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Good Faith Chapter 11 Filings Require the Debtor to Show Valid Reorganization Purpose and Financial Need for Bankruptcy

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Introduction

Section 1112 of title 11 of the United States Code (the "Bankruptcy Code") enumerates a non-exhaustive list of sixteen factors justifying dismissal of a bankruptcy case for lack of good cause, but bankruptcy courts have the authority to consider other factors as they arise and use equitable powers to reach appropriate results in individual cases.[1] Bankruptcy courts have determined that "good faith" is a requirement to remain in bankruptcy, and "bad faith" is among the reasons to dismiss. To date, no court has adopted a universally accepted definition of good faith.

In recent cases, courts have used their discretionary powers liberally, devising new tests for determining whether a chapter 11 filing is in good faith. In 2023, the Third Circuit held that a court analyzing whether a chapter 11 filing is in good faith must consider whether the petition serves a valid bankruptcy purpose, which turns on whether the debtor demonstrates "financial distress."[2] The U.S. Bankruptcy Court for the Southern District of Indiana adopted this test but

[1] 11 U.S.C.S. § 1112(b)(4)(A)-(P).
[2] *See* LTL Mgmt., LLC v. Those Parties Listed on Appendix A to Complaint (*In re* LTL Mgmt., LLC), 64 F.4th 84, 100–01 (3d Cir. 2023).

required a financial "need" for chapter 11 protection to establish good faith.[3] In the Third and Seventh Circuits, where a debtor is financially healthy, either because it is solvent or has secured a funding agreement indemnifying it from the consequences of litigation, it appears that a debtor cannot have a financial need for chapter 11 protection, and therefore no valid reorganizational purpose.

This memorandum examines what a debtor must show to establish a good faith filing and survive a motion to dismiss considering the court's holding in *Aearo*. Part I focuses on the requirements for a valid reorganizational purpose and financial need. Part II contrasts this test with those used by the Second and Fourth Circuits.

I. A Debtor's "Need" for Chapter 11 Reorganization may Turn on Whether a Valid Reorganizational Purpose Exists and the Status of the Debtor's Financial Health.

Under recent tests, good faith is best measured by whether the chapter 11 case serves a "valid reorganizational purpose"; the debtor's need for relief under chapter 11 is central to that inquiry.[4] Whether a debtor's filing serves a valid reorganizational purpose is a fact intensive inquiry primarily revolving around protecting assets and maximizing the estate.[5] Reorganizational purpose is therefore inextricably linked to financial need for protections, which requires the court to inquire into the debtor's financial health.[6] Therefore, under the modern test established in the Third and Seventh Circuits, a debtor must show that the chapter 11 protections would preserve or maximize property for the benefit of creditors, which is not otherwise accomplished because of the debtor's financial status.

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[3] *See In re* Aearo Techs., LLC, No. 22-02890-JJG-11, 2023 WL 3938436 (Bankr. S.D. Ind. June 9, 2023) (herein "*Aearo*").
[4] *In re* Aearo Techs., LLC, 2023 WL 3938436, at *14
[5] *Id.*
[6] *Id.* at *15.

A. A Valid Reorganizational Purpose Preserves or Maximizes Property.

A valid reorganization purpose invokes the Bankruptcy Code's equitable powers and requires the court to inquire into the debtor's objectives for filing to determine if they are consistent with the existing law.[7] The theme of recent bankruptcy decisions interpreting whether a "valid reorganizational purpose" exists is "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."[8] This requires a court to determine whether the debtor is attempting to affect a speedy, efficient reorganization on a feasible basis, or instead attempting to unreasonably deter creditors.[9] A "good faith" debtor's objective must be consistent with the Bankruptcy Code, grounded in fact, and warranted by the existing law for a good faith argument.[10]

A debtor files for chapter 11 in good faith when it seeks to prevent financial ruin and maximize the value of its estate to return to creditors. In *Bank of America National Trust & Sav. Association v. 203 North LaSalle Street Partnership*, the Supreme Court determined that preserving going concerns and maximizing property available to satisfy creditors are valid purposes.[11] Similarly, preventing waste and reduction in asset value that results from liquidation is valid.[12] Ultimately, if there is value that would be lost if the debtor were to file under a different provision, valid reorganizational purpose is likely satisfied.[13]

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[7] *See* Marsch v. Marsch (*In re* Marsch), 36 F.3d 825, 828 (9th Cir. 1994).
[8] *In re* SGL Carbon Corp., 200 F.3d 154, 161 (3d Cir. 1999) (citing *In re* Victory Constr. Co., 9 B.R. 549 (Bankr. C.D. Calif. 1981)).
[9] *In re* Marsch, 36 F.3d at 828.
[10] *Id.* at 827.
[11] *See* 526 U.S. 434, 453 (1999).
[12] *See In re* Schlangen, 91 B.R. 834, 836–37 (Bankr. N.D. Ill. 1988) (granting a motion to dismiss "for cause" because the debtor used chapter 11 as an entry to federal court, which is not a valid reorganization objective).
[13] *See In re* Integrated Telecom Express, Inc., 384 F.3d 108, 129 (3d Cir. 2004).

Where there is no realistic chance of reorganization because the debtor cannot confirm a plan, there is no valid reorganizational purpose.[14] Some factors relevant to that analysis are lack of assets, employees, and negative cash flow, which demonstrates that a plan is not economically or legally feasible.[15] Additionally, pre-bankruptcy wrongdoing by the principals of a debtor shows them to be unreliable or incompetent managers, casting doubt on their proposed plans.[16]

In *Aearo*, the bankruptcy court for the Southern District of Indiana placed significant emphasis on the alignment of the Debtor's objective intent with the overall Bankruptcy Code, endorsing a test that allows for broad application to chapter 11 cases.[17] The court noted that "[w]hen financially troubled petitioners seek a chance to remain in business, the exercise of these powers is justified. But this is not so when a petitioner's aims lie outside those of the Code."[18] In *Aearo*, the debtor had not actively participated in pending mass tort actions due to a funding agreement between the debtor and 3M, pursuant to which 3M agreed to fund all tort actions.[19] According to the bankruptcy court, because 3M guaranteed funding under any circumstances and the debtor had not faced operational interruptions or distractions that gave rise to a need for reorganization, there was a lack of good faith in its filing.[20]

B. Most Circuits Require Some Indication of Financial Distress for a Debtor to File Chapter 11 in Good Faith.

The First, Second, Third, Fourth, Fifth, Seventh, and Eighth Circuits have all determined that financial distress plays a central role in good faith inquiries, expanding on the statutory

[14] *See In re* Jer, 461 B.R. 293, 301–02 (Bankr. Dist. Del. 2011) (finding that there cannot be reorganization because the sole creditor did not consent to the plan).
[15] *See In re* Strug-Division, LLC, 375 B.R. 445, 449 (Bankr. N.D. Ill. 2007) (citing *In re* S. Beach Secs., 341 B.R. 853, 856–57 (N.D. Ill. 2006)).
[16] *See id.*
[17] *See In re* Aearo Techs., LLC, No. 22-02890-JJG-11, 2023 WL 3938436, at *14 (Bankr. S.D. Ind. June 9, 2023).
[18] *Id.* (quoting *In re* Integrated Telecom Express, Inc., 384 F.3d at 120).
[19] *See id.* at *21.
[20] *See id*.

requirements.[21] However, no court has given a precise requirement for how close a debtor must be to insolvency to warrant chapter 11 protections. When a debtor is fully insolvent, a petition will almost always be consistent with a valid bankruptcy scheme.[22] However, where a debtor is solvent, the filing strays from the intended application of the Bankruptcy Code, and the bankruptcy purpose dwindles.[23] Yet, courts interpreting the Bankruptcy Code have stressed that a debtor need not be insolvent to seek chapter 11 protections.[24]

Historically, most courts have looked towards cash flow problems as an indication that a debtor needs chapter 11 protection. This is particularly relevant if a debtor is balance sheet insolvent or has insufficient cash flow to pay liabilities likely to occur in the future.[25] If a debtor's estate has sufficient assets to pay all of their claims, it is solvent, and does not have any financial need for bankruptcy protections.[26] For example, a debtor experiencing cash flow problems can file a chapter 11 petition, extend the period of its debts, and return to the status of a viable entity while paying its creditors in full.[27]

The Third Circuit in *LTL Management* applied a two-step analysis for determining "financial distress:" (1) the distress must be apparent; and (2) it must be imminent, not merely speculative.[28] As to the first element, the court noted that, although insolvency is not strictly required and there is no exhaustive list of factors that may determine whether a particular debtor has filed in good faith, balance-sheet insolvency, or insufficient cash to pay liabilities are "likely

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[21] *See* LTL Mgmt., LLC v. Those Parties Listed on Appendix A to Complaint (*In re* LTL Mgmt., LLC), 64 F.4th 84, 104 (3d Cir. 2023) (collecting cases).
[22] *See In re* Aearo Techs., LLC, 2023 WL 3938436, at *15.
[23] *See id*.
[24] *See, e.g., In re* James Wilson Assocs., 965 F.2d 160, 170 (7th Cir. 1992).
[25] *See In re* AIG Fin. Prods. Corp., 651 B.R. 463, 474 (Bankr. Del. 2023) (noting that the filing satisfies the good faith requirement because the debtor was "hopelessly insolvent" and had a valid reorganizational purpose).
[26] *See* Miller v. FDIC, 428 B.R. 820, 825 (Bankr. N. Ohio 2010).
[27] *See In re* Madison Hotel Assoc., 749 F.2d 410, 420 (7th Cir. 1984).
[28] *See* LTL Mgmt., LLC v. Those Parties Listed on Appendix A to Complaint (*In re* LTL Mgmt., LLC), 64 F.4th 84, 101 (3d Cir. 2023).

always relevant."[29] Financial distress may come in the form of uncertain and unliquidated future liabilities that could pose an obstacle to a debtor efficiently obtaining financing and investment, such as impending mass-tort litigation.[30] Other litigation that results in serious managerial difficulties likely also satisfies financial distress.[31]

As to the Third Circuit's second factor, the financial distress must be immediate enough to justify a filing.[32] Attenuated possibilities that a debtor may face financial distress in the future will not satisfy the good faith requirement.[33] Though the Third Circuit recognized that a mass tort filing may require a debtor to file for bankruptcy to enable a continuation of business before it is insolvent, it declined to expand on how immediate the need must be to qualify as a good faith filing.[34] Instead, the Third Circuit encouraged a balance between early access to bankruptcy relief so that the debtor can rehabilitate before it faces a hopeless situation, and premature, bad faith filings.[35]

The bankruptcy court in *Aearo* agreed with the Third Circuit's logic, but ultimately chose to frame the issue as the debtor's "need," rather than financial distress.[36] The court noted that "financial distress" may be interpreted too literally and ignore the Bankruptcy Code's lack of insolvency requirement.[37] However, the primary inquiry is the same. When inquiring into good faith filings, the bankruptcy court in *Aero* instructs others to determine whether the financial

[29] *Id.* at 102.
[30] *See id.*
[31] *See id.* at 104 (citing *In re* SGL Carbon Corp., 200 F.3d 154, 166 (3d Cir. 1999)).
[32] *See id.* at 102.
[33] *See id.*
[34] *See id.*
[35] *See id.* at 103 (noting that "[r]isks associated with premature filing may be particularly relevant in the context of a mass tort bankruptcy").
[36] *See In re* Aearo Techs., LLC, No. 22-02890-JJG-11, 2023 WL 3938436, at *17 (Bankr. S.D. Ind. June 9, 2023).
[37] *See id.*

problems the debtor is facing is within the range of difficulties that Congress envisioned when it created chapter 11.[38]

Applying the renamed financial "need" test, the bankruptcy court determined that Aearo's need was neither apparent nor imminent.[39] The court looked to factors such as increased trends in sales, no cash flow problems, and timely satisfaction of obligations to demonstrate that the company is financially "thriving."[40] Additionally, despite facing one of the largest multi-district litigation dockets in history, Aearo's need for protection was not deemed to be imminent given the funding agreement between the debtor and its parent, 3M.[41] Per the terms of the funding agreement, 3M committed to pay all of Aero's valid claims, regardless of whether Aearo was in bankruptcy.[42] Therefore, Aearo did not face the kind of financial need that the Bankruptcy Code imagined for chapter 11 debtors, and the motion to dismiss Aero's chapter 11 was granted under 11 U.S.C. §1112(b).[43]

C. Debtors Face the Uncertainty of the Unresolved Terms "Need" and "Distress."

To date, only one court has cited *LTL Management* in granting a motion to dismiss for lack of financial distress.[44] In *Little*, the U.S. Bankruptcy Court for the District of Idaho determined that the debtors, a married couple facing medical debt, were solvent, and in a stable financial condition because their assets and monthly income far outweighed their liabilities.[45] Additionally, no creditor made any attempt to collect debts prior to the filing of the petition, and the debtors were able to make timely payments towards debt.[46] The bankruptcy court also determined that

[38] *See id.*
[39] *See id.* at 18.
[40] *See id.*; Miller v. FDIC, 428 B.R. 820, 825 (Bankr. N. Ohio 2010).
[41] *See id.* at 20.
[42] *See id.*
[43] *See id.*
[44] *See In re* Little, No. 23-00352 (NGH), 2024 WL 535099, at *5 (Bankr. Idaho Feb. 9, 2024).
[45] *See id.*
[46] *See id.*

there was no imminent threat to the debtors' financial health, as future expenses remained speculative at the time of the filing.[47] Because the debtor in *Little* was solvent, and therefore could not have a valid bankruptcy purpose under any test, it remains to be seen how the *LTL Management* and *Aearo* tests function for less solvent debtors.

While it appears fully indemnified debtors cannot file for bankruptcy in good faith, and financially "hopeless" debtors can file in good faith, courts are largely still in limbo as to what financial condition constitutes need for bankruptcy protections.[48]

II. Whether a Case is Filed in Good Faith may Depend Upon the Jurisdiction in Which the Case is Filed.

Though the general theme of good faith requirements is consistent between Circuits, several Circuits apply jurisdiction-specific tests. The Second Circuit applies factors pursuant to *In re C-TC 9th Ave. P'ship*, 113 F.3d 1304, 1311 (2d Cir. 1997), which was derived from the Eighth Circuit case, *Pleasant Pointe Apartments, Ltd. v. Kentucky Hous. Corp.*, 139 B.R. 828, 832 (W.D. Ky. 1992). The Second Circuit applies a list of eight factors[49] centered around the relationships between the debtor and creditors.[50] Unlike in the Third and Seventh Circuits, bankruptcy purpose and financial need play comparatively small roles in the overall application of the factors.[51]

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[47] *See id.*

[48] *See In re* Aearo Techs., LLC, No. 22-02890-JJG-11, 2023 WL 3938436, at *17 (Bankr. S.D. Ind. June 9, 2023); *In re* AIG Fin. Prods. Corp., 651 B.R. 463, 474 (Bankr. Del. 2023).

[49] The eight factors indicative of bad faith filing are: (1) the debtor has only one asset; (2) the debtor has few unsecured creditors whose claims are small in relation to those of the secured creditors; (3) the debtor's one asset is the subject of a foreclosure action as a result of arrearages or default on the debt; (4) 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 foreclosure action; (5) the timing of the debtor's filing evidences an intent to delay or frustrate the legitimate efforts of the debtor's secured creditors to enforce their rights; (6) the debtor has little or no cash flow; (7) the debtor cannot meet current expenses including the payment of personal property and real estate taxes; and (8) the debtor has no employees. *In re* C-TC 9th Ave. P'ship, 113 F.3d at 1311 (citing *Pleasant Pointe Apartments, Ltd.*, 139 B.R. at 832).

[50] *See In re* C-TC 9th Ave. P'ship, 113 F.3d at 1311.

[51] *See In re* New York Classic Motors, LLC, No. 21-10670 (MG), 2021 WL 2285440, at *3–4 (Bankr. S.D.N.Y. June 4, 2021).

The Fourth Circuit applies a similar jurisdictional test.[52] Under *Carolin*, to dismiss a case as filed in bad faith, the court must find (1) objective futility of reorganization proceedings, and (2) subjective bad faith.[53] This standard is more comprehensive than those of the Third or Seventh Circuit.[54] Applying the test, courts in the Fourth Circuit first determine objective futility through an inquiry into whether there is a realistic possibility of reorganization. Next, to determine subjective bad faith, the court looks to whether the case was filed for a permissible purpose.[55]

Conclusion

In light of the U.S. Bankruptcy Court for the Southern District of Indiana's recent decision, a debtor filing a chapter 11 petition in good faith must show a valid reorganizational purpose to survive a motion to dismiss under section 1112 of the Bankruptcy Code, which turns heavily on whether the debtor has "financial need" for bankruptcy protections.[56] Where a debtor is financially healthy, either because it is solvent, or has a funding agreement indemnifying it from the consequences of litigation, the company likely cannot establish a financial need, and therefore does not have a valid reorganization purpose in the Third and Seventh Circuits. The test for good faith remains dependent on jurisdiction, with the Second and Fourth Circuits requiring more expansive standards. Accordingly, a debtor will need to examine the requirements in the district where it plans to file its bankruptcy case to determine whether it would survive a motion to dismiss for lack of good faith.

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[52] *See* Carolin Corp. v. Miller, 886 F.2d 693 (4th Cir. 1989).
[53] *See id.* at 700–01.
[54] *See* Bestwall LLC v. Off. Comm. of Asbestos Claimants, 71 F.4th 168, 182 (4th Cir. 2023) (specifically declining to apply the *LTL Management* or *Aearo* standards to Fourth Circuit cases).
[55] *See* Md. Port Admin. v. Premier Auto. Servs. (*In re* Premier Auto. Servs.), 492 F.3d 274, 280 (4th Cir. 2007).
[56] *See In re* Aearo Techs., LLC, No. 22-02890-JJG-11, 2023 WL 3938436 (Bankr. S.D. Ind. June 9, 2023).