

Can a Bankruptcy Plan Wipe Out Default Interest?

By John C. Murray

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Introduction

Use of Chapter 11 of the Bankruptcy Code enables the mortgagor/debtor to recognize a variety of economic benefits with almost no downside. The mortgagor/debtor may use bankruptcy as a means of obtaining capital discounts,¹ as a means of extending the time to repay, and as a way to modify certain mortgage provisions, such as due-on-sale, default, and prepayment provisions.² When there is illiquidity of capital markets, bankruptcy is a convenient way to compel a refinancing. The mortgage lender may consent to this refinancing, or, under certain circumstances, the refinancing may be “crammed down” on the lender when the lender disagrees with the terms.³ If the lender believes that the debtor has abused the bankruptcy process by filing a “sham” bankruptcy proceeding solely for the purpose of avoiding the payment of all or a portion of the mortgage loan (including default interest), the lender may seek to have the automatic stay lifted shortly after commencement of the case, in order to proceed with a foreclosure or other enforcement action.⁴ If unsuccessful at this juncture, the lender’s next opportunity to move for dismissal would be when the debtor submits a plan that the lender deems unconfirmable. If the lender has the good fortune of having the judge rule in its favor, the debtor will have had its day in court and no more. However, this hope recently was dealt a severe blow by the Ninth Circuit Court of Appeals. In *Platinum Capital Inc. v. Sylmar Plaza, L.P.*,⁵ the Ninth Circuit upheld the confirmation of the debtors’ (a limited partnership and associated individuals) Chapter 11 reorganization plan, which was filed for the sole purpose of avoiding approximately \$1 million of default interest due on a mortgage loan from the debtors to Platinum Capital, Inc. (“Platinum”), as the successor to the original mortgagee. This article will discuss the Ninth Circuit’s ruling in this case, and its ramifications for mortgage lenders.

Background

Tokai Bank of California made the original mortgage loan, in the amount of approximately \$8 million, to Rita and Roberta Hornwood in 1992, with the collateral consisting of a shopping center (“Sylmar Plaza”) owned by the Hornwoods. In 1995, the loan was modified to change the original interest rate to 8.87% and the default rate to 13.87%. The modification also extended the maturity date to April 3, 2009 and prohibited prepayment of the loan. Tokai Bank also permitted the transfer of the Sylmar Plaza property to revocable family trusts created by the Hornwoods for estate-planning purposes.

In 1997, the Hornwoods defaulted on the loan, and transferred the property (in violation of the due-on-sale clause in the mortgage) to Sylmar Plaza, L.P. (“Sylmar”),

which was a newly formed limited partnership. Tokai Bank commenced a judicial foreclosure proceeding in state court against the Hornwoods, and during the course of the foreclosure sold its note to Platinum. Sylmar Plaza then filed its Chapter 11 bankruptcy petition one day after the state court issued notice of foreclosure judgment. Platinum immediately filed a motion to lift the automatic stay, prompting the Hornwoods to each file individual Chapter 11 cases. The bankruptcy court ordered the sale of the Sylmar Plaza property for approximately \$7 million (which Platinum did not contest) free and clear of Platinum's mortgage lien, notwithstanding that its lien exceeded \$10 million. Because the confirmed reorganization plan provided that both Platinum's secured and unsecured claims would be paid in full on the plan's effective date, Platinum was not considered "impaired" under sec. 1129(b) of the Bankruptcy Code and was not entitled to reject the plan or receive "cram down" protections. According to the Ninth Circuit, "[t]he financial significance was to effect a 'cure' of the default so that all interest, including post-petition interest, would be calculated at the 8.87% non-default rate, rather than the 13.87% default rate. The difference in accrued interest calculated between the two rates amounts to approximately \$1 million."⁶

Platinum objected to confirmation of the plan, arguing that it had not been proposed in good faith as a matter of law, because it had no independent economic significance and was filed for the sole purpose of avoiding \$1 million of default interest owed to Platinum. Platinum also asserted that the plan was discriminatory because it provided for payment of 10% post-petition interest to all other unsecured creditor classes, while paying only 8.87% interest to Platinum on the unsecured portion of its claim.

The Ninth Circuit's Ruling

The Ninth Circuit rejected Platinum's argument that the debtor's bankruptcy reorganization plan was not filed in good faith. The court noted that the Bankruptcy Code does not define "good faith," and that good faith is determined case-by-case based on "the totality of the circumstances."⁷ The court also stated that "insolvency is not a prerequisite to a finding of good faith," and the fact that "a creditor's contractual rights are adversely affected does not by itself warrant a bad faith finding."⁸ The Ninth Circuit referred to its prior holding in *In re Entz-White Lumber and Supply, Inc.*,⁹ in which it stated that "It is clear that the power to cure under the Bankruptcy Code authorizes a plan to nullify all consequences of default, including avoidance of default penalties such as higher interest."¹⁰ The court found that "Platinum's proposed per se rule would inject unnecessary rigidity into the good faith inquiry."¹¹ With respect to the disparity in the interest rate paid to other creditors and the rate paid to Platinum, the court ruled that as an "unimpaired" creditor (i.e., a creditor that received payment in full of its claim) it had no standing to contest its treatment under the plan because, under the Bankruptcy Code, it was conclusively presumed to have accepted the plan.¹²

Plan Proposed in “Good Faith”

Section 362(d) of the Bankruptcy Code provides two grounds upon which the court may grant relief from the automatic stay. Relief may be granted for cause.¹³ Relief may also be granted when the debtor has no equity in the property and property is not necessary for effective reorganization.¹⁴ With respect to relief from the automatic stay granted for cause, bankruptcy courts often assess whether the debtor has filed the bankruptcy petition in “good faith.”¹⁵ A creditor also may, at a later date, object to confirmation of the debtor’s proposed Chapter 11 bankruptcy plan on the grounds that the plan was not proposed in “good faith,” as required by Section 1129 of the Bankruptcy Code.¹⁶

The Ninth Circuit’s decision in *Sylmar Plaza* is not surprising based on the Bankruptcy Code and existing case law, which grant bankruptcy courts wide discretion in deciding whether a particular reorganization plan was filed in good faith. Appellate courts show great deference to the bankruptcy courts in this area, because of the subjective nature of the determination. The bankruptcy court in *Sylmar Plaza* stated that “the plan has been proposed in good faith, given the . . . facts in the record and . . . history of the case as well.” The BAP, in turn, as noted by the Ninth Circuit, determined “that the bankruptcy court did not clearly err in finding that the plan met sec. 1129(a)(3)’s good faith requirement.”¹⁷ However -- although perhaps not technically objectionable -- there is something inherently distasteful, from an equitable standpoint, about a commercial debtor using bankruptcy as a tool for the sole purpose of depriving its principal creditor of a contractually agreed-upon default rate while leaving the debtor solvent. The lender would certainly be able to claim the default amount in its foreclosure proceeding outside of bankruptcy.

Many bankruptcy judges are hostile to the concept of a bad-faith filing and will seldom dismiss a bankruptcy case on such grounds. Bankruptcy courts often shy away from the concept of bad faith, even if “objective” standards are satisfied.¹⁸ However, a number of courts have recognized the burdens imposed on secured creditors, especially in single-asset cases. Some courts are responsive to motions to dismiss single-asset cases or to modify the stay on the grounds that the case was filed in bad faith, while other courts may, upon recognizing the filing a having been made in bad faith, allow the debtor no more than the 120-day exclusive period¹⁹ in which to file a plan of reorganization.²⁰ However, the case law in this area has been less than uniform.

These are the factors some courts consider in finding bad faith:

- The debtor has few or no unsecured creditors;
- There has been a previous bankruptcy petition by the debtor or a related entity;
- The pre-petition conduct of the debtor has been improper;
- The petition effectively allows the debtor to evade court orders;
- There are few debts to non-moving creditors;
- The petition was filed on the eve of foreclosure;

- The foreclosed property is the sole or major asset of the debtor;
- The debtor has no ongoing business or employees;
- There is no possibility of reorganization;
- The debtor's income is not sufficient to operate;
- There was no pressure from non-moving creditors;
- Reorganization essentially involves the resolution of a two-party dispute;
- A corporate debtor was formed and received title to its major assets immediately before the petition (the "new debtor syndrome"); and
- The debtor filed solely to create the automatic stay.²¹

The secured creditor should consider moving for dismissal immediately after the debtor files the bankruptcy petition. The creditor's motion for dismissal may be heard simultaneously with the debtor's motion to use cash collateral. This hearing is the first opportunity to present to the judge the creditor's interests and efforts, or inability, to work out a solution to the case. The creditor may try to persuade the judge that the filing is made in bad faith or that a reorganization is futile. Although it is unlikely that the case will be dismissed at such an early stage, the judge may set a strict time limit for extensions to the exclusivity period and may deny any motions without prejudice.

Treatment of Unimpaired Classes; "Cramdown"

The court in *Sylmar Plaza* found that as an unimpaired creditor, Platinum had no standing to complain of discrimination in the interest rates paid to other creditors because, under the Bankruptcy Code, it was conclusively presumed to have accepted the plan. It is true that unimpaired classes are not allowed to vote for or against the confirmation of a bankruptcy plan.²² However, under the Bankruptcy Code, treatment of unimpaired claims must comply with one of the following standards: (1) the plan must not alter the legal, equitable, and contractual rights of claims holders in the class; or (2) the plan must cure all pre-bankruptcy arrearage, reinstate the maturity of the claims, and compensate the claims holders for damages incurred as a result of reasonable reliance on their contractual provisions.²³

Prior to the passage of the 1994 Bankruptcy Reform Act,²⁴ the Bankruptcy Code provided that a class was considered to be unimpaired if, on the effective date of the plan, the class members received cash for the allowed amount of their claims.²⁵ However, the Reform Act specifically deleted this provision of the Bankruptcy Code with the intention of forcing debtors to pay interest to unsecured creditors if the creditors' allowed unsecured claims were paid in full.²⁶ Congress deleted this section to overrule a 1994 bankruptcy decision, *In re New Valley Corp.*,²⁷ which held that under certain circumstances the claims of unsecured creditors could be considered paid in full and unimpaired, even though no post-petition interest was to be paid on such claims. Unfortunately, the deletion of this provision may make it easier for a single-asset debtor to impair unsecured creditors and confirm a plan. Arguably a debtor can now pay allowed unsecured claims in full upon confirmation of the plan without paying interest and still treat the class as impaired for voting purposes. Prior to deletion of this provision,

the debtor avoided paying interest only by paying less than 100% of such claims or by paying the impaired unsecured creditors in full within an extended period of time—for example, ninety days after the effective date of the plan—and taking a greater risk that the class would reject the plan.

The Bankruptcy Code requires that a Chapter 11 reorganization plan provide adequate means for the plan's implementation, such as curing or waiving any default.²⁸ The Bankruptcy Code also provides that a class that is not impaired under a plan is conclusively presumed to have accepted the plan.²⁹ The bankruptcy court must confirm the plan if it does not discriminate unfairly with respect to each class of claims that is impaired.³⁰

If all of the legal requirements of a Chapter 11 reorganization plan are met, with the exception of a successful confirmation vote by creditors, the plan may still be confirmed under the Bankruptcy Code over the objection of a dissenting class.³¹ If the plan does not discriminate unfairly and is fair and equitable to the dissenting class, it can be "crammed down" on the impaired class that votes against the plan. In a cramdown, the debtor may (1) reduce the principal amount of the secured claim to the value of the collateral; (2) reduce the interest rate; (3) extend the maturity date; or (4) alter the repayment schedule.³² The debtor may also make a minimal payment on the unsecured claim. Under the Bankruptcy Code a cramdown is permissible when the plan provides a dissenting secured class with consideration equal to the amount of its claim or when no class below the dissenting unsecured class participates under the plan.³³

A cramdown is the single biggest workout and bankruptcy threat to a lender. However, the confirmation and other requirements that a debtor must satisfy in order to cram down both a secured and an unsecured claim, particularly in the case of a single-asset real estate bankruptcy, impose such burdens on a debtor that few Chapter 11 debtors who propose cramdown plans successfully achieve reorganization by cramming down the lender. Although a mortgagee may be entitled to retain all of its rights under the mortgage, the mortgagee will not necessarily receive an obligation with level periodic payments. Also, the present value requirement necessitates the use of an interest rate. This rate varies in each jurisdiction and can be either the contract rate or a market rate based on Treasury bill rates plus a court determined upward adjustment for risk factors. The debtor's plan may also propose negative amortization of the lender's secured claim. Negative amortization occurs when part or all of the interest on the claim is deferred, allowed to accrue, and added to the principal periodically to be paid at a later date when the income from the property has increased or its value has appreciated. Bankruptcy courts have held that negative amortization is not per se impermissible, but courts will closely scrutinize plans proposing this form of payment on a case-by-case basis. A class of secured creditors can also be crammed down if each secured creditor receives the indubitable equivalent of the claim. A secured creditor receives the indubitable equivalent of the claim when the secured creditor receives a return of part of its collateral while the remainder of its secured claim continues to be secured by the remaining collateral, and when the debtor proposes to pay the present value of the remaining secured claim over a period of time.

The 1111(b)(2) Election

As noted in the Ninth Circuit's opinion in *Sylmar Plaza*, Sylmar's claim was "bifurcated into a secured claim measured by the net proceeds of the sale of Sylmar Plaza (plus funds in the hands of the receiver appointed by the state court) and an unsecured claim for the balance."³⁴ Section 1111(b)³⁵ of the Bankruptcy Code enables an undersecured, non-recourse creditor to avoid being cashed out at the depressed value of the secured collateral and enables the creditor to share in any future appreciation in such value. The claim of an undersecured creditor is divided into two claims: (1) a secured claim equal to the value of its collateral, and (2) an unsecured deficiency claim for the balance. Under sec. 1111(b)(2), an undersecured creditor may elect to have the entire claim treated as fully secured.

The following are two important aspects of making the sec. 1111(b)(2) election: (1) the undersecured creditor loses the right to vote regarding the previously unsecured claim; and (2) the unsecured creditor must make the election before the conclusion of the hearing on the disclosure statement. Often, this second requirement forces the undersecured creditor to elect before adequate disclosure has been made concerning the plan and the proponent's intentions. By making a sec. 1111(b)(2) election, a creditor may significantly affect whether the amount of deferred cash payments proposed under a plan and the present value of those payments satisfy the cramdown confirmation standards of sec. 1129(b). For example, assume that a creditor has a \$5 million claim secured by collateral worth \$3 million. Under sec. 1129(b)(2)(A)(i)(II), the plan would have to provide the secured creditor with deferred cash payments that total at least \$3 million (the amount of the allowed secured claim) and that have a present value of at least \$3 million. These cash payments may continue over five years and would total \$4.5 million at a 10% rate of interest. Expecting the confirmation of a cramdown, the debtor would be likely to propose some treatment of the \$2 million unsecured deficiency claim. Usually, the debtor proposes to pay the deficiency claim at a fraction of the face amount over a period of time, such as 20% over five years.

If, however, the creditor makes the sec. 1111(b)(2) election, the deferred cash payments for the secured claim must equal \$5 million (the allowed amount of the entire claim) and have a present value of \$3 million (the value of the collateral). Thus, in this example, if the undersecured creditor makes this election, the creditor is entitled to a total of \$2 million of additional deferred cash payments, not just a fraction of this amount. However, this requirement is often met by lengthening the term of the deferred payments. Here, seven years of payments at 10% would total \$5.1 million and would satisfy sec.1111(b)(2).

Under sec. 1111(b)(2), the creditor will never get less than the full mortgage amount, but also will never get more than the net present value of the collateral on the plan date. On the other hand, a cramdown plan could provide a market rate of return on the collateral value plus a potential benefit in the form of a share of the excess cash flow, sharp depreciation upon a subsequent sale or refinancing, or a scheduled payment on the unsecured portion of the claim. By making the sec. 1111(b)(2) election, the creditor

becomes secured and, therefore, loses the right to vote in the unsecured class. In other words, the creditor loses one opportunity to vote against the plan. By foregoing the unsecured claim, the undersecured creditor also foregoes the opportunity to assert any potential classification, unfair discrimination, and fair-and-equitable objections. These objections could prove fatal to the confirmation of the debtor's plan. Thus, the undersecured creditor could be relinquishing major litigation advantages by making the sec.1111(b)(2) election. Nevertheless, a secured creditor should consider making a sec.1111(b)(2) election when the deficiency claim is small and unlikely to dominate voting in the secured creditor's class. In this instance, losing a vote as a consequence of making the sec. 1111(b)(2) election may not be a factor that the creditor needs to consider. The right to make the sec.1111(b)(2) election belongs solely to the secured creditor. This election cannot be made by the debtor on behalf of the secured creditor.

Unpermitted Pre-Petition Transfers

It is interesting when things started going bad for the individual plaintiffs in *Sylmar Plaza*, they transferred the mortgaged property to a new entity, Sylmar Partnership, without bothering to get the required permission from the lender. In *Travelers Ins. Co. v. Corporex Properties, Inc.*,³⁶ (a case with which the author was intimately involved as in-house counsel for The Travelers Insurance Company ("Travelers")), the court expressly upheld a pre-negotiation agreement entered into between Travelers and the borrower in connection with a proposed negotiated workout of a \$6.4 million nonrecourse commercial mortgage loan on an office building in Covington, Kentucky. Because the borrower had conveyed the mortgaged property during the negotiation discussions to a corporation controlled by the borrower in violation of the due-on-sale clause in the mortgage, to better position the borrower for a "new debtor" bankruptcy, to avoid negative publicity, and to put the borrower, in its own words, "in a better position to negotiate on an even basis," the court, in an unusual form of relief awarded to Travelers, ordered a reconveyance of the property to the original borrower. The borrower appealed the court's decision to the U.S. Sixth Circuit Court of Appeals based solely on the court's order of reconveyance, but Travelers and the borrower subsequently reached a settlement providing for conveyance of the property to Travelers by a deed in lieu of foreclosure, and the appeal was dismissed with prejudice.

Cases Permitting Default Interest or Finding Bad Faith

Other federal courts, under circumstances similar to those found in *Sylmar Plaza*, have found that the mortgagee was entitled to the default rate of interest stated in the loan documents. For example, in *In re 139-141 Owners Corp.*,³⁷ the bankruptcy court for the Southern District of New York, citing prior authority in the Second Circuit (and in other jurisdictions), rejected the court's holding in *Sylmar*. The court ruled that while in most circumstances it is within the court's equitable power to limit or prevent the collection of the contractual default rate by the mortgagee in order to provide an "equitable

distribution” to creditors, this is not a statutory right and is inappropriate and inequitable, and therefore should not be invoked, where the debtor is solvent and the rights of unsecured creditors are not adversely affected. The bankruptcy court cited the Second Circuit’s prior ruling in *Ruskin v. Griffiths*,³⁸ which enforced the creditor’s right to the contractual default interest rate where the debtor was solvent. The court in *139-141 Owners Corp.* stated that, “*Ruskin* remains effective to date in the Second Circuit and is recognized by other circuits,”³⁹ and cited numerous decisions upholding the creditor’s right to contractual default interest where there were no countervailing equitable considerations.⁴⁰ The court found that in this case the equities did not warrant the exercise of the court’s equitable discretion to nullify the creditor’s contractual right to collect default interest, for the following reasons: the debtor was solvent at all times, (the value of the debtor’s assets was more than twice its liabilities); its income was more than sufficient to pay its obligations as they became due, including debt service on both the first mortgage and second mortgage in effect on the property; the debtor defaulted in the payment of both mortgages for the sole purpose of diverting income to pay for the debtor’s other business ventures; the debtor did not file its bankruptcy proceeding to become profitable, to protect other creditors, or to prevent a foreclosure sale that would wipe out equity in the property; and any prohibition of the creditor’s right to collect interest at the stated default rate would be of sole benefit to the debtor and would create an unwarranted windfall.

In *In re Integrated Telecom Express, Inc.*,⁴¹ the landlord contended that the tenant-debtor’s Chapter 11 bankruptcy petition should be dismissed for having been filed in bad faith because the debtor-tenant was “highly solvent” and “cash rich,” never in financial distress, and filed its petition for the sole purpose of limiting the landlord’s recovery under § 502(b) (6) of the Bankruptcy Code in order to increase the distribution to the debtor’s shareholders at the landlord’s expense. (Under sec. 502(b)(6) of the Bankruptcy Code, a landlord’s claim for early termination of a lease is limited to the rent due under the lease for the greater of one year or 15 percent, not to exceed three years.) According to the court, “[t]hese contentions are corroborated by the record.”⁴² The court noted that, at the time of the debtor’s bankruptcy filing, the debtor had almost \$107 million in cash and other assets while its only indebtedness, outside of the landlord’s discounted claim of approximately \$26 million, was for miscellaneous liabilities of approximately \$430,000. The court also referred to a “smoking gun” resolution approved by the debtor’s board of directors, which authorized a letter from the debtor’s law firm [Murray and Murray -- no relation to the author] to the landlord threatening a bankruptcy filing in order to avail itself of certain provisions of the Bankruptcy Code -- specifically including the § 502(b)(6) cap on the landlord’s damages -- if the landlord did not enter into a settlement of lease obligations for \$8 million.

Both the bankruptcy court and the Federal district court rejected the landlord’s request to dismiss the debtor’s bankruptcy bad-faith claim, ruling that the debtor was in financial distress and that, in any event, filing the Chapter 11 petition was in accordance with the fiduciary obligations to its shareholders and the debtor’s expressed intention to take advantage of the § 502(b) (6) cap was not a sufficient basis to dismiss the petition as a “matter of law.” (Imposition of the cap effectively reduced the landlord’s claim from \$26 million to \$4.3 million.) The bankruptcy court cited other cases for the proposition that a solvent debtor could avail itself of the § 502(b)(6) cap, including *Sylmar Plaza*,

supra, which the bankruptcy court described as “almost on all fours with the situation before me.”⁴³

The Third Circuit reversed the holdings of the bankruptcy court and the district court, ruling that under the facts of this case the debtor’s Chapter 11 petition was filed in bad faith because the debtor was financially sound, had no intention of reorganizing or liquidating as a going concern, had no reasonable expectation that the bankruptcy filing would maximize the value of the debtor’s estate for creditors, and was commenced solely to take advantage of a Bankruptcy Code provision limiting the rights of landlords. The court noted that the burden is on the debtor to establish that its petition is filed in good faith, and that the prime purposes of Chapter 11 are to preserve going-concern value and maximize the value of the debtor’s estate for the benefit of creditors (and not, as is the instant case, to distribute value directly from a creditor to a company’s shareholders). In this connection, the court cited cases holding that a petition filed without a valid reorganizational purpose and merely to obtain a tactical legal advantage would constitute bad faith and constitute cause for dismissal. The court noted that these principles applied equally to a liquidating Chapter 11 plan (as occurred in this case). The court reasoned that “[w]hile the owners of [the debtor] may never recover the full value of their investments, they stand to reap a substantial gain through bankruptcy, at the expense of the company’s sole creditor.”⁴⁴ The court found further that the debtor was not in fact in any “financial distress,” and noted that the fact that there is no insolvency requirement for a bankruptcy filing “does not mean that all solvent firms should have unfettered access to Chapter 11.”⁴⁵ Furthermore, according to the court, there was “no value for [the debtor’s] assets that was threatened outside of bankruptcy by the collapse of [the debtor’s] bankruptcy model, but that could be preserved or maximized in an orderly liquidation under Chapter 11.”⁴⁶

The Third Circuit distinguished *Sylmar Plaza, supra*, which the court found (in a rather strained analysis) differed from the instant case because it involved a situation where “the Bankruptcy Code was used to maximize value for creditors as a whole” and “although the debtors appear to have come out solvent in *Sylmar Plaza*, there is no indication that they would have come out solvent had the bank’s claim not been limited, or that solvency was a foregone conclusion when the petition was filed.”⁴⁷ With respect to the issue of filing a bankruptcy petition for the purpose of taking advantage of the § 502(b)(6) cap on a landlord’s damages, the court stated that, “§ 502(b)(6) and the legislative policy underlying that provision assume the existence of a valid bankruptcy, which, in turn, assumes a debtor in financial distress. The question of good faith is therefore antecedent to the operation of § 502(b)(6).”⁴⁸ In this case, the court found that always allowing a tenant to file bankruptcy for the sole purpose of avoiding its lease whenever the landlord’s state law remedy exceeded the § 502(b)(6) cap was not countenanced by the Bankruptcy Code or its legislative history and that, “[s]uch a rule would not only obviate the need for a good faith requirement, but would be antithetical to the structure and purposes of the Bankruptcy Code.”⁴⁹

The Third Circuit also distinguished another case cited by the debtor in support of its position, *In re PPI Enters.*⁵⁰ In this case, the Third Circuit permitted a Chapter 11 bankruptcy filing by a tenant to take advantage of special tenant lease protections, even when there was no other rationale for a bankruptcy filing and the debtor (and the court)

acknowledged that the primary purpose of the filing was to cap the landlord's claim under § 502(b)(6). The Third Circuit, in *Integrated Telecom*, distinguished its prior ruling in the *PPI* case based on the following factors:

- 1) "The [bankruptcy court in *Integrated Telecom*] saw no significance in the fact that the sec. 502(b)(6) cap would operate solely to the benefit of equity holders, as opposed to creditors."⁵¹
- 2) "The absence of any financial distress facing *Integrated* distinguishes the two principal cases relied on by the Bankruptcy Court and the District Court" [i.e., *PPI* and *Sylmar Plaza*].⁵²
- 3) "Critically, the debtor in *PPI* claimed to have been insolvent. In addition to the landlord's claims, the debtor had unsecured claims of approximately \$54.6 million, dwarfing the value of its only asset, the Del Monte stock . . . Accordingly, *PPI* stands for the proposition that an insolvent debtor can file under Chapter 11 in order to maximize the value of its sole asset to satisfy its creditors, while at the same time availing itself of the landlord cap under sec. 502(b)(6)."⁵³

The Third Circuit also cited another recent bankruptcy case, *In re Liberate Techs*,⁵⁴ in which the court dismissed, for lack of good faith, a Chapter 11 petition filed by the debtor-tenant solely to take advantage of claim for future rent under § 502(b)(6)). The bankruptcy court in that case stated that, "[u]se of the section 502(b)(6) cap, while not establishing bad faith, also does not establish the requisite need for chapter 11 relief," and, "[t]here is no evidence that Congress determined that state landlord-tenant law should be superseded by federal law except where necessary to help an entity with genuine financial problems".⁵⁵

Finally, the court dismissed the debtor's assertion that a pending securities class action necessitated the filing of a Chapter 11 petition, because the debtor's maximum liability (pursuant to a settlement agreement and available insurance proceeds) was limited to a \$5 million reserve. In fact, the court stated that "[r]ather than pursuing a valid bankruptcy purpose . . . [the debtor] filed for Chapter 11 in part to gain a litigation advantage over the securities class, a use of Chapter 11 that we emphatically rejected."⁵⁶

The ruling in *Integrated Telecom* is, of course, a victory for the landlord and for its lawyers, Seth P. Waxman and Craig Goldblatt of Wilmer Cutler Pickering Hale & Dorr in Washington, D.C. Mr. Waxman, who served as U.S. solicitor general during the second Clinton administration, was supported in the appeal by an amicus brief filed by three bankruptcy-law professors -- David A. Skeel Jr. of the University of Pennsylvania Law School; Robert K. Rasmussen of the Vanderbilt Law School; and G. Marcus Cole of the Stanford Law School.

In their amicus brief, the professors argued that *Integrated Telecom* failed to satisfy one of the key prerequisites for seeking protection in bankruptcy court -- i.e., it was unable to show that it was in "financial distress." According to the professors' brief,

at the time it sought to invoke the powers of Chapter 11, the debtor had sufficient cash on hand to pay all of its creditors in full and this cash was not necessary to fund ongoing operations of the debtor, because the debtor had ceased all operations. Also, according to the professors, this case was neither a reorganization nor a liquidation but a redistribution and did not belong in Chapter 11.⁵⁷

Conclusion

The Ninth Circuit, in *Sylmar Plaza*, rejected Platinum's argument that the entire plan was a "sham" that had "no material economic impact other than to deprive Platinum of the \$1 million in default interest."⁵⁸ The court noted that Platinum did not challenge the bankruptcy court's finding of good faith based on the "totality of the circumstances," but rather argued that lack of good faith had been established as a matter of law. The Ninth Circuit was not willing to adopt such an "inflexible" *per se* rule.⁵⁹ Although the Ninth Circuit showed great deference to the bankruptcy court's factual findings on the issue of Sylmar's good faith, based on existing case law this was certainly – at the very least – a close call. Sylmar expressly acknowledged filing for the sole purpose of avoiding payment of \$1 million in default interest, which it would have been contractually liable to pay if the bankruptcy court had permitted the pending state foreclosure action to proceed. The court also acknowledged that Sylmar's plan would leave it solvent while permitting it to avoid paying post-petition interest to Platinum at the contractual default rate. Furthermore, Sylmar admitted that the individual debtors had transferred the real estate collateral to Sylmar at the same time they defaulted under their mortgage loan obligations to Platinum, in clear and deliberate violation of the due-on-sale clause in the mortgage. It is difficult to imagine a more egregious factual situation, and one is left to wonder what possible set of circumstances would persuade the Ninth Circuit to rule that a debtor's Chapter 11 petition had been filed in bad faith. Fortunately, as noted in this article, there is case law to the contrary -- at least in those situations where a solvent tenant files a bankruptcy petition solely to limit the landlord's damages under § 502(b)(6) of the Bankruptcy Code. But the message to lenders subject to the Ninth Circuit's jurisdiction appears to be: It doesn't really matter what the debtor's motives are, we aren't going to rule that the filing was in bad faith.

Endnotes

¹ A capital discount is the re-writing of debt to market rates that are usually lower or more favorable to the debtor.

² See *infra* note 33, and accompanying text.

³ In a cramdown, a plan may be confirmed by the court even though a class of creditors does not vote to accept the plan, provided that the plan complies with 11 USC 1129(b) (2003). The plan must not discriminate unfairly and must be fair and equitable to each class of impaired creditors, including those that have not accepted the plan. See 11 USC 1129(b) (2003). See also *infra* notes 31-33, and accompanying text.

⁴ See discussion *infra* at notes 12-14, and accompanying text.

⁵ (*In re Sylmar Plaza, LP*), 314 F3d 1070 (9th Cir. 2002), *cert. denied.*, 123 S.Ct. 2097 (2003).

⁶ *Id* at 1073.

⁷ *Id* at 1074.

⁸ *Id* at 1074-75. See 11 USC 1129(a) (2003), which lists all the requirements for confirmation of a Chapter 11 plan. *But see In re Consolidated Operating Powers, L.P.*, 91 B.R. 113, 116-17 (Bankr. D. Colo. 1988) (“When the debtor is solvent, the equities dictate that the additional interest be paid to the secured creditor rather than to the debtor . . . the benefit derived from any reduction in the contract rate would not inure to the creditors but instead would be a windfall to the debtor. Such a result would mean that any solvent debtor seeking to avoid the cost of default rate interest could file for Chapter 11. No such result was intended by Congress.”)

⁹ 850 F2d 1338 (9th Cir 1988).

¹⁰ *Id* at 1342.

¹¹ *Sylmar Plaza*, *supra* note 1, 314 F3d at 1075.

¹² 11 USC 1126(f) (2003).

¹³ 11 USC 362(d)(1) (2003). “Cause” is not defined in the Bankruptcy Code. See also 11 USC 1112(b), which provides that bankruptcy courts may dismiss Chapter 11 cases for “cause” if certain non-exclusive factors are present. See 11 USC 1112(b) (1) - (10). Although not specifically mentioned, Chapter 11 petitions may be dismissed for “bad faith” under 1112(b), which is determined by considering the “totality of the circumstances.” For example, the “new debtor syndrome,” in which a single-asset special purpose entity is created immediately prior to foreclosure in an attempt to isolate and “bankruptcy-proof” the insolvent debtor and its property from creditors, is such a circumstance. See *In re Trident Assocs Ltd Partnership*, 52 F3d 127, 130 (6th Cir 1995), *cert denied*, 516 US 869 (1995) (stating that “[t]he bankruptcy court may dismiss a Chapter 11 case for cause” under 1112(b) “if it was filed in bad faith,” and holding that debtor’s “new debtor syndrome” filing was in bad faith and was properly dismissed by bankruptcy court).

¹⁴ 11 USC 362(d)(2) (2003).

¹⁵ See, e.g., *Matter of Holly’s, Inc*, 140 BR 643, 689 (Bankr, WD Mich 1992) (ruling that “cause” to appoint trustee under 11 USC 1104 and “cause” to modify stay for benefit of secured creditor are not identical); *Matter of 1025 Associates, Inc*, 106 BR 805, 808 (Bankr D Del 1989) (finding that although fraud may constitute cause for relief from automatic stay, there was insufficient evidence of such fraud in instant case); cf. *In re Powers Aero Marine Services, Inc*, 42 BR 540, 546 (Bankr SD Tex 1984) (holding that prepetition mismanagement by debtor was sufficient cause for relief from stay).

¹⁶ See USC 1129(a)(3) (2003) (stating that the court may confirm a plan only if “[t]he plan has been proposed in good faith and not by any means forbidden by law”). Section 1129(a)(3) does not define “good faith”).

¹⁷ *Sylmar Plaza*, *supra* note 1, 314 F3d at 1074.

¹⁸ See, e.g., *In re James Wilson Assocs*, 965 F2d 160, 170 (7th Cir 1992) (holding that it is not bad faith for debtor to seek to gain an advantage from declaring bankruptcy and stating “why else would one declare it,” but stating also that “[t]he clearest case of bad faith is where the debtor enters Chapter 11 knowing that there is no chance to reorganize his business and hoping merely to stave off the evil day when the creditors take control of his property”); *In re Cadwell’s Corners Partnership*, 174 BR 744, 762 (Bankr ND Ill 1994) (“[a]lthough evidence was presented indicating that the partners were concerned about the tax consequences of foreclosure, this alone is not enough to establish bad faith”); *In re LDN Corp.*, 191 BR 320, 327 (Bankr ED Va 1996); cf. *In re 203 North LaSalle Street Ltd Partnership*, 190 BR 567, 590 (Bankr

D Ill 1995), *order aff'd*, 195 BR 692 (ND Ill 1996), *judgment aff'd*, 126 F3d 955 (7th Cir 1997), *cert granted*, 523 U.S. 1106 (1998), *judgment rev'd on other grounds*, 526 U.S. 434 (1999) (finding that debtor's single-asset real estate reorganization plan proposal was made in good faith despite underlying motivation of avoiding adverse tax consequences, but stating that "unnecessary bankruptcies filed by debtors who can pay their creditors in the ordinary course of business, unless bankruptcies filed without prospect for reorganization, and harassing bankruptcies filed as part of a pattern of delay or misconduct, are found to be filed in bad faith (citation omitted)"); *Ryan v. Loui (In re Corey)*, 892 F.2d 829, 835 (9th Cir 1989) ("granting the district court's findings substantial deference, we find no absence of good faith on the part of the [debtors] in proposing this plan. The [debtors] plan appears to be a fair and well-reasoned effort to end [] years of litigation . . . [and] it results in payment in full of all creditors, with a substantial portion of the estate remaining in the debtor, an uncommon result in bankruptcy proceedings. The district court was well within its discretion in approving the plan"); *Solow v PPI Enters (In re PPI Enters)*, 2003 US App LEXIS 5937 (3rd Cir, March 28, 2003) (holding that debtor's Chapter 11 liquidating plan to sell off all its assets was not abuse of discretion and was filed in good faith).

¹⁹ 11 USC 1121(b) (2003). Section 1121(d) provides that the court, for cause, may increase or decrease the length of the exclusivity period by motion of any party in interest. In determining whether cause exists to extend the debtor's exclusivity period, courts may examine: (1) the size and complexity of the case; (2) the necessity of sufficient time to negotiate and prepare adequate information; (3) the existence of good faith progress toward reorganization; (4) whether the debtor is paying debts as they become due; (5) whether the debtor has demonstrated reasonable prospects for filing a viable plan; (6) whether the debtor has made progress in negotiating with creditors; (7) the length of time the case has been pending; (8) whether the debtor is seeking the extension to pressure creditors; and (9) whether unresolved contingencies exist. *In re Express One Int'l, Inc.*, 194 BR 98, 100 (Bankr ED Tex 1996). *See also In re Dow Corning Corp.*, 208 BR 661, 663 (Bankr ED Mich 1997) ("the Debtor bears the burden to continue the extension").

²⁰ *See, e.g., In re Cedar Shore Resort, Inc.*, 235 F3d 375, 380-82 (8th Cir 2000) (holding that Chapter 11 petition may be dismissed for bad faith alone when circumstances warrant, despite possibility of successful reorganization, and stating that "there is strong evidence to support the finding that [the debtor] did not file bankruptcy to effectuate a valid reorganization, but rather to prevent [the objecting creditors] from pursuing their claims in state court"); *Cedar Shore Resort, Inc v. Mueller (In re Cedar Shore Resort, Inc)*, 235 F3d 375, 380-82 (8th Cir 2000) (holding that Chapter 11 petition may be dismissed for bad faith alone when circumstances warrant, despite possibility of successful reorganization, and stating that "there is strong evidence to support the finding that [the debtor] did not file bankruptcy to effectuate a valid reorganization, but rather to prevent [the objecting creditors] from pursuing their claims in state court"); *In re LDN Corp.*, 191 BR 320, 327 (Bankr ED Va. 1996) (granting creditor's motion to dismiss for bad faith filing based on late filing of debtor's plan, failure of debtor to request filing extension and failure to commence interest payments or to pay debt service from operating income in the past); *In re Rusty Jones, Inc.*, 110 BR 362, 375 (Bankr ND Ill 1990) (holding that reorganization plan was not proposed in good faith when it did not effectively reorganize debtor's business affairs, prevent job loss, or prevent adverse economic effects); *In re Castleton Associates*, 109 BR 347, 350-51 (Bankr SD Ind 1989) (stating that purpose of reorganization is not to provide "soft landing" for debtor's partners); *In re Metropolitan Realty Corp.*, 433 F2d 676, 678 (5th Cir 1971) ("good faith implies an honest intent and genuine desire on the part of the petitioner to use the statutory process to effect a plan of reorganization and not merely as a device to serve some sinister or unworthy purpose").

²¹ *See, e.g., In re SGL Carbon Corp.*, 200 F3d 154, 166 n. 10 (3rd Cir 1999) ("no list is exhaustive of all the factors which could be relevant when analyzing a particular debtor's good faith"); *In re Love*, 957 F2d 1350, 1357 (7th Cir 1992) (stating that the factors that are relevant in determining good faith include (1) the nature of the debt, (2) timing of the petition, (3) how the debt arose, (4) the debtor's motive in filing the petition, (5) how the debtor's action affected creditors, (6) the debtor's treatment of creditors both before and after the petition was filed, and (7) whether the debtor has been forthcoming with the bankruptcy court creditors); *Barclays-Am/Bus. Credit, Inc. v. Radio WBHP, Inc (In re Dixie Broadcasting, Inc)*, 871 F2d 1023, 1027 (11th Cir 1989), *cert. denied*, 493 US 853 (1989) (stating that factors to be considered by court in permitting relief from automatic stay include findings by court that debtor has filed the petition (1) at an inappropriate time, (2) despite good financial health, (3) strictly to avoid pending litigation, and (4) 'solely to reject an unprofitable contract'); *In re Phoenix Piccadilly, Ltd.*, 849 F2d 1393, 1394-95 (11th Cir 1988) (setting forth an exhausting description of six factors that court may consider when deciding whether

debtor's bankruptcy has been filed in bad faith); *In re Midway Investments, Ltd.*, 187 BR 382, 387 (Bankr SD Fla 1995) (concluding that "the Bankruptcy Reform Act of 1994 does not limit the *Phoenix Piccadilly* line of cases"); *In re Madison Hotel Assocs.*, 749 F2d 410, 425 (7th Cir 1984) (applying an objective test of inquiry into terms of plan itself and whether plan will "fairly achieve a result consistent with the objectives and purposes of the Bankruptcy Code"); *In re Corey*, *supra* note 17, 892 F2d at 835 ("In order to satisfy the statutory requirement of good faith, a plan must be intended to achieve a result consistent with the objectives of the Bankruptcy Code (citations omitted)"); *In re Victoria Ltd Partnership*, 187 BR 54, 59 (Bankr D Mass 1995) (discussing perceived conflict between good faith filing doctrine and section 1112(b)(1), "which authorizes the court to dismiss the case for continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation," and the additional perceived conflict with section 1112(b)(2), which requires dismissal for inability to effectuate a plan).

²² See 11 USC 1126(f) (2003).

²³ 11 USC 1122(a) (2003).

²⁴ Pub L No 103-394, sec 202, 108 S. 4106, 4121 (codified as amended in scattered sections of 11 USC) (hereinafter the "Reform Act").

²⁵ See 11 USC 1124(3) (2003).

²⁶ See sec 213 of the Reform Act, deleting 11 USC 1124(3).

²⁷ 168 BR 73 (Bankr D NJ 1994).

²⁸ See 11 USC 1123(a)(5)(G) (2003).

²⁹ See 11 USC 1126(f) (2003).

³⁰ See 11 USC 1129(b)(1) (2003).

³¹ See 11 USC 1129(b) (2003)

³² See 11 USC 506(a), 1123(a)(5) (f) and (h) (2003).

³³ See 11 USC 1129(b)(2)(B) (2003).

³⁴ *Sylmar Plaza*, *supra* note 1, 314 F3d at 1073.

³⁵ 11 USC 1111(b)(2) (2003).

³⁶ 798 F Supp 423 (ED Ky 1992).

³⁷ 306 B.R. 763 (2004).

³⁸ 269 F.2d 827 (2nd Cir. 1959), *cert. denied*, 361 U.S. 947 (1960).

³⁹ *139-141 Owners Corp.*, *supra* note 37, at 771

⁴⁰ *Id.* See, e.g., *In re Vest Assocs.*, 217 B.R. 696, 702-03 (Bankr. S.D.N.Y. 1998) ("The developing consensus is a presumption of favor in the contract default rate subject to equitable considerations . . . If a debtor is solvent, there is much more leeway to grant the default rate because other creditors will not be injured").

⁴¹ 384 F.3d 108 (3rd Cir. 2004).

⁴² *Id.* at 112.

⁴³ *Id.* at 116.

⁴⁴ *Id.* at 120 n.4.

⁴⁵ *Id.* at 122.

⁴⁶ *Id.*

⁴⁷ *Id.* at 123.

⁴⁸ *Id.* at 128.

⁴⁹ *Id.* at 129.

⁵⁰ 324 F.3d 197 (3d Cir. 2003).

⁵¹ *In re Integrated Telecom Express, Inc.*, 384 F.3d at 116.

⁵² *Id.* at 122-23.

⁵³ *Id.* at 123.

⁵⁴ 314 B.R. 206 (Bankr. N.D. Ga. Sept. 8, 2004).

⁵⁵ *Id.* at 215.

⁵⁶ *Id.* at 125.

⁵⁷ See also *In re Schur Mgmt. Co.*, 323 B.R. 123, 127-28 (Bankr. S.D.N.Y. 2005) (holding that Chapter 11 petitions filed by two financially viable debtors seeking only to protect their assets from potentially adverse judgment in connection with imminent trial in personal injury lawsuit lacked "intent to reorganize" or "reorganizational purpose" and, therefore, were prematurely filed and lacked good faith as required under 11 USC 1112(b)); Gregory G. Hesse, *Solvent Debtors and Good Faith*, 24-2 ABIJ 14 (March 2005)

(discussing whether bankruptcy filing by solvent debtor can be dismissed because it is not filed in good faith); Robert J. Keach, *Solvent Debtors and Myths of Good Faith and Fiduciary Duty*, 23-10 ABIJ 36 (January 2005) (arguing that Congress did not expressly limit Chapter 11 protection to debtors who are insolvent or suffering any other particular form of financial distress).

⁵⁸ *Sylmar Plaza*, *supra* note 1, 314 F.3d at 1073.

⁵⁹ *Id* at 1075 (“Inflexible rules rarely are the hallmark of good faith” (quoting 7 COLLIER ON BANKRUPTCY, secs 1129-34 (Matthew Bender & Co), 15th ed revised 2002)).