonbankruptcy proceeding.[10]

B. An Overview of the Good Faith Doctrine Under the Code

Unlike the Act, the Bankruptcy Code does not contain an express good faith condition for filing a bankruptcy petition. In chapter 11 cases, however, a plan may only be confirmed if it has been proposed in good faith.[11] Based on this continuation of the "good faith" doctrine and the Code's elastic definition of cause for dismissal of chapter 11 cases under section 1112(b), bankruptcy courts have asserted the authority to dismiss a chapter 11 case on the grounds that the case was not filed in good faith.[12]

Whether a chapter 11 case has been filed in good faith is determined by reference to the totality of the circumstances of a case, and the court has broad discretion in its review of the facts and ultimate conclusion. The case law has developed a laundry list of relevant factors with respect to only a few recurring situations, such as the classic single asset real estate, eve of foreclosure filing. Consequently, a survey of cases provides little specific guidance that would allow parties to predict with any degree of accuracy whether a case may be dismissed

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descriptive purposes, however, to develop some shorthand reference for chapter 11 filings that are typically attacked on the grounds of a lack of good faith. Hence, "strategic litigation filings" refer to chapter 11 cases filed to impact specific litigation involving the debtor; and "strategic commercial filings" refer to chapter 11 cases filed to alter specific contracts of the debtor without any true reorganization purpose.

[9] Judith Greenstone Miller, *Amendment to Provide Good Faith Filing Requirement for Chapter 11 Debtors*, 102 COM. L.J. 181, 185 (1997).

[10] *Id.*

[11] 11 U.S.C. § 1129(a)(3).

[12] Miller, *supra* note 9, at 186-87.

under other circumstances. The case law, however, identifies policies and principles to guide the bad faith analysis.

Dismissal is, of course, an extreme measure. Generally, courts are very reluctant to deny chapter 11 relief to an eligible debtor. On the other hand, a substantial body of case law supports the rights of creditors to protection from a solvent debtor's actions to favor equity to a creditor's detriment, even where the debtor otherwise acts in conformance with the Bankruptcy Code. Ultimately, most motions to dismiss chapter 11 cases (outside of the classic single asset, eve of foreclosure filing scenario) face long odds.

C. All the Courts of Appeal Follow the Good Faith Doctrine to Police the Chapter 11 Dockets

Bankruptcy Code section 1112(b) provides a nonexclusive list of factors that may constitute cause for conversion or dismissal, whichever is in the best interests of creditors.[13] Whether based on the bankruptcy court's inherent equitable power or as "cause" under Bankruptcy Code section 1112(b), all of the Courts of Appeal that have considered the issue have held that a bankruptcy court has the power to dismiss a voluntary chapter 11 petition on the grounds that the petition was filed in bad faith.[14] The good faith requirement ensures that the careful balancing process between debtors and creditors is not upset and justifies the delay and costs to creditors imposed by bankruptcy.[15]

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[13] C-TC 9th Avenue Partnership v. Norton Co. (*In re* C-TC 9th Avenue Partnership), 113 F.3d 1304, 1310-11, n.5 (2d Cir. 1997) (quoting legislative history, noting that court will be able to consider factors as they arise and use equitable powers to reach an appropriate result in individual cases).

[14] LAWRENCE P. KING, 7 COLLIER ON BANKRUPTCY ¶ 1112.07, at 1112-63 to 64 and 1112-71 to 72 (15th ed. rev. 2001) (hereinafter "Collier"). Collier argues for a distinction between dismissal for lack of good faith and dismissal for cause, but acknowledges that most courts do not make the distinction and apply the good faith standard as an element of cause under Bankruptcy Code section 1112(b). In any event, the standards for dismissal developed by the case law (and espoused by Collier) are equivalent whether the court invokes section 1112(b) or its own equitable powers. Accordingly, this article will not join that debate.

[15] *C-TC 9th Avenue Partnership*, 113 F.3d at 1310 (citing Little Creek Dev. Co. v. Commonwealth Mortgage Corp. (*In re* Little Creek Dev. Co.), 779 F.2d 1068, 1071 (5th Cir. 1986)).

D. Application of the Good Faith Doctrine

1. Burden of Proof

The burden of proof on a motion to dismiss for bad faith is initially with the movant, who must produce sufficient evidence to put the debtor's good faith at issue. Once at issue, the debtor has the burden to establish that the petition was filed in good faith.[16]

2. The Totality of the Circumstances Test

The bad faith factors cited in *C-TC* are typical of single asset, two party dispute cases.[17] The bad faith doctrine, however, is not limited to such situations. No list of factors is exhaustive of the circumstances that may be relevant to a particular debtor's good faith.[18] The bad faith analysis is conducted by review of the totality of the circumstances in order to determine whether the case serves a valid reorganizational purpose or represents an unjust attack by the debtor on the legitimate interests of other parties. This fact intensive inquiry requires the court to determine where the debtor's conduct falls on a spectrum ranging from clearly acceptable to patently abusive.[19]

3. Objective and Subjective Tests

Courts in the Second and Fourth Circuits apply a two-step bad faith analysis – the court must find both objective futility of the reorganization process and subjective bad faith in the filing of the petition or prosecution of the case.[20]

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[16] *In re* SGL Carbon Corp., 200 F.3d 154, 162 (3d Cir. 1999); *In re* RCM Global Long Term Capital Appreciation Fund, Ltd., 200 B.R. 514, 520 (Bankr. S.D.N.Y. 1996).

[17] The Second Circuit held that the bankruptcy court did not abuse its discretion in dismissing the case for bad faith, because the lower court's decision was based on findings that: (1) *C-TC* had only one asset; (2) *C-TC* had few unsecured creditors and their claims were small in relation to the disputed secured claim; (3) a foreclosure action was pending as a result of a mortgage being in default; (4) *C-TC*'s financial problems involved only a two party dispute that could be resolved in the pending state court action; (5) the timing of *C-TC*'s filing evidenced an intent to delay and frustrate the legitimate efforts of a creditor to enforce its rights; (6) *C-TC* had not paid its property or other taxes; (7) *C-TC* had no employees; and (8) more than a year had elapsed after the filing of the bankruptcy case without filing a plan or other reorganizing efforts. *C-TC 9th Avenue Partnership*, 113 F.3d at 1311-12.

[18] *SGL Carbon*, 200 F.3d at 166 n.16 (3d Cir. 1999).

[19] *Id.* at 162.

[20] *RCM Global*, 200 B.R. at 520; Carolin Corp. v. Miller, 886 F.2d 693 (4th Cir. 1989).

To meet the objective test for good faith, the debtor must have a potentially viable business to protect and reorganize.[21] Under the subjective test, the debtor must have an actual intent to reorganize, rather than to cause hardship and delay to creditors.[22]

III. Good Faith Doctrine as Applied to Strategic Litigation Filings

As set forth above, commencement of a bankruptcy case in bad faith constitutes sufficient "cause" to dismiss a case under Bankruptcy Code section 1112(b) and it also constitutes cause for relief from the automatic stay to continue nonbankruptcy proceedings under section 362(d)(1).[23] To establish bad faith, the movant need not show malice.[24] Rather, the movant is merely required to show that the case was filed "for a purpose other than that sanctioned by the Bankruptcy Code."[25]

A. Traditional Bad Faith Indicia

Certain recurring fact patterns occupy much of the reported bad faith case law. Most prevalent is the single asset, eve of foreclosure filing. As a result, the bad faith "factors" typically enumerated in determining whether a voluntary bankruptcy petition was filed in bad faith include: (1) the debtor has only one asset; (2) the debtor has few unsecured creditors whose claims are small in relation to the claim of the secured creditor; (3) the debtor has few employees; (4) the property is the subject of a foreclosure action as a result of a default on the debt; (5) the debtor's financial problems involve essentially a dispute between the debtor and the secured creditor; and (6) the timing of the filing evidences an intent to delay or frustrate the legitimate efforts of the debtor's secured creditors to

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[21] *RCM Global*, 200 B.R. at 520.

[22] *Id.*

[23] *See*, Can-Alta Properties, Ltd. v. State Savings Mortgage Co. (*In re* Can-Alta Properties, Ltd.), 87 B.R. 89, 90 (B.A.P. 9th Cir. 1988) (citing *In re* Arnold, 806 F.2d 937, 939 (9th Cir. 1986); Matter of Little Creek Development Co., 779 F.2d 1068, 1072 (5th Cir. 1986); *In re* Thirtieth Place, Inc., 30 B.R. 503, 505 (B.A.P. 9th Cir. 1983)).

[24] *In re* Southern Cal. Sound Sys., Inc., 69 B.R. 893, 901 n.2 (Bankr. S.D. Cal. 1987).

[25] *Id.*

enforce their rights.[26] A debtor need only satisfy some of the factors for the court to find bad faith.[27]

Dismissal or relief from stay on bad faith grounds prevents debtors from engaging in improper attempts to obtain the benefit of the automatic stay and a more convenient forum to resolve their disputes with creditors.[28] Debtors are not permitted to use chapter 11 as an extortion tool in two-party disputes that may be resolved readily in a nonbankruptcy forum.

B. Solvency Is a Factor in Bad Faith Analysis

In *SGL Carbon*, the Third Circuit acknowledged that there is no solvency prerequisite or reorganization requirement in the Code, but clearly relied on the debtor's solvency as a critical factor supporting its determination that the case had been filed in bad faith.[29] In *SGL Carbon*, the official committee of unsecured creditors, controlled by antitrust claimants, moved to dismiss the case as a bad faith litigation tactic in pending antitrust litigation. The debtor made repeated public pronouncements that the company was healthy, thriving, and would continue to be so even in the event of a total loss in the litigation. The Third Circuit held that the bankruptcy court's finding that the litigation posed a serious threat to the company (either fiscally or as a distraction from its operations) were clearly erroneous based on the debtor's admissions. The Third Circuit reversed and directed dismissal of the case.[30]

The Ninth Circuit has also acknowledged that a debtor's solvency is a factor to be considered in the bad faith analysis.[31] In *Singer Furniture Acquisition Corp. v. SSMC Inc.*, the debtor, a related company and certain of its shareholders were defendants in state court litigation.[32] Thirteen days before trial, the debtor

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[26] *In re* Club Tower L.P., 138 B.R. 307, 309-10 (Bankr. N.D. Ga. 1991); *see also*, *Little Creek Dev. Co.*, 779 F.2d at 1073 (listing ten factors, including those above).

[27] Can-Alta Properties, Ltd. v. State Savings Mortgage Co. (*In re* Can-Alta Properties, Ltd.), 87 B.R. 89, 91 (B.A.P. 9th Cir. 1988); *see also*, *Southern Cal. Sound Sys.*, 69 B.R. at 899-900 (finding bad faith on the presence of four factors).

[28] *See*, *In re* St. Paul Self Storage Ltd. Partnership, 185 B.R. 580, 583 (B.A.P. 9th Cir. 1995).

[29] *In re* SGL Carbon Corp., 200 F.3d 154, 163-64 (3d Cir. 1999).

[30] *Id.* at 162-63.

[31] Marsch v. Marsch (*In re* Marsch), 36 F.3d 825, 827 (9th Cir. 1994) (case of solvent debtor filed to use automatic stay in lieu of appeal bond dismissed because debtor had ability to pay all debts and should not benefit from stay to detriment of creditor).

[32] Singer Furniture Acquisition Corp. v. SSMC Inc., 254 B.R. 46 (M.D. Fla. 2000).

filed a chapter 11 petition. The plaintiff moved to dismiss the case as having been filed in bad faith. The court found that the debtor was a holding company and was not engaged in business, had no employees, and had more than enough assets to pay its creditors. Because the debtor's filing on the eve of trial was an obvious litigation tactic and the debtor could have satisfied the creditor's claim and all other claims outside of bankruptcy, the court dismissed the case.[33]

C. The Ninth Circuit's Strenuous Approach as Gatekeeper in the Context of Strategic Litigation Filings

1. *In re Marsch*

The Ninth Circuit has shown little patience for strategic litigation filings by chapter 11 debtors, as exemplified by the court's decision in *Marsch*. In that case, the debtor filed a chapter 11 petition before a state court could enter a judgment against her in favor of her ex-husband.[34] The bankruptcy court found that the debtor had sufficient nonbusiness assets to satisfy the judgment or post a bond on appeal.[35] The bankruptcy court dismissed the chapter 11 case and imposed sanctions under Rule 9011 of the Federal Rules of Bankruptcy Procedure.[36] The Bankruptcy Appellate Panel reversed both the dismissal order and sanctions award, and the case proceeded on appeal to the Ninth Circuit.

The Ninth Circuit reversed the Bankruptcy Appellate Panel, holding that the bankruptcy court correctly determined that "the purpose for which the petition was filed was not consonant with the purpose of the Bankruptcy Code" and, therefore, dismissal was proper.[37] The Ninth Circuit test for good faith is "whether a debtor is attempting to unreasonably deter and harass creditors or

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[33] *Id.* at 52. A recent case from the Southern District of New York, which did not involve a solvent debtor, but a defunct entity with no need or prospect for reorganization, is also instructive. *In re* Syndicom Corp., 268 B.R. 26, 52 (Bankr. S.D.N.Y. 2001). The bankruptcy court dismissed the debtor's case where it found that the corporate debtor had already dissolved and filed only to attempt to revive a terminated lease of residential property held in its name for property occupied by its principals. The court dismissed the case because it was intended solely to use bankruptcy to secure the profit in the lease (which included an option to buy the property) for the benefit of the debtor's principals. *Id.* at 50-51.

[34] *Marsch*, 36 F.3d at 827.

[35] *Id.*

[36] *Id.*

[37] *Id.* at 828

attempting to effect a speedy, efficient reorganization on a feasible basis."[38] "Good faith" does not contemplate an inquiry into the subjective intent of the debtor, but encompasses several, distinct equitable limitations that courts have placed on chapter 11 filings to deter filings that seek to achieve objectives that are outside the legitimate scope of the Bankruptcy Code.[39]

The Ninth Circuit noted that bankruptcy courts typically dispatch cases that are filed as a "litigating tactic." Because the bankruptcy court found that entry of the judgment against the debtor would not disrupt any business of the debtor, the debtor's forum shopping would not be permitted and the case was rightly dismissed.[40]

The Ninth Circuit held that this record clearly supported a finding that the debtor's petition was filed for an improper purpose. Additionally, the court held that the filing of the petition was "of dubious legal merit," based on the overwhelming weight of authority that directly contradicted the position asserted by the debtor. On these grounds, the Ninth Circuit upheld the bankruptcy court's award of sanctions against the debtor for its bad faith filing.[41]

2. *In re Silberkraus*[42]

More recently, the Ninth Circuit again applied the bad faith filing doctrine to dismiss a chapter 11 case that was nothing more than litigation forum shopping by the debtor, and again awarded sanctions to the aggrieved creditor. In *Silberkraus*, the debtor, as lessor, entered into a commercial real property lease that provided the lessee with an option to purchase the leased premises at the end of the five-year lease term.[43] Ultimately, the lessee exercised its option to purchase the property, but the debtor refused to close escrow. The lessee-optionee filed a specific performance action in state court. In response, the debtor filed its chapter 11 petition, thereby staying proceedings in state court.

The bankruptcy court granted the lessee relief from the automatic stay, subject to a stay on any enforcement, to proceed in state court; denied

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[38] *Id.* at 827 (citing *Arnold*, 806 F.2d at 939).

[39] *Id.*

[40] *Id.* at 829.

[41] *Id.* at 831.

[42] Silberkraus v. The Steeley Co. (*In re* Silberkraus), 336 F.3d 864 (9th Cir. 2003).

[43] *Id.* at 867.

confirmation of the debtor's original plan because it impermissibly classified the lessee's unsecured claims into a separate class; and set a deadline for the filing of an amended disclosure statement and plan. The debtor failed to meet that deadline, and the lessee-optionee moved for sanctions against the debtor, contending that the debtor filed its bankruptcy petition in bad faith as a means of forum shopping.[44] At the hearing on the sanctions motion, the debtor acknowledged that it could not confirm a plan over the lessee-optionee's objection. The bankruptcy court further found that the debtor had sufficient equity to pay most, if not all, of its debt. The bankruptcy court ultimately converted the case and granted sanctions against the debtor and its counsel.[45]

The Ninth Circuit affirmed the sanctions award:

> In sum, the fact that the bankruptcy petition was filed a mere two days before the state court was to schedule a trial date on [the lessee-optionee's] claim for specific performance, the admission by the Debtor and [its counsel] that reorganization was impossible over the objections of [the lessee-optionee], and the fact that bankruptcy could not have provided more value to the Debtor than proceeding with the state court action all provide more than enough support for the bankruptcy court's determination that the Chapter 11 filing was frivolous and for an improper purpose, and thus in bad faith.[46]

IV. Good Faith as Applied to Strategic Commercial Filings

Courts have often dismissed chapter 11 petitions filed by financially healthy company with no need to reorganize.[47] A debtor's true need for bankruptcy protection is a relevant, even threshold consideration in the bad faith

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[44] *Id.*

[45] *Id.* at 868.

[46] *Id.* at 871.

[47] *In re* SGL Carbon Corp., 200 F.3d 154, 166 (3d Cir. 1999) (citing Marsch v. Marsch (*In re* Marsch), 36 F.3d 825, 828-29 (9th Cir. 1994); *In re* Argus Group 1700, Inc., 206 B.R. 757, 765-66 (E.D. Pa. 1997); Furness v. Lilienfield, 35 B.R. 1006, 1011-13 (D. Md. 1983); *In re* Talledega Steaks, Inc., 50 B.R. 42, 44 (Bankr. N.D. Ala. 1985)); *see also*, Cedar Shore Resort, Inc. v. Mueller (*In re* Cedar Shore Resort, Inc.), 235 F.3d 275 (8th Cir. 2000); Singer Furniture Acquisition Corp. v. SSMC Inc., 254 B.R. 46 (M.D. Fla. 2000); *In re* Muskogee Environmental Conserv. Co., 236 B.R. 57 (Bankr. N.D. Okla. 1999).

analysis.[48] Courts recognize that if a petitioner has no need to rehabilitate or reorganize, its petition cannot serve the rehabilitative purpose of chapter 11.[49]

Chapter 11 is founded on the principle that the debtor must do equity because it seeks the equitable relief of the bankruptcy court.[50] To abuse the Bankruptcy Code by preferring the debtor's equity holders over creditors is to turn this principle on its head.[51] Accordingly, courts have granted relief to creditors from acts taken by a solvent debtor, ostensibly pursuant to the Code, that have the result of benefiting the debtor or its insiders at the expense of the creditor.[52]

Solvent debtors who file chapter 11 to take advantage of the Code's provisions concerning rejection of executory contracts often meet resistance where rejection would confer an unfair advantage on the debtor.[53] If bankruptcy

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[48] SGL Carbon, 200 F.3d at 163 (holding that while insolvency is not a prerequisite for chapter 11 relief, the bankruptcy courts are not open to "premature filing, [or] the filing of a bankruptcy petition that lacks a valid reorganizational purpose"); *Marsch*, 36 F.3d 825 (case of solvent debtor filed to use automatic stay in lieu of appeal bond dismissed because debtor had ability to pay all debts and should not benefit from stay to detriment of creditor).

[49] *SGL Carbon*, 200 F.3d at 166 (citing *In re* Winshall Settlor's Trust, 758 F.2d 1136, 1137 (6th Cir. 1985) ("The purpose of Chapter 11 reorganization is to assist financially distressed business enterprises by providing them with breathing space in which to return to a viable state."); S. REP. NO. 95-989, at 9 reprinted in 1978 U.S.C.C.A.N. 5787, 5795 (noting that "Chapter 11 deals with the reorganization of a financially distressed enterprise . . . .").

[50] *SGL Carbon*, 200 F.3d at 161 (chapter 11 case must be commenced and conducted "in a manner which does equity and is fair to rights and interests of parties affected.").

[51] *See*, *In re* Syndicom Corp., 268 B.R. 26, 52 (Bankr. S.D.N.Y. 2001) (dismissal appropriate where purpose of case is to secure benefits for nondebtor insiders rather than bankruptcy estate with no ongoing business).

[52] *See, e.g.,* Dunes Hotel Assocs. v. Hyatt Corp., 245 B.R. 492, 507 (D.S.C. 2000) (permitting a fiduciary debtor in possession to use strong arm powers against creditors to create a windfall for equity is contrary to Code's purpose); *In re* Danrik, Ltd., 92 B.R. 964 (Bankr. N.D. Ga. 1988) (section 502(b)(6) not applied to claim of lessor against guarantor where all other creditors paid in full).

[53] *See, e.g.*, Barclays-American/Business Credit, Inc. v. Radio WBHP, Inc. (*In re* Dixie Broad., Inc.), 871 F.2d 1023, 1028 (11th Cir. 1989) *cert. denied* 493 U.S. 853 ("The Bankruptcy Code is not intended to insulate financially secure sellers or buyers from the bargains they strike."); Huang v. Pierce (*In re* Chi-Feng Huang), 23 B.R. 798, 803 (B.A.P. 9th Cir. 1982) ("[I]t is not true that solvent debtors may petition for bankruptcy and then obtain a windfall by rejecting their executory contracts . . . ."); *In re* Albrechts Ohio Inns, Inc., 152 B.R. 496, 501 (Bankr. S.D. Ohio 1993) ("It perverts the wholesome economic objective of Chapter 11[as] an instrument for the rehabilitation of troubled businesses [to] nakedly . . . allow the remaking of a bilateral contract by one of the parties thereto."); *Furness v. Lilienfield*, 35 B.R. at 1009 ("Chapter 11 was designed to give those teetering on the verge of a fatal financial plummet an opportunity to reorganize on solid ground

courts can, as these courts hold, deny rejection of an executory contract on equitable grounds, courts should also have the power to deny a debtor bankruptcy relief where the only purpose of the case is to take unfair advantage of nondebtor parties to its agreements as a result of rejection.

A. Specific Applications of the Good Faith Doctrine to Police Commercially Strategic Filings

Following are summaries of a number of cases in which the courts have rejected strategic commercial filings – using the bankruptcy court to modify or dispose of contracts enforceable under applicable nonbankruptcy law – where the result would be ill-gotten gains to the debtor.

1. *Dunes Hotel*

Dismissal of a case has been granted where the only purpose of the case was to avoid an unrecorded lease agreement that would result in a benefit only to the debtor and its interest holders, even though a literal reading of the Code supported avoidance.[54] In *Dunes Hotel*, a debtor hotel operator filed to avoid foreclosure. During the case, however, the debtor reached an arrangement with its secured creditor that resolved its need for bankruptcy protection and left the debtor solvent. The only outstanding matter in the chapter 11 case was the debtor's action to avoid its long term lease with Hyatt, which inexplicably had not been recorded. The bankruptcy court determined that the unrecorded lease was avoidable. As a result, avoidance of the lease would result in a great windfall to equity at the direct expense of Hyatt. Based on these facts, the district court affirmed the bankruptcy court's decision to dismiss the case for lack of good faith, notwithstanding the court's prior holding that the lease was avoidable pursuant to a literal application of the Code.[55] In a telling comment, the district court stated:

> Dunes as a solvent debtor-in-possession should not be permitted to remain in bankruptcy for the sole purpose of being able to use the strong-arm clause of the Bankruptcy Code to strike down a bilateral contract to the detriment of its only remaining non-insider creditor. To allow Dunes to

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and try again, not to give profitable enterprises an opportunity to evade contractual or other liability."); *In re* Carrere, 64 B.R. 156, 160 (Bankr. C.D. Cal. 1986) ("greedy" debtor should not be allowed to evade its obligations to creditors to line its own pockets); *In re* Southern Cal. Sound Sys., Inc., 69 B.R. 893 (Bankr. S.D. Cal. 1987); Shell Oil Co. v. Waldron (*In re* Waldron), 785 F.2d 936 (11th Cir. 1986) *cert. dismissed* 478 U.S. 1028.

[54] Dunes Hotel Assocs. v. Hyatt Corp., 245 B.R. 492 (D.S.C. 2000).

[55] *Id.* at 507.

> do so would set the stage for a post-deal negotiation of a lease that was entered into between two sophisticated entities in 1973.[56]

2. *Southern California Sound Systems*

In *Southern California Sound Systems*, the debtor had only been in business for a few months and was solvent. Debtor had entered into a contract for the exclusive sale of its goods. Debtor filed a chapter 11 petition and moved to reject the contract. The court noted in determining whether rejection would be permitted that "one factor to be considered in the exercise of business judgment is the size of the claim flowing from the breach caused by rejection."[57] There, the potential dollar value of the contract was approximately $78.5 million whereas debtor's liabilities were only approximately $67,000. In finding that debtor lacked good faith, the court stated, "Where the sole objective to be achieved by filing for relief by a not yet operational entity is to reject a hastily formed contract in order to avoid the state law remedy of specific performance, the Court should not use its equity powers to assist the debtor in the manipulative endeavor. Here, the debtor is attempting to use rejection to create a business rather than preserve one."[58] The court also found four indicia of bad faith filing, including "(1) the absence of employees except for the principals, (2) . . . little or no cash flow and no available source of income to sustain a plan of reorganization, (3) . . . few, if any, unsecured creditors whose claims are relatively small, and (4) the debtor and one creditor may have proceeded to a standstill in state court litigation and the debtor has lost or been required to post a bond which it cannot afford."[59] The court ultimately held that rejection was not supported by a valid reorganization purpose stating, "Where the Court becomes convinced that the true purpose of filing a petition is other than to reorganize a financially distressed business, but to merely take advantage of one of the remedies available under the Code, dismissal is appropriate to protect the jurisdictional integrity of the Court."[60]

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[56] *Id.* (citations omitted).

[57] *In re* Southern Cal. Sound Sys., Inc., 69 B.R. 893, 896 (Bankr. S.D. Cal. 1987).

[58] *Id.*

[59] *Id.* at 899.

[60] *Id.* at 900.

3. *Waldron*

Likewise, the Eleventh Circuit directed dismissal of a chapter 13 case where the debtors were solvent and filed bankruptcy only to reject an option to sell a parcel of real property. In *Waldron*, a third party had an option contract to purchase a parcel of land from debtors.[61] The land significantly increased in value and the third party decided to exercise the option. Debtors filed a chapter 13 petition solely to reject the option contract. Debtors had no debts whatsoever. The bankruptcy court and district court (on appeal) permitted the rejection of the option contract. In reversing the lower courts, and instructing the case be dismissed, the Eleventh Circuit held that the rejection of an executory contract must serve a "useful purpose such as providing a troubled debtor with a 'fresh start.'"[62]

4. *Carrere*

In *Carrere*, the debtor entered into a personal services contract with a third party. A more lucrative opportunity for Ms. Carrere arose and she filed a chapter 11 petition and moved to reject the contract. Though not solvent, the court found that the debtor had no financial hardship that would normally lead to the filing of a bankruptcy petition, but that her primary motive was to reject the contract. The court first determined that an executory personal services contract is not property of the estate and, therefore, is not subject to rejection.[63] The court also found that even if the contract were executory and subject to rejection, it would be inequitable to permit her to reject simply to allow for a more lucrative contract.[64]

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[61] Shell Oil Co. v. Waldron (*In re* Waldron), 785 F.2d 936, 940 (11th Cir. 1986) *cert. dismissed* 478 U.S. 1028.

[62] *Id.*

[63] *In re* Carrere, 64 B.R. 156, 158-59 (Bankr. C.D. Cal. 1986).

[64] *Id.* at 160. The Third Circuit has distinguished *Carrere*. In Delightful Music, Ltd. v. Taylor (*In re* Taylor), 913 F.2d 102 (3d Cir. 1990), the debtor sought to reject a personal services contract. The Third Circuit, in affirming a decision permitting rejection, rejected the reasoning in *Carrere* on the grounds that personal services contracts are subject to rejection. In *Taylor*, however, the court also found that debtor was not solvent and filed his petition in good faith.

B. The Contrary View: The Code Applies Without Consideration of Whether the Bankruptcy Case Is Legitimate

1. *PPI Enterprises* - The Bankruptcy Court Decision[65]

PPI Enterprises stands for the proposition that filing for the purpose of taking advantage of a particularly helpful Bankruptcy Code provision cannot be an indicator of bad faith. Rather than analyze whether the provisions of the Code could be (and were being) abused, the court asked the rhetorical question - why else would a debtor file a chapter 11 but to take advantage of the Bankruptcy Code?

In *PPI Enterprises*, the debtor and its English parent were the tenant and guarantor, respectively, of a lease of nonresidential real property. The parent company commenced insolvency proceedings in England and thereafter directed PPI to abandon its lease. After three years of litigation and settlement negotiations related to the landlord's claim, on the eve of trial on the damages issue, PPI filed its voluntary chapter 11 petition.[66] At the time of its filing, PPI had no ongoing business, only one employee, and no noncash assets other than a 2% stock interest in Del Monte Foods Company.[67] The landlord moved to dismiss the chapter 11 case, contending that PPI filed its petition with the intent of capping the landlord's claim under section 502(b)(6) and thereby creating substantial value for PPI's ultimate, offshore owner.[68]

For purposes of its decision, the bankruptcy court [Judge Walsh] accepted the landlord's contention that PPI filed solely for the purpose of utilizing the section 502(b)(6) cap.[69] PPI's proposed liquidating plan provided for payment to the landlord of the full amount of its capped claim plus pre and postpetition interest (other general unsecured creditors received similar treatment, absent the cap).[70] The bankruptcy court summarized the case law on the good faith filing doctrine and then distinguished the "good faith" cases cited by the landlord as

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[65] *In re* PPI Enters. (U.S.), Inc., 228 B.R. 339, 344-45 (Bankr. D. Del. 1998) *aff'd* 324 F.3d 197 (3d Cir. 2003).

[66] *Id.* at 342.

[67] *Id.*

[68] *Id.* at 343.

[69] *Id.*

[70] *Id.*

involving two party disputes in single asset real estate cases.[71] The court cautioned against using the good faith filing doctrine to override the Bankruptcy Code's statutory scheme.[72] Noting several specific Code provisions that restructure creditor's rights (sections 502(b)(2), (7), and (8), 510(b), 365(f), and 1129(a)(9)(C)), and that other courts have allowed filing solely for the purpose of rejecting a contract pursuant to Bankruptcy Code section 365, the court held that *PPI's* chapter 11 filing did not violate the good faith filing doctrine.[73] The *PPI* court dealt summarily with the landlord's argument that the debtor's alleged solvency and the liquidating nature of its plan were indicia of bad faith by noting that chapter 11 has no solvency prerequisite or "reorganization" plan requirement.[74]

2. The *PPI Enterprises* Approach Gains Support

PPI Enterprises has been cited with approval by courts refusing to dismiss voluntary petitions as bad faith filings. The common characteristic of the cases following *PPI Enterprises* is the refusal to consider the fundamental purposes and policy of the Code and strict application of the Code's provisions without regard to any inequitable result in the form of a windfall to the debtor or equity holders at the expense of a particular creditor.

a. *Arden*

The Ninth Circuit has previously followed *PPI Enterprises* with respect to the strict application approach regarding the section 502(b)(6) cap.[75] In *Arden*, the Ninth Circuit held that application of the cap to a claim against an apparently solvent guarantor did not collide with Congressional intent such that a literal application of section 502(b)(6) could be avoided.[76] The Ninth Circuit affirmed the BAP's reversal of the lower court's approval of a compromise based on the lower court's failure to take into account the application of the cap in settling a

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[71] *Id.* at 346 (distinguishing Carolin Corp. v. Miller, 886 F.2d 693 (4th Cir. 1989); Phoenix Piccadilly, Ltd. v. Life Ins. Co. (*In re* Phoenix Piccadilly, Ltd.), 849 F.2d 1393 (11th Cir. 1988)).

[72] *PPI Enters.*, 228 B.R. 339 at 345 (citing *In re* Clinton Centrifuge, Inc., 72 B.R. 900, 905 (Bankr. E.D. Pa. 1987).

[73] *Id.*

[74] *Id.*

[75] *In re* Arden, 176 F.3d 1226 (9th Cir. 1999).

[76] *Id.* at 1229.

lessor's allowed claim.[77] Oddly, after citing the legislative history that states the cap is designed to protect creditors, the Ninth Circuit added its own gloss to the legislative history, reading creditor protection out: "[Section 502(b)(6)] reflects a Congressional desire to limit otherwise disproportionately large claims of landlords."[78] Because the landlord's claim was "substantial," the Ninth Circuit could not say that Congress obviously intended that it should not be subject to the cap.[79]

b. *68 West*

The bankruptcy court for the Southern District of New York has cited *PPI Enterprises* with approval in refusing to grant relief from the automatic stay on bad faith grounds.[80] The *68 West* case involved a corporate debtor with no income, no employees, and a single asset – an empty, derelict residential building that debtor acquired shortly before filing – in which the debtor had no equity.[81] The bankruptcy court noted that factors used to find "cause" under section 1112(b) were not substantively different than the factors to be applied in the relief from stay context and listed the factors cited by the *C-TC* case.[82] The court found that each of the *C-TC* factors, save one, applied to the debtor. Following closely the *PPI* analysis, however, the court refused to apply such factors "mechanically" and held that such factors "do no more than assist the exercise of discretion in deciding whether the debtor has improperly invoked the Bankruptcy Code" and only heighten one's sensitivity to the possibility that a creditor is entitled to relief from the automatic stay."[83]

The court denied relief from stay after finding that the debtor had experience in renovating property such as its single asset and committed its own funds to such renovation during the pendency of the case and therefore had a legitimate prospect of reorganization.[84] Interestingly, the court addressed each of the *C-TC* factors from the perspective that no court had held that, by itself, the

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[77] *Id.*

[78] *Id.*

[79] *Id.*

[80] *In re* 68 West 127 Street, LLC, 285 B.R. 838 (Bankr. S.D.N.Y. 2002).

[81] *Id.* at 840-41.

[82] *Id.* at 843.

[83] *Id.* at 844, 846.

[84] *Id.* at 847.

presence of such factor constituted bad faith - an approach that seems to turn the "totality of the circumstances" analysis on its head. Finally, the court admonished the movant that creditors are generally better off relying on the Bankruptcy Code's many provisions providing protection and governing debtor misconduct than on "vague assertions of bad faith."[85]

V. Citing *PPI Enterprises*, the Ninth Circuit Refuses to Shut the Gate to Strategic Commercial Filings

A. The *Sylmar Plaza* Decision

In *Sylmar Plaza*, the Ninth Circuit considered a chapter 11 plan proposed by a solvent debtor for the sole purpose of curing a default under a loan, thereby escaping its contractual obligation to pay a million dollars in default interest.[86] *Sylmar Plaza* involved wealthy real estate investors (the "Hornwoods") who owned a real estate portfolio valued at approximately $55 million, with equity of more than $15 million. The Hornwoods obtained an $8 million loan secured by one of their real property assets - the Sylmar Plaza shopping center. When Sylmar Plaza began to encounter cash flow problems, the Hornwoods transferred title to Sylmar Plaza to a new limited partnership (without the secured lender's consent) and transferred the rest of their portfolio into separate limited partnerships. Sylmar Plaza's secured lender commenced foreclosure proceedings and Sylmar Plaza filed its voluntary chapter 11 petition after the state court issued its statement of intended decision in favor of the secured lender.

In Sylmar Plaza's chapter 11 case, it was undisputed that the debtor was solvent. Under Sylmar Plaza's proposed plan, a small group of unsecured creditors were paid in full, with interest at a rate of 10%. The secured creditor, however, would receive payment "in full" with only its nondefault rate of interest of 8.87% (and not its default rate of 13.87% as required under the terms of its loan). Sylmar Plaza's equity holders retained their very valuable interests in the debtor. The objecting secured creditor argued for a per se rule that a solvent debtor could not take advantage of Bankruptcy Code section 1124(2) to escape payment of default interest where that was the sole purpose of the bankruptcy case, which provided advantages exclusively to the debtor and its interest holders to the expense of the creditor. The Ninth Circuit refused to apply a per se bad faith rule. The Ninth Circuit cited *PPI Enterprises* with approval for the

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[85] *Id.*

[86] Platinum Capital, Inc. v. Sylmar Plaza, L.P. (*In re* Sylmar Plaza, L.P.), 314 F.3d 1070 (9th Cir. 2002) *cert. denied* 123 S. Ct. 2097 (2003).

proposition that "[t]he fact that a debtor proposes a plan in which it avails itself of an applicable code provision does not constitute evidence of bad faith."[87]

B. The Trouble with the Ninth Circuit's Analysis

Sylmar Plaza solicited at least one gasp from the academy. Professor Dan Shechter's immediate comment was: "If this wasn't a 'bad faith' plan, what does 'bad faith' mean?"[88] Professor Schechter contends that *Sylmar Plaza*'s effect could likely be more broad than its actual holding. Even though the Ninth Circuit purported to limit its holding to a rejection of a per se rule, the Ninth Circuit's analysis, if followed by other courts, will likely make it more difficult to attack chapter 11 petitions and plans as lacking good faith.[89]

1. The Fickle Ninth Circuit

The Ninth Circuit's holdings in *Marsch* and *Silberkraus*, on the one hand, and in *Sylmar Plaza*, on the other hand, cannot be reconciled. As set forth above, the Ninth Circuit affirmed sanctions awards against the debtor and debtor's counsel in *Marsch* and *Silberkraus* . An award of sanctions must be based on findings that the filing in question is frivolous and brought for an improper purpose.[90] In *Sylmar Plaza*, however, the Court rejected any application of a per se rule in the context of chapter 11 bad faith analysis. If the Ninth Circuit is unwilling to establish any outside limits of good faith in chapter 11 filings, it is patently unfair for the court to expect debtors and their attorneys to be able to find that outside limit with any certainty. Under such circumstances, it is unreasonable for the court to find that a particular chapter 11 filing is frivolous. A petition is frivolous if, after a reasonable inquiry, a debtor could not form a reasonable belief that the petition is well grounded in fact and warranted by existing law or a good faith argument for the modification or reversal of existing law.[91]

Another apparent inconsistency in these holdings is in the court's treatment of strategic litigation filings and strategic commercial filings. The Ninth Circuit's reasoning in *Marsch* and *Silberkraus* indicate that it is far more

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[87] *Id.* at 1075 (citing *PPI Enters.*, 228 B.R. at 347).

[88] Dan Schechter, 2003 COMM. FIN. NEWS. 1 (Jan. 6, 2003).

[89] *Id.*

[90] Marsch v. Marsch (*In re* Marsch), 36 F.3d 825, 830 (9th Cir. 1994) (court must consider both frivolousness and improper purpose on a sliding scale, where the more compelling the showing as to one element, the less decisive need be the showing as to the other).

[91] *Id.* at 831 (Judge Trott, dissenting).

comfortable in disposing with the former. As set forth below, however, there is no sound basis for such a distinction.

2. *Sylmar Plaza* and *PPI Enterprises* Mistakenly Treat the Bankruptcy Code as Nothing More than Mandatory Contract Rules

The *Sylmar Plaza* and *PPI Enterprises* courts refused to look to the purposes and objectives of the Code to determine whether application of the Code provisions under which the debtor sought was justified. Instead, the courts narrowed their focus to scrutinize whether the specific application of the particular Code provision achieved the expected results as applied within a bankruptcy case. That analysis uses the wrong focal point for perceiving whether the case itself is consistent with the Code's purposes. The result of this analysis, ignoring whether a case is justified by the purposes of the Code, is to treat the Bankruptcy Code as merely a set of generally applicable mandatory, immutable contract rules. By comparing the employment of mandatory contract rules outside of bankruptcy, however, it becomes clear that the *Sylmar Plaza* and *PPI Enterprises* approach is faulty.

a. Mandatory, Immutable Contract Rules Are Justified Only by Sound Public Policy

Although it is often said that the Bankruptcy Code must be read into all debtor-creditor relationships, the Code must be more than a set of generally applicable mandatory contract rules. The Code's provisions should be invoked only where the purpose of the chapter 11 filing and/or the plan does not conflict with the Code's own purposes and policies. Otherwise, the Bankruptcy Code will encourage forum shopping and rent seeking - allowing debtors and their insiders the ability to use the bankruptcy court to extract wealth from creditors.[92] The *Sylmar Plaza* and *PPI Enterprises* courts failed to abide by this principle and, as a result, abdicated their critical gatekeeper position.

Commentators typically describe the interplay of the Bankruptcy Code and contract law as the imposition of the provisions of the Bankruptcy Code as implied, immutable terms of all commercial contracts.[93] The Code represents a

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[92] Ted Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design*, 43 ARIZ. L. REV. 559, 572, 609 (2001).

[93] Paul B. Lewis, *Bankruptcy Thermodynamics*, 50 FLA. L. REV. 329, 353-54 (April 1998); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 56 (Nov. 1992); Janger, *supra* note 92, at 609.

brand of immutable contract rules that is unique, however, for two reasons. First, the provisions of the Code, implied as they are in commercial contracts, only spring into effect upon the satisfaction of a condition precedent – the filing of a bankruptcy petition by or against one of the parties to the contract. Second, the Code, once invoked, trumps many of the rights and remedies that were available under the contract pursuant to nonbankruptcy law.[94]

Accordingly, a valid chapter 11 purpose must be a prerequisite to the application of the Bankruptcy Code's provisions to alter debtor/creditor relationships. Outside of bankruptcy, rules that are implied into contracts are typically default rules - provisions that the parties may change or eliminate by their agreement.[95] Implied rules that are mandatory and immutable are established only based on public policy concerns. Such rules are justified only where an unregulated agreement would be socially deleterious because parties to the contract or third parties cannot adequately protect themselves from the effects of the parties' agreement.[96] The purpose of such rules is to prevent enforcement of fraudulently procured terms.[97] In nonbankruptcy commercial law, the policy determination of whether an implied contract rule should be mandatory and immutable is made *ex ante*, before the parties to the contract enter into their agreement. For example, the Uniform Commercial Code includes a duty to act in good faith as an immutable component of every contract.

On the other hand, the Bankruptcy Code's mandatory, immutable rules apply not from the time of entry into the parties' contract, but only after a bankruptcy filing. Based on chapter 11 policy determinations, Congress may have defined, *ex ante*, the provisions for chapter 11 arrangement that will apply in bankruptcy, but the determination as to whether a particular bankruptcy case is valid can only be made after the fact of the filing.[98] In other words, the Bankruptcy Code's provisions should not be applied as mandatory and immutable simply because a bankruptcy case has been filed. Outside of bankruptcy, before

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[94] Lewis, *supra* note 93, at 354.

[95] *See generally*, Ayres and Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989).

[96] *Id.* at 88.

[97] Thomas L. Hudson, Note, *Immutable Contract Rules, the Bargaining Process, and Inalienable Rights: Why Concerns Over the Bargaining Process Do Not Justify Substantive Contract Limitations*, 34 ARIZ. L. REV. 337, 342-43 (1992).

[98] Of course, Congress could establish criteria for determining whether a bankruptcy filing is in good faith, but the application of those criteria would remain a precursor to the application of the Bankruptcy Code's substantive provisions.

any rule of contract is enforced as immutable, it must be justified by a sound public policy. By the same token, without determining that a bankruptcy petition or plan is filed in good faith, it is impossible to justify application of the provisions of the Code consistently with the Code's purposes and objectives.

b. Chapter 11's Purposes and Objectives Must Be Considered in Bad Faith Analysis

In the context of plan confirmation under Bankruptcy Code section 1129(a)(3), the relevant inquiry is whether the plan will fairly achieve a result consistent with the objectives and purposes of the Bankruptcy Code.[99] In the context of dismissal of a case under section 1112(b), the relevant inquiry is whether a debtor is attempting to unreasonably deter and harass creditors or attempting to effect a speedy, efficient reorganization on a feasible basis.[100] Either inquiry requires consideration of the Bankruptcy Code's fundamental purposes. The Bankruptcy Code's legislative history indicates the purpose of chapter 11 is to promote business reorganizations in order to preserve the going concern value of business enterprises.[101]

In *C-TC*, the Second Circuit noted the fundamental purpose of chapter 11:

> [t]he purpose of Chapter 11 reorganization is to assist financially distressed business enterprises by providing them with breathing space in which to return to a viable state. If there is not a potentially viable business in place worthy of protection and rehabilitation, the Chapter 11 effort has lost its *raison d'etre* . . . .[102]

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[99] Platinum Capital, Inc. v. Sylmar Plaza, L.P. (*In re* Sylmar Plaza, L.P.), 314 F. 3d 1070, 1074 (9th Cir. 2002).

[100] Marsch v. Marsch (*In re* Marsch), 36 F.3d 825, 828 (9th Cir. 1994).

[101] See H.R. REP. NO. 595, 95th Cong., 2d Sess. 222 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6179 ("The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they are designed are more valuable than those same assets sold for scrap. Often, the return on assets that a business can produce is inadequate to compensate those who have invested in the business. Cash flow problems may develop, and require creditors of the business, both trade creditors and long-term lenders, to wait for payment of their claims. If the business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.").

[102] C-TC 9th Avenue Partnership v. Norton Co. (*In re* C-TC 9th Avenue Partnership), 113 F.3d

In *SGL Carbon*, the Third Circuit held forth on the court's role in reviewing cases for good faith in light of the purposes of the Code:

> Review and analysis of [the bankruptcy laws and relevant cases] disclose a common theme and objective [underlying the reorganization provisions]: avoidance of the consequences of economic dismemberment and liquidation, and the preservation of ongoing values in a manner which does equity and is fair to rights and interests of the parties affected. But the perimeters of this potential mark the borderline between fulfillment and perversion; between accomplishing the objectives of rehabilitation and reorganization, and the use of these statutory provisions to destroy and undermine the legitimate rights and interests of those intended to benefit by this statutory policy. That borderline is patrolled by courts of equity, armed with the doctrine of "good faith" . . . .[103]

In addition to Congress's own legislative history and the principles espoused in the case law, there are two primary theoretical justifications for chapter 11 reorganization. The traditionalist or social benefit theory views bankruptcy as fundamentally different from state law creditors' rights law, since it involves numerous creditors and numerous defaults.[104] Under this theory, reorganization is considered to be the best approach to address the social concerns of a business's financial distress.[105] On the other hand, the "Creditors' Bargain" theory justifies reorganization as a means to maximize distributions to creditors and postulates that chapter 11 provides for a mechanism for the creditors to reach a bargain among themselves as to the distribution of the bankrupt entity's value.[106] The creditors' bargain theory views bankruptcy primarily as a collective action problem and chapter 11 as a means to prevent inefficient liquidations.[107]

1304, 1310 (2d Cir. 1997) (quoting *In re* Winshall Settlor's Trust, 758 F.2d 1136, 1137 (6th Cir. 1985)).

[103] *In re* SGL Carbon Corp., 200 F.3d 154, 161 (3d Cir. 1999) (quoting *In re* Victory Construction Co., Inc., 9 B.R. 549, 558 (Bankr. C.D. Calif. 1981) *order stayed* Hadley v. Victory Construction Co., Inc. (*In re* Victory Construction Co., Inc.), 9 B.R. 570 (Bankr. C.D. Calif. 1981).

[104] Lewis, *supra* note 93, at 359.

[105] *Id.* at 361.

[106] Rasmussen, *supra* note 93, at 59 (citing various works of Douglas G. Baird and Thomas H. Jackson).

[107] Janger, *supra* note 92, at 569.

None of the purposes and objectives of chapter 11 as expressed by Congress, the courts, or academics, support the continuation of the chapter 11 cases or confirmation of plans like those in *Sylmar Plaza* and *PPI Enterprises*. Denying a secured creditor default interest payments where all other creditors would be paid in full, even allowing for payment of such interest, benefits only the debtor's interest holders. It does not promote the debtor's rehabilitation because the debtor was not in financial distress. It does not address any collective action problem among creditors because creditors all will be paid in full. Likewise, denying a landlord his full state law damages claim when the debtor has no business but sufficient cash to pay all claims (including the landlord's uncapped claim), serves no identifiable bankruptcy purpose. The mere fact that the Bankruptcy Code provides for such relief cannot cleanse these cases of the stench of a bad faith strategic filing.

C. The Progeny of *PPI Enterprises* Foretells Continuing Trouble with Strategic Commercial Filings[108]

The bankruptcy court decision in *PPI Enterprises* was decided prior to the Third Circuit decision in *SGL Carbon*, where the Court of Appeals placed great emphasis on the necessity of a valid reorganizational purpose to support a good faith chapter 11 case. In light of the contrast between *SGL Carbon's* emphasis on a valid reorganizational purpose to support a good faith filing and the bankruptcy court's rather glib treatment of the solvency and liquidation issues in *PPI*,[109] it was reasonable to wonder whether the Third Circuit might reverse the bankruptcy court. Unfortunately, that was not the case. The Third Circuit affirmed the bankruptcy court's decision, giving great deference to the bankruptcy court's factual findings under the totality of the circumstances analysis.[110]

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[108] There seems to be a fine distinction between the Delaware approach (represented by *PPI*) and the Ninth Circuit approach in this context. In *PPI Enterprises*, the bankruptcy court established what appears to be a per se rule that filing solely for the purpose of the debtor taking advantage of a Code provision cannot be a factor in a finding of bad faith. On the other hand, the Ninth Circuit holds that there is no per se rule that filing solely for the purpose of the debtor taking advantage of a Code provision is a bad faith filing.

[109] *In re* PPI Enters. (U.S.), Inc., 228 B.R. 339, 345 (Bankr. D. Del. 1998) *aff'd* 324 F.3d 197 (3d Cir. 2003).

[110] Solow v. PPI Enters. (U.S.), Inc. (*In re* PPI Enters. (U.S.), Inc.), 324 F.3d 197, 210-11 (3d Cir. 2003).

Following up on its *PPI Enterprises* decision, the Delaware bankruptcy court denied a motion to dismiss the chapter 11 case in *Integrated Telecom Express, Inc.*[111] Several months prepetition, Integrated Telecom ceased operations and put together a plan to wind up under state law. The company held about $100 million in cash, but had only about $20 million in noninsured creditors' claims (including the landlord's noncapped claim for damages under state law). Before the chapter 11 filing, debtor's counsel attempted to negotiate concessions from its landlord under threat of bankruptcy, admittedly for the sole purpose of applying the section 502(b)(6) cap. The landlord refused any concessions, prompting the debtor to file its voluntary chapter 11 in Delaware and immediately file its liquidating plan to pay creditors in full (except the landlord who would receive "full" 502(b)(6) cap payment). The plan provided for many millions of dollars of distributions to shareholders.

Much like *PPI Enterprises* and *Sylmar Plaza*, the *Integrated Telecom* chapter 11 case had no reorganization purpose or collective action problem. The case is an even more blatant abuse of the Bankruptcy Code, however, because the assets had already been liquidated and a state law distribution plan formulated. No question can be thoughtfully entertained about the strategic, forum shopping purpose of this case. But, under the precedent set in *Sylmar Plaza* and *PPI Enterprises*, it appears that in the context of strategic commercial filings, the bankruptcy court need never ask whether the debtor should be allowed to take advantage of the Code's contract altering provisions, but need only ask whether the debtor can take advantage.

VI. Conclusion

Although the transaction costs of chapter 11 are very high, limiting the Code's utility for this purpose in many instances, the courts' recent liberal approach to strategic commercial filings could encourage further abuse of the Bankruptcy Code. Such abuse not only harms the targeted creditors, it reflects poorly on the integrity of the bankruptcy system. In turn, this may give momentum to the push for a legislative remedy to the bad faith filing problem.[112] Although no legislative good faith mandate is likely to be a panacea, the courts, left to their own devices, seem to be lost in the proverbial woods. The problem is exacerbated by the fact that bankruptcy courts across the country apply a totality

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[111] *In re* Integrated Telecom Express, 02-12945 (Bankr. D. Del. 2003) (unreported decision issued January 8, 2003).

[112] Miller, *supra* note 9.

of the circumstances test, which is then reviewed under a deferential standard by appellate courts. Clarification of the good faith standards to which debtors and counsel are expected to adhere is required. In the meantime, debtors and their counsel are left to weigh the high risks and rewards of strategic chapter 11 filings, and certain creditors will be left holding the bag.