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UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

In re Case No. 03-54784
CHAMELEON SYSTEMS, INC., Chapter 11
Debtor.

MEMORANDUM DECISION AND ORDER THEREON RE
CHAMELEON SYSTEMS' MOTION TO REJECT REAL PROPERTY LEASE
AND NORTECH'S COUNTERMOTION TO DISMISS THE CHAPTER 11 CASE

I. INTRODUCTION

The debtor, Chameleon Systems, Inc., filed its Chapter 11 petition for the purpose of rejecting the lease with its landlord, Nortech Ventures LLC, and then capping Nortech's damage claim pursuant to § 502(b)(6) of the Bankruptcy Code. Before the court is Chameleon's motion to reject the Nortech lease. In addition, the court has before it Nortech's counter motion to dismiss the Chapter 11 petition under § 1112(b) of the Bankruptcy Code as having been filed in bad faith. For the reasons hereafter stated Chameleon's motion to reject is granted and Nortech's counter motion to dismiss is denied.

II. FACTUAL BACKGROUND

1 Chameleon was in the telecom business. Like many companies
2 in this business it found itself in financial trouble in late 2002.
3 The company's December Board minutes reflect that several options
4 were being considered at that time including a sale of the
5 corporation, downsizing and a wind-down and dissolution. The Board
6 decided to continue operations.

7 Less than two months later the situation had deteriorated.
8 On February 3, 2003, the company's Board of Directors decided to
9 terminate its operations and wind-down its affairs. The
10 corporation would dissolve and liquidate under California law.
11 Sherwood Partners, a consulting firm, was hired to manage the wind-
12 down process, sell the assets of the company, and settle various
13 obligations of the company to its creditors. Bernie Murphy, the
14 senior Vice President of Sherwood, stated in his deposition that
15 Sherwood was retained to liquidate everything and the time frame
16 for completion of the assignment was June 2003.

17 By the end of February, the only major issues remaining were
18 to sell the company's intellectual property, close its 401(k) plan
19 and negotiate a settlement with Nortech. By May 2003, Sherwood had
20 sold Chameleon's intellectual property and resolved its 401(k)
21 problems. According to Nortech the only remaining issue that
22 prevented the company from completing its dissolution was the
23 Nortech lease.

24 Chameleon had attempted to surrender possession of the
25 premises to Nortech in March 2003, and to negotiate a termination
26 of the lease but the parties were unable to reach an agreement.
27 Chameleon had a problem. It did not want to continue paying
28 Nortech the monthly rent on the lease which does not expire until

1 May 14, 2006, despite the fact that it had sufficient funds to do
2 so.

3 Chameleon and Nortech continued their negotiations but were
4 unable to resolve the situation. On July 24, 2003, Chameleon filed
5 a petition under Chapter 11 of the Bankruptcy Code. Chameleon
6 again attempted to surrender the lease but Nortech rejected the
7 offer.

8 Under California law Nortech had the option of accepting the
9 surrender of the property and then having the state court fix the
10 damages for the breach of the lease. This would have adjudicated
11 the total damages suffered by Nortech as a result of the breach of
12 the lease. Rather than pursue this course of action Nortech
13 elected its other option, to continue to consider Chameleon its
14 tenant and seek to collect rent on a monthly basis through May
15 2006. Toward this end, Nortech had filed two lawsuits prior to
16 Chameleon filing its Chapter 11 petition. Nortech's position is
17 that Chameleon is obligated to pay the monthly rent and if there
18 is to be a mitigation of the damages, then Chameleon should seek
19 to find a new tenant for the property. Nortech is entitled to take
20 this position under California law.

21 Chameleon filed its motion to reject the Nortech lease on July
22 24, 2003. In response, Nortech filed an opposition to Nortech's
23 motion and a countermotion to dismiss the Chapter 11 case. The
24 court considered and heard oral argument on Nortech's countermotion
25 on January 9, 2004.¹

26 The debtor has no income, no employees (except Sherwood
27

28 ¹ On January 15, 2004, the court made an initial oral ruling denying Nortech's
countermotion to dismiss and deferred ruling on Chameleon's motion to reject.

1 partners), and has \$4.05 million in its bank accounts. Unsecured
2 debt (other than to Nortech) is less than \$10,000. Total
3 obligations to other creditors (mainly tax obligations) are
4 approximately \$15,000. As of the petition date, Chameleon admits
5 it has reserves for its full liability under the Nortech lease and
6 all other known and outstanding liabilities, as well as a reserve
7 for unknown liabilities and for legal expenses.

8 **III. DISCUSSION**

9 The court finds it necessary to first address Nortech's
10 countermotion.

11 **A. Nortech's Countermotion To Dismiss The Chapter 11 Case**

12 In the course of argument the applicability of PPI Enterprises
13 (U.S.), Inc., 228 B.R. 339 (Bankr. Del. 1998) was raised. This is
14 a similar case where the debtor filed Chapter 11 for the purpose
15 of rejecting its landlord's lease and then capping the resulting
16 damages under § 502(b)(6) of the Code.

17 The question before the court was whether such a purpose was
18 per se bad faith. The court summarized a variety of statutes in
19 the Code that can have an adverse impact on creditors and noted
20 that §502(b)(6) is simply one such provision. The court viewed the
21 statute as being clear in its meaning and found there was no
22 equitable determination required for its application to the claim
23 of a landlord. As a result, to the extent there are additional
24 funds available after capping the damages in the landlord's claim,
25 it is not relevant to whom they are ultimately paid. Based on this
26 analysis the court found that the debtor's purpose in filing
27 Chapter 11 was not per se bad faith. The decision was then
28 affirmed on appeal. PPI Enterprises (U.S.), Inc., 324 F.3d 197 (3rd

1 Cir. 2003). This court concurs with the decision.

2 Because rejection and the capping of a landlord's claim is not
3 per se bad faith, that purpose may not form the basis for a bad
4 faith finding under § 1112(b). Section 1112(b) provides that a
5 Chapter 11 petition may be dismissed for cause if it appears that
6 the petition was not filed in good faith. In re Marsch, 36 F.3d
7 825, 828 (9th Cir. 1994). Although case law enumerates specific
8 causes for which a case may be dismissed under § 1112(b), the test
9 is whether a debtor is attempting to deter and harass creditors
10 unreasonably, and not attempting to effect a speedy, efficient
11 reorganization on a timely basis. Id.

12 Good faith "depends on an amalgam of factors and not upon a
13 specific fact." Id. "The bankruptcy court should examine the
14 debtor's financial status, motives, and the local economic
15 environment Good faith is lacking only when the debtor's
16 actions are a clear abuse of the bankruptcy process." In re
17 Arnold, 806 F.2d 937, 939 (9th Cir. 1986) (citations omitted). The
18 term good faith may suggest that the debtor's subjective intent is
19 determinative, this is not the case. Instead, the good faith
20 filing requirement encompasses several distinct equitable
21 limitations that courts have placed on Chapter 11 filings. In re
22 Marsch, 36 F.3d at 828. Courts have implied such limitations to
23 deter filings that seek to achieve objectives outside the
24 legitimate scope of the bankruptcy laws, which include tactical
25 reasons unrelated to reorganization. Id.

26 The purpose of Chapter 11 reorganization "is to restructure
27 a business's finances so that it may continue to operate, provide
28 its employees with jobs, pay its creditors, and produce a return

1 for its stockholders." In re Cedar Shore Resort, Inc., 235 F.3d
2 375, 379 (8th Cir. 2000) (quoting H.R.Rep.No. 595 (1975), *reprinted*
3 *in* 1978 U.S.C.C.A.N. 6179). The intent of the Code was to provide
4 rules of fairness and equity to govern, adjust, and balance these
5 conflicting rights; to permit the debtor's continued use, enjoyment
6 and exploitation of property and assets essential to
7 rehabilitation, but on terms which protect the rights of others.
8 In re Victory Constr. Co., 9 B.R. 549, 559 (Bankr. C.D. Cal.
9 1981)(citing H.R. 95-595, pp. 339-40; 1978 U.S.C.C.A.N. 5787, 6295-
10 96), *vacated on other grounds*, 37 B.R. 222 (B.A.P. 9th Cir. 1984).

11 Many of the cases discussing good faith involve debtors who
12 are seeking to remain in business. Chameleon discusses at great
13 length that liquidation is a valid purpose in filing Chapter 11,
14 and the cases cited by Chameleon support this proposition. See,
15 e.g., In re Klein/Ray Broad., 100 B.R. 509, 513 (B.A.P. 9th Cir.
16 1987). The Code also recognizes liquidation in that § 1123(b)(4)
17 provides that a reorganization plan may "provide for the sale of
18 all or substantially all of the property of the estate, and the
19 distribution of the proceeds of such sale among holders of claims
20 or interests."

21 While the reorganization of an ongoing business or the
22 liquidations of assets are valid purposes for filing Chapter 11,
23 neither is present here in the traditional sense. Chameleon has no
24 ongoing business and Sherwood partners completed the liquidation
25 of assets prior to the filing.

26 The debtor's purpose in filing was to reject the Nortech real
27 property lease and the underlying facts present the court with a
28 novel question. The court's inquiry must focus on whether a

1 debtor is attempting to deter and harass creditors unreasonably,
2 and not attempting to effect a speedy, efficient reorganization on
3 a timely basis as discussed in the Marsch decision.

4 Nortech argues that the debtor has acted in bad faith because
5 the filing is just a litigation tactic that Chameleon is using to
6 avoid its obligation under the lease. It has enough money to pay
7 the landlord's claim through May 2006. Nortech filed a proof of
8 claim with the court calculating that it is owed \$4,368,867.88
9 through May 2006. The fact that Chameleon has enough money to pay
10 this claim may well be the reason Nortech declined to accept the
11 surrender of the property.

12 Chameleon, on the other hand, argues that it is just trying
13 to complete its liquidation, wind up its affairs, and dissolve. It
14 has been unable to do so because Nortech will not accept a
15 surrender of the property and negotiate the amount due. As a
16 result, the debtor is in a position of being forced to continue in
17 existence for another two to three years for the sole purpose of
18 continuing to be the lessee on the Nortech property, insuring and
19 protecting it, and paying Nortech in excess of \$90,000 a month
20 while not using it.

21 Given the choices Chameleon chose to file Chapter 11, reject
22 the lease and cap Nortech's claim under § 502(b)(6). The result
23 is that Nortech will be paid approximately \$1,816,000.00 on its
24 capped claim and Chameleon will complete its dissolution without
25 having to pay the cost of having to stay in existence for the next
26 two to three years. At the time the motion was argued, the court
27 described the debtor's request as the plea of the owners of the
28 business to "go home," that is, the desire of a failing business

1 to wind-down and dissolve and not be forced to continue in business
2 for the sole benefit of its landlord.

3 It is unfortunate that the parties were not able to resolve
4 their differences outside of bankruptcy. Somewhere between the
5 capped claim of \$1,816,000.00 and the total claim of \$4,368,867.68
6 an agreement should have been reached. But courts exist for those
7 cases where agreement can not be reached.

8 The court also recognizes that the resolution of this dispute
9 involves a possible windfall no matter what the decision. If the
10 court decides in favor of the debtor and allows the bankruptcy to
11 continue the claim will be capped and it appears that additional
12 funds will flow to shareholders of the debtor. On the other hand
13 if the case proceeds under California law, the debtor is presented
14 with a Hobson's choice. Chameleon must stay in existence for
15 another two to three years, or pay Nortech now whatever it demands
16 to terminate the lease regardless of what might happen in terms of
17 mitigation later in 2004, 2005 or 2006. In the latter case, if the
18 property is rented in the next two and a half years for any amount
19 the landlord will receive a windfall and the debtor will not be in
20 existence to complain. Either way there is the possibility of a
21 windfall.

22 As a result of these unusual facts, the court's focus is on
23 the question of whether the use of Chapter 11 in these
24 circumstances represents a legitimate use of the Bankruptcy Code.
25 After considering all the evidence and argument, the court's answer
26 to the question is yes. If this case had been filed under Chapter
27 7 we would not be having this discussion. In re Padilla, 222 F.3d
28 1184 (9th Cir. 2000)(holding that bad faith does not per se

1 constitute cause for dismissal of an individual's case under §
2 707(a) of the Bankruptcy Code). Failed businesses regularly file
3 for Chapter 7 turning the wind-down over to a trustee. The owners
4 provide the pertinent information to the trustee and "go home."
5 The fact that the business is solvent does not change that right.
6 The fact that this petition was filed under Chapter 11, and not
7 Chapter 7, similarly does not change the right to terminate
8 operations completely and "go home."

9 **B. Chameleon's Motion To Reject The Lease**

10 The Court notes that since filing its motion to reject the
11 lease, Chameleon has presented the court with an additional
12 argument that the lease was deemed rejected by operation of law
13 when the sixty-day period under Bankruptcy Code § 365(d)(4) ran.
14 Thus, § 365(a) does not apply and court approval is not required.
15 In re Arizona Appetito's Stores, Inc., 893 F.2d 216,219 (9th Cir.
16 1989). However, Chameleon seeks to have the rejection effective
17 as of the date it filed the motion to reject, July 24, 2003.
18 Arizona Appetito did not address the issue of whether rejection
19 could be ordered retroactively when it occurs by operation of law.

20 Because Chameleon seeks to have the rejection effective to a
21 date prior to the expiration of sixty-day period under § 365(d)(4),
22 the court will consider the merits of Chameleon's motion to reject.
23 In considering the business judgment test, the court finds that if
24 Chameleon's motion to reject is denied, it will be in the exact
25 same position it would be in had the court dismissed the case.

26 Chameleon would be restrained in its ability to wind-down its
27 affairs due to the landlord's refusal to accept a surrender of the
28 lease. This will only prolong the administration of the estate and

1 the wind-down of this failed company. There is no reason Chameleon
2 should remain in operation for the sole purpose of servicing this
3 lease. For that reason the court approves Chameleon's motion to
4 reject the lease. However, the court approves rejection effective
5 as of July 30, 2003. At the initial hearing on the motion to
6 reject, Nortech had agreed that if the court ultimately approved
7 rejection of the lease, it would stipulate that rejection would be
8 effective no later than July 30, 2003.

9 **IV. CONCLUSION**

10 For the reasons stated herein, Nortech's countermotion to
11 dismiss the case is denied. In addition, for the reasons stated
12 herein, the court grants Chameleon's motion to reject the lease
13 effective as of July 30, 2003.

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15 DATED: _____

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19 JAMES R. GRUBE
20 UNITED STATES BANKRUPTCY JUDGE
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1 Case No. 03-54784
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5 UNITED STATES BANKRUPTCY COURT
6 FOR THE NORTHERN DISTRICT OF CALIFORNIA
7 CERTIFICATE OF SERVICE

8
9 I, the undersigned, a regularly appointed and qualified Judicial
10 Assistant in the office of the Bankruptcy Judges of the United States
11 Bankruptcy Court for the Northern District of California, San Jose,
12 California hereby certify:

13 That I, in the performance of my duties as such Judicial Assistant,
14 served a copy of the Court's: MEMORANDUM DECISION AND ORDER THEREON RE
15 CHAMELEON SYSTEMS' MOTION TO REJECT REAL PROPERTY LEASE
16 AND NORTECH'S COUNTERMOTION TO DISMISS THE CHAPTER 11 CASE by
17 placing it in the United States Mail, First Class, postage prepaid, at San
18 Jose, California on the date shown below, in a sealed envelope addressed
19 as listed below.

20 I declare under penalty of perjury under the laws of the United
21 States of America that the foregoing is true and correct.

22 Executed on _____ at San Jose, California.

23 _____
24 LISA OLSEN

25 John Wesolowski, Esq.
26 Office of the U.S. Trustee
27 280 So. First St., Rm. 268
28 San Jose, CA 95113

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