ALM | LAW.COM

New York Law Journal

Good Faith and Financial Distress: Can a Solvent Debtor Have a Valid Reorganizational Purpose?

September 11, 2023

Historically, Chapter 11 has been used by companies to restructure debtor-creditor relationships of all shapes and sizes. The Bankruptcy Code provides companies with useful tools to achieve such restructuring objectives including the power to shed burdensome contracts and leases, sell valuable contracts and leases, sell company assets free and clear of liens, claims, encumbrances and other interests, restructure debt (consensually or through the Code's "cram-down" provisions), renegotiate or reject labor contracts, resolve multi-district litigations through global plan settlements, and implement broad liability releases in favor of officers, directors and other parties in interest.

Additionally, in the 45 years since the enactment of the Bankruptcy Code, the Chapter 11 process has been successfully used by companies to address and resolve mass tort liabilities (*e.g*, Dow Corning, Johns-Manville, Texaco). What were once considered legitimate uses of Chapter 11 may now be rejected by bankruptcy courts as bad faith filings.

Earlier this year, a panel of the U.S. Court of Appeals for the Third Circuit dismissed the Chapter 11 filing of J&J subsidiary, LTL Management, based on a lack of immediate financial distress due to LTL's rights under a $61.5 billion funding agreement. *See In re LTL Management, LLC* 64 F.4th 84 (3d Cir. 2023). And

LTL's immediate "take two" re-filing attempt was similarly rejected in June.

Also in June, a bankruptcy court in Indiana dismissed a Chapter 11 petition filed by 3M subsidiary, Aearo Technologies, on the basis that its petition did not serve a valid bankruptcy purposes because Aearo was, at the time of its filing, a "financially healthy" company with limitless litigation support provided by its parent, 3M. *See In re Aearo Technologies LLC, et al.*, Case No. 22-02890 (Bankr. S.D. Ind. June 9, 2023).

Broadly viewed, these decisions reflect what appears to be growing judicial resistance to the use of Chapter 11 to shield companies against mass torts. More narrowly, though, these decisions further define the good faith filing requirement for resort to Chapter 11 by

raising the bar for solvent companies to seek bankruptcy relief.

Good Faith Filing Requirement

Though the text of the Bankruptcy Code does not contain a solvency requirement, a Chapter 11 petition must be filed in in good faith. Courts have repeatedly held that a Chapter 11 petition is subject to dismissal if not filed in good faith.

Whether a bankruptcy petition has been filed in good faith is a fact intensive inquiry, one which the court must examine based on the totality of the circumstances surrounding the filing including an evaluation of the debtor's financial condition and motives.

The rationale behind a requirement that Chapter 11 petitions be filed in good faith is to protect creditors from abusive filings not designed to achieve any of the objectives under Chapter 11. There is no uniform standard for determining good faith and it varies based on jurisdiction.

The good faith inquiry generally involves a determination as to whether the debtor has a need for Chapter 11 relief. Where a filing is motivated by a desire to stay a creditor's enforcement remedies without an ability to reorganize, the bankruptcy court will dismiss the case as having been filed in bad faith.

Courts within the U.S. Court of Appeals for the Second Circuit will dismiss a Chapter 11 petition if both objective futility of the reorganization process and subjective bad faith are found. *In re Kingston Square Assocs.*, 214 B.R. 713, 725 (Bankr. S.D.N.Y. 1997).

The Second Circuit considers a number of factors relevant to bad faith including: (i) whether a debtor has only one asset; (ii) whether the debtor has few unsecured creditors whose claims are small relative to those of the secured creditors; (iii) whether the debtor's one asset is the subject of a foreclosure action as a result of arrearages or default on the debt; (iv) whether the debtor's financial condition, is, in essence, a two party dispute between the debtor and secured creditors which can be resolved in the pending state foreclosure action; (v) whether the timing of the debtor's filing evidences an intent to delay or frustrate the legitimate efforts of the debtors secured creditors and the debtor has little or no cash flow and can't meet current expenses including payment of taxes. *See C-TC 9th Ave. P'ship v. Norton Co. (In re C-TC 9th Ave. P'ship)*, 113 F.3d 1304 (2d Cir. 1997).

The Third Circuit inquiry relevant to good faith is more stringent than that of the Second Circuit and requires that: (i) the petition serve a valid bankruptcy purpose such as preserving a going concern or maximizing value for stakeholders and (ii) the petition not be filed merely to obtain a tactical advantage. *See Integrated Telecom Express*, 384 F.3d 108 (3d Cir. 2004).

LTL Management

LTL filed Chapter 11 to pursue an expedient and global resolution of approximately 38,000 then pending claims and potentially hundreds of thousands of future tort claims stemming from lawsuits concerning talc products sold by J&J.

LTL was formed prior to the bankruptcy filing through a divisional merger, leaving LTL with liabilities for tort claims and rights under a funding support agreement with J&J. In March, the Third Circuit considered whether LTL's Chapter 11 petition was filed in good faith and determined it was not because LTL was not in financial distress at the time of the bankruptcy filing. *See In re LTL Management, LLC* 64 F.4th 84 (3d Cir. 2023).

The court held that a valid bankruptcy purpose assumes a debtor in financial distress. Thus, in the Third Circuit's view, a Chapter 11 petition filed by a debtor not in financial distress does not serve a valid bankruptcy purpose.

Notwithstanding the thousands of talc powder tort claims and billions of dollars of potential liability LTL faced, the court determined a lack of financial distress based upon the Debtor's rights under a funding agreement which obligated J&J to provide funding for the Chapter 11

case and a trust that would satisfy current and future talc claims.

The court's decision in *LTL* is in line with earlier decisions within the Third Circuit such as *Integrated Telecom*, 384 F.3d 108, and *SGL Carbon*, 200 F.3d 154 (3d Cir. 1999), each of which involved solvent debtors that filed for relief under Chapter 11 to gain a tactical advantage with regard to certain creditors.

Aearo Technologies

Aearo Technologies LLC and six of its affiliates filed Chapter 11 petitions in the Southern District of Indiana on July 26, 2022 to hundreds of thousands of lawsuits pending in a multidistrict litigation arising from its former manufacture and sale of allegedly defective ear plugs.

At the time of the filings, Aaero had assets totaling approximately $43 million in addition to a $1 billion funding commitment from its parent company, 3M. Aearo's liabilities at filing were comprised of approximately $1.46 billion in tort claims, $200 million in legal fees and $2.24 million in trade debt.

Based on these facts, the bankruptcy court concluded that Aearo was solvent based on balance sheet and cash flow analyses. In assessing good faith, the bankruptcy court held that good faith should be measured by whether the Chapter 11 case serves a valid reorganizational purpose.

The bankruptcy court then concluded that the Aearo cases did not serve a valid reorganization purpose because it was financially healthy, had no reported cash flow problems and was able to timely meet its current and future obligations in light of its funding agreement with 3M (which provided Aaero with an "uncapped and no cost" guarantee that 3M will pay Aaero's creditors in full regardless of whether Aearo is in bankruptcy).

The recent dismissals of the *LTL* and *Aearo* bankruptcy cases raise questions surrounding when, if ever, a solvent debtor may have a valid reorganization purpose in Chapter 11.

Though the specific contours of financial distress remain ill-defined by courts, equating a valid bankruptcy purpose with financial distress ignores many of the restructuring tools provided for by the plain text of the Bankruptcy Code.

Focusing on a debtor's solvency ignores that a financially healthy company today may not be financially healthy tomorrow, following the occurrence of, among other things, a maturity date default, interest rate adjustments, above-market pricing terms in vendor agreements or a sizeable judgment. This healthy company today may seek relief under Chapter 11 to accomplish one or more objectives under the Bankruptcy Code and may be able to confirm an economically viable plan by rejecting burdensome contracts or rewriting loans on more economically favorable (to the debtor).

The notion that a solvent debtor may not be in financial distress sufficient to overcome a bad faith filing dismissal is contradicted by the provisions of the Code that expressly contemplate solvent debtors. *See, e,g.*, 11 U.S.C. 506(b) (post-petition interest allowed to oversecured creditors); 11 U.S.C. §1129(a)(7) (confirmation standard requiring creditors receive more under Chapter 11 plan that if the company were liquidated); 11 U.S.C. §1102 (providing for appointment of equity committee in cases involving solvent debtors); 11 U.S.C. §§1129(a)(8); 1129(b)(2)(C) (plan protections for holders of interests).

Incorporating a uniform good faith filing standard into the Bankruptcy Code would provide much needed clarity on these issues. For now, however, solvent debtors- particularly those filing to address mass tort claims—likely will have greater difficulty defending their Chapter 11 filings.

Theresa A. Driscoll *is a partner at Moritt Hock & Hamroff.*

Reprinted with permission from the September 11, 2023 edition of the NEW YORK LAW JOURNAL © 2023 ALM Global Properties, LLC. All rights reserved. Further duplication without permission is prohibited, contact 877-256-2472 or asset-and-logo-licensing@alm.com. # NYLJ-9112023-46875