

**STALKING HORSE LENDERS AND GOOD FAITH REVISITED: THE
AVAILABILITY OF APPELLATE PROTECTION UNDER SECTIONS 363(m) AND
364(e) FOR ASSET PURCHASERS EXTENDING DEBTOR-IN-POSSESSION
FINANCING AND/OR PURCHASING BY CREDIT BID**

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I. Introduction

What if you threw a §363 sale and no one showed up? At least no one other than your secured lender, the same secured lender that is providing just enough DIP financing to get to the sale hearing and whose stalking horse bid consists entirely or almost entirely of a credit bid. Given the state of the credit and commercial markets, this scenario is not at all far-fetched. Indeed, it is happening in courts across the country.

With the already increased prevalence of “Chapter 363” cases, where the chapter 11 case is commenced and prosecuted primarily, if not exclusively, to facilitate a sale of the debtor’s assets free and clear of liens, claims, encumbrances and interests, motions to approve bid protections and procedures and asset sales are increasingly found among the “first day” motions. Increasingly, the financing allegedly necessary to preserve asset value and/or continue operations is being supplied by the stalking horse bidder with whom the putative debtor-in-possession has negotiated both sale and financing terms prepetition (sometimes referred to in this article as the “stalking horse/lender”). The motion to approve such debtor-in-possession financing (the “DIP financing”) by the proposed purchaser (sometimes referred to as the “DIP to buy”), usually on an emergency basis, is also among the first day motions. Approval of the bulk of the DIP to buy financing will be sought—and often obtained—prior to the appointment or activation of any statutory committees. The debtor will seek to justify obtaining financing from the stalking horse

on the basis that there is no other source of financing and—without the loans—the debtor will not survive until the approval of the sale, will be forced to a liquidation, and all creditor constituencies will be harmed by the resulting loss in value of the assets.

At the same time, the stalking horse/lender, via the sale motion, will seek the usual bid protections, such as break-up fees, minimum bid increments and deposit requirements. In addition, as part of the DIP to buy, the stalking horse/lender will want lender protections, such as priming liens, superpriority claims, drop dead provisions, and provisions for the payment of the DIP financing in the event of a sale to another bidder. A major part of the stalking horse/lender's sale consideration may be in the form of a "credit bid" of the DIP financing. The stalking horse/lender may also be tempted to use the terms of the loan to create disincentives for possible competing bidders and find a willing accomplice in the debtor's management, who may perceive few options other than the sale at hand, and possible advantages in dealing with their chosen white knight, or at least "the devil they know". The terms of the loan-through increased interest and fees, may "grow" the credit bid. Increasingly, the time from motion to sale is growing shorter and shorter.

The stalking horse/lender will also want a finding that it is a good faith lender under section 364(e) of the Bankruptcy Code in connection with the DIP to buy, as well as a finding that it is a good faith purchaser under section 363(m) if it is the successful purchaser, in order to protect both arrangements on appeal. Opponents of the borrowing or the sale, or both, will argue that the arrangement must be examined as a whole and that certain terms of the loan or the sale, or the process of reaching agreement and approval on either or both, deprive the stalking horse/lender of "good faith" purchaser or lender status, thus permitting an attack on appeal even

in the absence of a stay of the borrowing or sale order. Creditors may contend that the process is too accelerated to generate competing bids.

This paper will briefly examine the degree to which the stalking horse/lender can obtain “good faith lender” and “good faith purchaser” status, and what facts may deprive the stalking horse/lender of such status.¹ While the standards are expectedly similar, for convenience, we will first examine the relevant decisions under section 363(m) as applied in the “DIP to buy” context and then the relatively limited number of decisions on DIP to buy structures decided under section 364(e). We will then briefly examine how such arrangements can be structured, and prosecuted before the bankruptcy court, in order to preserve such status, and, conversely, the strategies that competing bidders or creditors should pursue, and the evidence they must muster at each stage of the proceedings, to contest “good faith” findings and, ultimately, the deal itself.

II. Section 363(m) and the Definition of “Good Faith Purchaser”

Bankruptcy Code section 363(m) provides that:

The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.²

¹ The Ninth Circuit Bankruptcy Appellate Panel recently held that §363(m) provides appellate protection only to the actual transfer of “title” and does not shield a “free and clear” finding from appellate review, even where the purchaser was found to act in good faith and no stay was obtained. The opinion relies on the lack of a reference to §363(f) in §363(m). The decision also implies that a DIP to buy, credit-bidding lender will seldom, if ever, be protected by the equitable mootness doctrine. *In re PW, LLC*, 391 B.R. 25 (9th Cir. B.A.P. 2008). The effect of that decision will be covered by a separate paper in connection with this panel. For what may have been a preview of the *PW, LLC* opinion, see *In re Popp*, 323 B.R. 260 (9th Cir. B.A.P. 2005)(Court reaches merits first to decide that estate did not have an interest in property and that §363(b) did not apply; therefore the court finds that §363(m) did not apply at all despite good faith finding and lack of a stay pending appeal; dissent contends that “the majority’s efforts to slip-slide around [§363(m)’s] mandate is.... tortured.”). See also, Joel H. Levitan, Stephen J. Gordon, Richard A. Stieglitz, Jr., *Ninth Circuit BAP Dresses Down Lienstripping*, 27 Am. Bankr. Inst. J 1(October 2008)

² 11 U.S.C. § 363(m).

Thus, sales under section 363 are insulated from reversal or modification on appeal unless the sale order, and the sale, were stayed pending appeal under an order of the bankruptcy or reviewing court or the purchaser was not a good faith purchaser.³ However, the reviewing court will not presume the purchaser's good faith, and the burden of proof falls upon the proponents of the sale to present evidence to the bankruptcy court supporting a finding of good faith and to obtain a specific finding of good faith in the sale order in order to trigger section 363(m) protection.⁴

The Code does not contain a definition of "good faith purchaser." However, most courts have defined the term as a purchaser who (1) purchases in good faith; (2) for value; and (3) without knowledge of adverse claims.⁵ The purchaser's good faith is a mixed question of law and fact.⁶ The "good faith" of a buyer—or the absence thereof—concerns the conduct of the buyer prior to and through the sale process.⁷ "Typically, the misconduct that would destroy a purchaser's good faith status at a judicial sale involves fraud, collusion between the purchaser and other bidders or the trustee [or debtor-in-possession], or an attempt to take grossly unfair advantage of other bidders."⁸ At least one court has stated that the conduct must be "extremely

³ E.g., Mark Bell Furniture Warehouse, Inc. vs. D. M. Reid Associates, LTD. (In re Mark Bell Furniture Warehouse, Inc.), 992 F. 2d 7,8 (1st Cir. 1993); Dick's Clothing & Sporting Goods, Inc. vs. Phar-Mor, Inc., 212 B.R. 283, 289 (N.D. Ohio 1997).

⁴ In re Abbotts Dairies of Pennsylvania, Inc., 788 F. 2d 143 (3rd Cir. 1986). See also In re M Capital Corp., 290 B.R. 743, (9th Cir. B.A.P. 2003).

⁵ E.g., Licensing by Paolo, Inc. v. Sinatra (In re Gucci), 126 F.3d 380, 390 (2nd Cir. 1997); Mark Bell Furniture, 992 F. 2d, at 8.

⁶ E.g., Gucci, 126 F. 3d at 390; Mark Bell Furniture, 992 F. 2d at 8.

⁷ Abbotts Dairies, 788 F.2d at 147; See also Gucci, 126 F. 3d at 390-393 (intended use of assets after the sale not relevant to good faith). Thus, conduct in negotiating the DIP to buy, and its terms, are relevant to "good faith purchaser" status.

⁸ Gucci, 126 F. 3d at 390; In re Filtercorp, Inc., 163 F. 3d 570, 577 (9th Cir. 1998); Mark Bell Furniture, 992 F. 2d at 8; Abbotts Dairies, 788 F. 2d at 147.

egregious” to affect good faith purchaser status.⁹ However, among the kinds of conduct which might affect “good faith purchaser” status are failure to disclose certain material terms of the purchase, secret side deals between debtor’s management and the seller, and manipulation of information such that one bidder was supplied information not generally available to all bidders.¹⁰

III. Application of “Good Faith Purchaser” Standard to “DIP to Buy”

Any examination of the application of section 363(m) to a “DIP to buy” arrangement must begin with the seminal Third Circuit decision in Abbotts Dairies.¹¹ While the decision is best known for imposing the requirement that the bankruptcy court make a finding on the purchaser’s good faith, the court also discussed what findings would *prevent* a finding of good faith in the context of that case. In Abbotts Dairies, the proposed purchaser and the putative debtor had entered into an agreement (the “Interim Agreement”), on the eve of the bankruptcy filing, whereby the purchaser (ADC) would “effectively take over Abbotts’ business.” ADC agreed to purchase Abbotts’ existing inventory at cost; to lease its trademarks; to maintain deliveries to current customers; to employ most of Abbotts’ employees; and to collect, on commission, about \$6 million in accounts receivable.¹² Upon the filing of the Chapter 11 petition, the debtor sought approval of the Interim Agreement on an emergency basis, as well as

⁹ Phar-Mor, 212 B.R. at 288.

¹⁰ See, e.g., Abbotts Dairies, supra; In re National Health & Safety Corp., 1999 WL 703208 (Bankr. E.D. pa.) (court expresses concern about “managed emergencies” and “ managed information.”). But see Phar-Mor, 212 B.R. at 294 (undisclosed agreement between purchaser and third party, former bidder to sell certain assets if purchaser prevailed at auction did not suggest lack of good faith); In re Cable One CATV, 169 B.R. 488 (Bankr. D.N.H. 1994) (buyer does not lack good faith just because it is aware that sale may be procedurally defective); In re Sasson Jeans, Inc., 90 B.R. 608 (S.D.N.Y. 1988) (that purchaser is also a creditor does not affect good faith status); In re Cost Control Marketing & Management, Inc., 1992 W.L. 398402 (M.D. Pa. 1992) (that purchaser sought and obtained release as part of sale did not indicate lack of good faith).

¹¹ In re Abbotts Dairies of Pa., Inc., supra n. 3.

approval of a sale of all of

its assets to ADC.¹³ Certain creditors and prospective purchasers objected to approval of the Interim Agreement on the ground, *inter alia*, that its approval would chill other bidding for the assets. During the hearing on the motion to approve the Interim Agreement, the debtor's CEO testified that he had reached an "informal agreement" to act as a consultant to ADC during the bankruptcy case at his current salary, provided the court approved the Interim Agreement. He also testified that he had been offered a senior executive position with ADC for five years, at current salary, and that he "hoped" ADC would relieve him of personal liability for some of Abbotts' obligations, should ADC be the successful purchaser. The court approved the Interim Agreement with certain conditions apparently designed to lessen any chill on the bidding.¹⁴

The notice of sale, inviting counter bids, did not reveal the consultant arrangement or the offer of employment to the CEO. The notice also did not provide details of the Interim Agreement, although it did mention its approval.¹⁵ Three parties objected to the sale motion, citing factors, including the Interim Agreement, that would chill the bidding. Two other parties submitted bids, but conditioned the bids upon obtaining relief from the Interim Agreement or orders that ADC could not compete. The court refused the requested relief, and the bidders withdrew the counterbids. The court also refused to hear evidence offered by an objector.¹⁶ The court then approved the sale to ADC, and certain of the objectors timely filed notices of appeal, but no stay pending appeal was obtained. The debtor filed a motion with the district court to

¹² *Id.* at 145, n. 1.

¹³ *Id.* at 145.

¹⁴ *Id.* at 145-46.

¹⁵ *Id.*

¹⁶ *Id.* at 146.

dismiss the appeals citing “mootness” under section 363(m) and the district court granted the motion.¹⁷

On appeal, the Third Circuit reversed, finding that the bankruptcy court, or the district court independently, should have inquired about and entered a finding regarding the purchaser’s good faith, and in the absence of such a finding, section 363(m) was not triggered.¹⁸

In the course of the opinion, the Third Circuit made it clear that, if certain findings were made upon remand, a finding of good faith was precluded:

[The objectors’] assertion of collusion...concerns, *inter alia*, the claim that the “emergency” justifying the immediate sale of Abbotts was itself contrived or orchestrated by ADC and Abbotts. For example, they claim that in exchange for a lucrative employment agreement for [the CEO]—Abbotts permitted ADC to manipulate the timing of Abbotts’ bankruptcy so that the bankruptcy court had no choice but to approve the Interim Agreement on August 10, the terms of which were designed to preclude any truly competitive bidding for the assets on September 12. Surely, if [the objectors] substantiated these claims, it would, *as a matter of law*, constitute “collusion between the purchaser and...trustee [or in this case, the debtor-in-possession], or an attempt to take grossly unfair advantage of other bidders,” sufficient to destroy ADC’s “good faith status.”¹⁹

In addition, the court noted the objectors’ claims that certain terms of the Interim Agreement had “chilled” the bidding for Abbotts, and that the Interim Agreement gave an undue advantage to ADC vis-a-vis other prospective bidders, which significantly depreciated the overall value of the company.²⁰ In chiding the district court, the Third Circuit noted that “considering ADC’s lucrative offer of employment to [the CEO], the timing of Abbotts’ petitions in bankruptcy, and its motion for approval of the Interim Agreement, the situation was ripe for collusion and

¹⁷ *Id.* at 147.

¹⁸ *Id.* at 150-151.

¹⁹ *Id.* at 148 (emphasis supplied).

²⁰ *Id.* The fact that bidders withdrew when the Interim Agreement could not be changed is obviously strong evidence of a “chilling effect”.

interested dealing between ADC and Abbotts.”²¹ Moreover, the “auction” could not be counted on to determine value; if the alleged collusion tainted the process, no real “auction” took place.²²

While the Interim Agreement in Abbotts Dairies, in allowing operation of the business pending sale, may have exceeded the usual “control” provisions of a DIP to buy, the difference is not so great that the case is not instructive in the DIP to buy context. In a DIP to buy arrangement, the stalking horse/lender and the debtor often negotiate in an environment where the debtor is cash-starved and where the process of negotiation can leave the debtor with only one choice. The timing of the filing will usually leave the debtor with little time to obtain sale approval. If there is evidence that the stalking horse/lender “manipulated” the timing of the deal and the chapter 11 filing, or that the timing emergency is the product of strategic planning rather than an unavoidable exigency, and there are “chilling” provisions in the DIP financing (such as early payoff provisions if the debtor accepts another bid, drop-dead clauses, or access to information beyond due diligence provided to all bidders), Abbotts Dairies provides authority to deny a stalking horse/lender the benefits of a good faith finding and ammunition to attack the DIP to buy and the sale process.

Subsequent courts, while acknowledging the teachings of Abbotts Dairies, have been reluctant to conclude an absence of good faith in “DIP to buy” situations based upon the facts before them. In Tempo Technology²³, the Delaware Bankruptcy Court was faced with a pure DIP to buy arrangement. The bankruptcy court granted the debtor’s first day motions, including an order authorizing the use of cash collateral and allowing DIP financing from the stalking horse/lender, with the stalking horse/lender (TAC) being granted first liens and superpriority claims. On the same day, in response to the debtor’s first-day motion to sell, the court scheduled

²¹ Id. at 149.

²² Id.

a hearing date for the approval of the sale of substantially all of the debtor's assets to the stalking horse/lender, and scheduled an auction to entertain higher or better offers.²⁴ Over objections, including by a prospective bidder, the court approved the sale to the stalking horse (the only bidder) on short notice and prior to the formation of the creditors committee, and found that TAC was a good faith purchaser.²⁵ No stay of the sale was obtained, but certain objectors appealed, questioning the good faith of the stalking horse/lender; the debtor sought to dismiss the appeal as moot under section 363(m).

The objectors' challenge mirrored the allegations in Abbotts Dairies. They alleged that the debtor waited for all of the pieces of its negotiations with TAC to fall into place before filing the petition (and could have filed earlier), and that the first day motions and orders had the effect of depreciating the value of the debtor's assets and chilling the bidding at the auction. They claimed that the DIP financing enjoyed by the debtor locked up the debtor's assets and weighed it down with (presumably unnecessary) debt, insuring that TAC would be the only bidder, and that TAC and the debtor contrived such tactics to take unfair advantage of the bidding process. They further noted that the debtor's CEO later obtained a favorable employment package from the buyer.²⁶

However, the district court noted that the bankruptcy court had found good faith, a finding with which it agreed, and dismissed the appeal under section 363(m). Noting the only testimony (that of the debtor's CEO), the court concluded that the bankruptcy court could have found that the debtor had been extensively marketed prepetition, that the debtor's cash situation

²³ In re Tempo Technology Corp., 202 B.R. 363 (D. Del. 1996).

²⁴ Id. at 364.

²⁵ Id. at 365.

²⁶ Id. at 367-68.

was such that a quick sale had to occur, that the negotiations were arm's length, and that the CEO had received, at the time of the sale, no promise of future employment.²⁷

The district court noted the absence of other bidders, despite three week's notice (including in the WSJ) and the fact that four other bidders had done due diligence.²⁸ Indeed, the court seems to state that a problematic term of the DIP financing *justified* the sale to TAC on short notice because of the potential difficulty in replacing the working capital financing:

Nevertheless, it is undisputed that no person or entity other than TAC bid at the auction. In the event that a competing bid had been entered, the ...DIP financing would have had to have been replaced by the competing bidder so that any loans advanced to the Debtor by [the stalking horse/lender] could be paid back and *the additional DIP funding would be available pending closing of the sale.*²⁹

Thus, the term of the DIP financing apparently provided that repayment occurred on bid acceptance, thus requiring any other bidder to be also a lender and a buyer. Notwithstanding this term, good faith was found due to the buyer's lack of affiliation with the debtor and the allegedly arm's length nature of the negotiations as established by the debtor's CEO's "unrebutted testimony." The district court noted an absence of evidence "that any prospective purchasers regarded the auction terms as chilling their interest in bidding."³⁰ Thus, the bankruptcy court's good faith finding was upheld and the appeal was held moot under section 363(m).³¹ The Third Circuit affirmed without a reported opinion.³²

²⁷ *Id.* at 368.

²⁷ *Id.* at 369.

²⁸ *Id.* at 369.

²⁹ *Id.* Such a term would appear to be a pure disincentive to bidding, but one which would have to be addressed at the borrowing motion hearing. See *infra* at section VI.

³⁰ *Id.* at 370. The fact that they did not bid was apparently not such a sign.

³¹ *Id.* at 370-74.

³² *In re Temtecho, Inc.*, 141 F. 3d 1155 (3d Cir. 1998) (table).

A subsequent action by the now-formed creditors committee seeking to set aside the sale to TAC was equally unavailing.³³ The committee alleged that certain lock-up and “no-shop” agreements existed between the debtor and the stalking horse/lender which prevented the CEO from shopping for financing or other bidders. The court, noting the CEO’s testimony that the other directors were not bound by the agreements and had shopped the deal, found these allegations insufficient.³⁴ The committee also noted that it had not been formed at the time of the sale and therefore could not object. The court, while finding the late formation of the committee “unfortunate,” found this an insufficient ground to overcome the effects of section 363(m) and the prior proceedings.³⁵ The committee’s complaint was dismissed for failure to state a claim upon which relief might be granted.³⁶

In the Medical Software Solutions case,³⁷ the Utah bankruptcy court found “good faith purchaser” status where an insider was the stalking horse/lender. In Medical Software the stalking horse/lender was a prepetition investor in, and later a prepetition lender to, the debtor. As the debtor slid into financial distress and a management dispute, the debtor hired an investment banker to sell the business, which attempted for about a year to market the company, without success.³⁸ With no ‘white knight’ in sight, the debtor filed a chapter 11 case and sought leave to sell the business to the prepetition investor/lenders (who also had had representatives on the debtor’s board). The debtor took the somewhat unusual step of seeking the appointment of an examiner to investigate the appropriateness of the DIP financing to be provided by the prepetition investor, as well as the proposed sale to the same group (the “DF

³³ Official Committee of Unsecured Creditors v. CIBC Wood Gurdy Ventures, Inc. (In re Temtecho, Inc.), 1998 WL 887256 (Bankr. D. Del.).

³⁴ Id. at *9.

³⁵ Id. at *18-19.

³⁶ Id. at *19.

³⁷ In re Medical Software Solutions, 286 B.R. 431 (Bankr. D. Utah 2002).

Lenders”), specifically to preempt any issues of conflict of interest.³⁹ The DIP financing required a sale within 60 days of the filing, or a default would occur.⁴⁰

Relying heavily on the examiner’s report, the court approved the DIP financing.⁴¹ The debtor’s motion to sell was also approved, over the objection of a minority shareholder, even though the consideration was primarily forgiveness of prepetition secured debt and assumption of debt and the sale was premised upon a release being granted to the prepetition lenders, as well as a finding of no successor liability. The stalking horse/lender was also found to be a good faith purchaser. Again, heavy reliance was placed upon the favorable examiner’s report.⁴² The court specifically found that there was nothing wrong with the stalking horse/lender being an insider, because the insider had, here, complied with its fiduciary duty of full disclosure.⁴³

Similarly, in the Delaware & Hudson Railway case⁴⁴, a stalking horse/lender was found to have acted in good faith under both section 363(m) and section 364(e). The key, again, was that the deal was negotiated at arm’s length, following attempts to solicit other financing and interested buyers, and there was full disclosure.⁴⁵

The Kentucky District Court dismissed as moot under Section 363(m) an appeal from an order allowing a sale to an entity formed, *inter alia*, by junior secured noteholders and where the bid consisted of a combination of some cash and a credit bid.⁴⁶ The bankruptcy court had found

³⁸ Id. at 435-36.

³⁹ Id. at 437.

⁴⁰ Id.

⁴¹ Id.

⁴² Id. at 438-439.

⁴³ Id. at 445-446. The court also validated the stalking horse/lenders use of credit bids of the prepetition secured debt as well as the DIP loan for the majority of the sale consideration, rejecting the objectors’ attempts to recharacterize the prepetition loans as capital contributions, or to equitably subordinate the lender’s claims. Id. at 442-444.

⁴⁴ In re Delaware & Hudson Railway Co., 124 B.R. 169 (D. Del 1991).

⁴⁵ Id. at 176-177.

⁴⁶ In re HNRC Dissolution Co., 2005 WL 1972592 (E.D.Ky.)

that the buyer acted in good faith, finding that the fact that the buyer held subordinated secured notes did not preclude a good faith finding where “section 363(k) expressly permits lien holders to bid in their liens to purchase assets in a bankruptcy sale”.⁴⁷

The District Court for the District of Maryland reached a similar result, dismissing as moot under section 363(m) an appeal of an order approving a sale via credit bid (in part) to an insider who also provided DIP financing. The Court noted that the assets had been well marketed, the bid was the highest and best bid and the insider had abstained from board votes or consideration of the sale.⁴⁸

Moreover, in the available reported decisions, bankruptcy courts have consistently approved sales to credit-bidding lenders where (1) the facts of the transaction are fully disclosed; (2) the sale process is fair and open, with reasonable marketing efforts pre- or post-petition; (3) the same due diligence is available to all bidders; and (4) the price paid is reasonable under the circumstances⁴⁹.

IV. Section 364(e) and the DIP to Buy

Section 364(e) provides that:

The reversal or modification on appeal of an authorization under this section to obtain credit or to incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.⁵⁰

⁴⁷ Id. at *5.

⁴⁸ In re Xact Telesolutions, Inc., 2006 WL 66665 (D. Md). See also, In the Matter of Watch Ltd., 2008 WL 4474808 (5th Cir.) (appeal dismissed as moot; credit bid); In re Quaker City Castings, Inc., 337 B.R. 729 (6th Cir. B.A.P. 2005)(appeal from order approving sale to insider-controlled entity dismissed as most under §363(m)).

⁴⁹ E.g., In re Summitt Global Logistics, Inc., 2008 WL 819934 (Bankr. D. N.J.); In re Dealmaker Developments, Inc., 2008 WL 5157454 (Bankr. W.D. La.).

⁵⁰ 11 U.S.C. §364(e).

Courts have generally defined “good faith lender” under this section in the same way as “good faith purchaser” under section 363(m). The conduct that will destroy “good faith lender” status is fraud, collusion between the lender and the debtor for an improper purpose, or an attempt to take or acquire grossly unfair advantage.⁵¹

One of the few reported decisions other than Delaware & Hudson Railway to consider the application of section 364(e) in a DIP to buy transaction is the opinion of the district court in In re Pan Am Corp.⁵² In Pan Am, the debtor was seeking to sell its trans-Atlantic routes and entered into negotiations with Delta whereby Delta would acquire them. In order to acquire the routes, Delta agreed to “sponsor” a reorganization of the debtors and to supply DIP financing to continue funding of operating losses. Delta and the debtors agreed to an asset purchase agreement, and, when other bidders emerged, Delta increased its purchase price for the routes, and agreed to fund a plan, provide post-petition financing and to hire certain Delta employees. The bankruptcy court approved the financing and the sale, finding Delta to have acted in good faith, over the objection of a creditor. The creditor sought to appeal the approval of the financing, but did not obtain a stay. At the district court, the creditor sought to preserve its right to appeal in the face of dismissal motions by challenging Delta’s status as a “good faith lender” under section 364(e).⁵³

Invoking Abbotts Dairies, the creditor, Evergreen, argued that Delta was complicit in contriving the emergencies under which the borrowing and sale orders were obtained. Evergreen further argued that there was no evidentiary basis for the good faith finding. Delta was also

⁵¹ In re PanAm Corp., 1992 WL 154200 (S.D.N.Y.), at *4.

⁵² Id.

⁵³ Id. at *3.

alleged to have made the loans for an “ulterior purpose”, i.e., to gain an advantage in buying the trans-Atlantic routes.⁵⁴

The district court rejected these arguments and found that the appeal was moot under section 364(e). The district court emphasized that the bankruptcy court’s good faith finding “must be viewed in the context of facts known to the Bankruptcy Court—and presumably Evergreen and Delta—at the time the orders appealed from were entered.”⁵⁵ Those facts included the debtor’s heavy, daily operating losses, and the fact that cessation of operations—a real possibility without financing—would have resulted in loss of the trans-Atlantic routes, as well as traveler confidence, thus dooming the reorganization. Thus, the debtor and Delta had not colluded to create a contrived emergency; the court considered Abbotts Dairies as the standard, and found no similar evidence of collusion in the case at bar.⁵⁶ The court also found nothing in Delta’s conduct suggesting bad faith. “That Delta imposed conditions on its loans, and advanced money in segments, rather than putting the entire amount ultimately advanced at the debtor’s disposal all at once, simply reflects rational business judgment, not bad faith.”⁵⁷ Delta and the debtors had not concealed any information about the loans or their conditions. The court noted that “[t]he loan documents were, in the case of the three loans, a part of the record.”⁵⁸

The district court also found unpersuasive Evergreen’s arguments that Delta was not a good faith lender because it had advanced money for an “ulterior purpose.” In so finding, the district court endorsed the very concept of the DIP to buy, properly conducted:

⁵⁴ Id. at *2.

⁵⁰ Id. at *3. Thus, facts alleged in a later adversary proceeding against Delta, when the reorganization broke down, were not relevant.

⁵⁶ Id. at *4.

⁵⁷ Id. at *5. Presumably the allegation here was that Delta use the “installment lending” to exercise undue control; the court rejected that allegation on these facts.

⁵⁸ Id.

In the present case, Delta did, of course, have its own purposes: it wanted the Debtor's trans-Atlantic routes. It was willing to risk advancing funds to the Debtors in the effort to get those routes. But that is not an improper purpose, but one contemplated by the bankruptcy laws....⁵⁹

Evergreen's appeals were, accordingly, dismissed as moot under section 364(e).⁶⁰

However, the Bankruptcy Court for the Western District of New York refused to approve a DIP financing agreement where the parties contemplated that the DIP lender would be the stalking horse via credit bid and where the court found various terms of the DIP financing would provide an unfair advantage to the stalking horse/lender at the proposed sale.⁶¹ In particular, the court found that this credit bid would be unfairly enhanced by exorbitant interest and loan fees charged as part of the DIP financing.⁶² The Colad court noted that "Investors may not use the bankruptcy process to obtain respectability for otherwise suspect efforts to influence a bidding process."⁶³

V. Establishing and Preserving Good Faith Status in the DIP to Buy.

While the reported cases are few, they do establish a series of guidelines, or practice pointers, to the proponent of "the DIP to buy" in obtaining "good faith lender" and "good faith purchaser" status. Among those guidelines are the following:

1. Put on evidence at the hearings on the borrowing motion and the sale motion to establish good faith in both capacities, including evidence to support any emergency approval or shortened notice. Good faith will not be presumed and it is the proponents' burden to establish it. Evidence should include information regarding the debtor's financial condition, the attempts to obtain other lenders and buyers, the effect on the debtor if the financing and the sale do not

⁵⁹ Id. at *6.

⁶⁰ Id.

⁶¹ In re the Colad Group, Inc., 324 B.R. 208, 222-23 (Bankr. W.D.N.Y. 2005).

⁶² Id. at 222.

⁶³ Id. at 223.

occur, and why the debtor's condition and the timing of the borrowing and sale are not products of any collusion or strategizing by the buyer or the debtor. Do not rely on "offers of proof."

2. Disclose, at the first hearing on the borrowing, all of the conditions of the borrowing, and include copies of all loan and security documents in the record, making them available to any parties-in-interest. Also disclose at the same hearing (or have filed at this time) all of the terms and conditions of the sale, filing with the sale pleadings a copy of the asset purchase agreement and all schedules thereto and making same available to all parties-in-interest. Any and all ancillary agreements with third parties, including any consulting or employment agreements with present or former employees of the debtor should be disclosed (and justified) as early as possible. Establish that all amounts advanced under the DIP loan are necessary (and are not more than necessary), rather than an attempt to enlarge a credit bid.

3. Give as much notice to as many people as the circumstances legitimately permit, and seek emergency or expedited approval only when it is truly needed.

4. Avoid terms in the DIP financing which appear only designed to advantage the lender as a purchaser or to provide incentives to others not to bid. Providing that the DIP loan must be repaid when another bid is accepted, as opposed to when it closes or on a date certain, is suspect. Fees payable only if the lender is not also the purchaser are also suspect, as are waivers which are triggered only by the stalking horse/lender's successful purchase. The DIP loan documents should not allow for damage which cannot be undone or which lowers value to all bidders, such as exposing confidential customer information, source codes, etc. to the stalking horse/lender under the guise of lender protections or "reporting".

5. Make all information which is available to the stalking horse/lender available to all potential bidders; the court will frown heavily on manipulation of information flow. If

bidders must sign a confidentiality agreement, the stalking horse/lender must sign one as well, on the same terms.

6. In certain cases, such as where the stalking horse/lender is an insider, consider asking for an examiner to (quickly) investigate the circumstances of both the financing and the sale, and who can opine on the good faith of the stalking horse/lender. Favorable examiner findings were clearly a factor in the Medical Software case and again in Summit Global Logistics.

VI. Attacking the DIP to Buy.

At the same time, the case law also suggests the difficult path encountered by the opponent of the DIP to buy. DIP financing by a potential purchaser, while carefully scrutinized by the courts, is not per se impermissible or inherently in bad faith; indeed, the cases endorse the practice absent unusual circumstances. The opponent must come forth with actual evidence of fraud, collusion, concealment or an attempt to take “grossly unfair advantage” over other bidders. Given the usual time and information constraints, obtaining this evidence may be difficult. Some key considerations include:

1. Attack early. The opponent should object to the borrowing motion with respect to DIP terms which advantage the stalking horse/lender as a purchaser and seek leave to take expedited discovery. Attempt to obtain and introduce evidence at the borrowing hearing about possible objections to the borrowing and the sale, treating the transactions as necessarily integrated and as one deal. Show that identified prospective bidders will not bid if the DIP loan terms are approved, or if bidding procedures are not modified. Focus on the budget as well; insure that all borrowing leading up to the sale is necessary and that no other source of funding is

available or sufficient. If the court approves a term of the borrowing, it will be hard to undo later, and hard to use as evidence of lack of good faith.




2. Focus on the time period leading up to the agreement on financing and the execution of the asset purchase agreement. Were those negotiations unnecessarily protracted as the debtor slid into its cash-starved state? Is so, why? Who controlled the timing of the filing, the debtor or the purchaser? Would an earlier filing have been possible or beneficial? Who chose the debtors' professionals, or influenced their selection? Was financing available from a non-buyer, even if less favorable?

3. Fight any attempt to get a "good faith lender" finding at the borrowing motion stage, and ask the court to delay any finding on "good faith" until all evidence has been presented at the sale hearing. Otherwise, the opponent risks being a victim of momentum, if not "law of the case" or issue preclusion.

4. If possible, have an alternative. The opponent should be able to point to a bidder who will enter the fray (including the opponent itself) if various of the "chilling" terms of the DIP to buy are not approved or the terms are modified. Be prepared to show that alternative financing is possible, perhaps by use of cash collateral.

VII. Conclusion.

"DIP's to buy", while not new, are increasingly common, and may provide a legitimate way—and sometimes the only way—to preserve value and continue operations pending a going concern sale. However, the temptation exists to use the terms of the DIP financing to tip the bidding in favor of the stalking horse/lender. The velocity of the proposed transactions has markedly increased. Courts will carefully scrutinize these arrangements, and the proponents of DIP's to buy should be prepared with evidence to support a finding of good faith in order to



achieve approval and preserve the benefits of sections 363(m) and 364(e). At the same time, if a proper record is built, the courts will generally find good faith in this context in the absence of strong contrary evidence that the stalking horse/lender has sought and obtained an unfair advantage over other bidders through the DIP to buy or a manipulation of the approval process. Time will tell if the increased tendency toward quicker and less advantageous credit-bid sales will try courts' patience and willingness to accept this approach.

