THE CLOAK OF GOOD FAITH: PROTECTING BANKRUPTCY SALES FROM APPELLATE REVIEW

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Introduction

Section 363(b) of the Bankruptcy Code empowers a Chapter 11 debtor to sell all or substantially all of its assets with court approval. “363 sales” offer a variety of advantages for buyers and sellers (i.e., debtors). For example, § 363(f) allows a debtor, under certain conditions, to sell its assets free and clear of security interests, which often increases the market value of the assets as compared to a sale outside of bankruptcy. In addition, § 363(k) allows a secured creditor to credit bid the face value of its claim in an auction of assets that serve as the creditor’s collateral. For creditors that purchase secured claims on the secondary debt markets for less than face value, the power to credit bid creates opportunities for the immediate realization of a return on investment.

In Mission Product Holdings, Inc. v. Old Cold, LLC (In re Old Cold, LLC),¹ the Bankruptcy Appellate Panel of the First Circuit reminded us of another advantage to 363 sales—protection from appeal for good faith purchasers. In Old Cold, the BAP affirmed a bankruptcy court order approving a sale, effectuated through an auction, of substantially all of debtor’s assets. The BAP relied on § 363(m), which establishes that, if a party appealing a sale order fails to obtain a stay pending

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appeal, the appeal is statutorily moot on all issues other than whether the buyer purchased the assets in good faith. The BAP’s decision in *Old Cold* highlights a distinction between the scope of appellate review of 363 sale orders as compared to the scope of review of plan confirmation orders. This distinction should factor into reorganization strategies. Moreover, the decision reinforces the importance for debtors and distressed debt investors to develop a record of good faith engagement with all interested parties during a sale process, and sheds some light on best practices.

**Facts of the Case**

In *Old Cold*, the debtor (then known as Tempnology, LLC) was a developer of chemical-free cooling fabrics. Prior to its Chapter 11 filing, the debtor obtained a secured line of credit, with a credit limit of $350,000, through People’s United Bank. In addition, the debtor borrowed millions of dollars, on an unsecured basis, from Schleicher & Stebbins Hotels, L.L.C. (“S&S”), which was also an equity holder of Frigid Fabrics LLC, a member of and investor in the debtor. S&S subsequently acquired People’s United Bank’s secured claim, and then converted a substantial portion of its unsecured claim into a secured claim under the same line of credit by increasing the credit limit and causing the debtor to repay the unsecured loan and re-borrow under the secured line of credit. The debtor also accepted a proposal by S&S to convert a portion of its remaining unsecured debt into equity. As a result of this transaction, in conjunction with S&S’ existing ownership interests in Frigid Fabrics LLC, S&S became the debtor’s majority owner. S&S also designated two individuals to sit on the debtor’s management committee.

From its inception, the debtor had been unprofitable and suffered from liquidity issues. Despite attempts to improve its balance sheet, the debtor’s financial circumstances worsened and it eventually became clear that the debtor would need to engage in a deleveraging transaction. After determining that the debtor would be unable to make an upcoming interest payment to S&S, the debtor’s management committee met with S&S to discuss entering into a forbearance agreement. After this meeting, S&S’ representatives on the debtor’s management committee resigned from their positions and S&S issued a notice of default to the debtor. After the default notice, the debtor and S&S, through their respective counsel, negotiated a forbearance agreement, under which S&S agreed to provide an additional $1.4 million of secured financing on the condition that the debtor would file for Chapter 11 relief and seek to sell substantially all of its assets pursuant to § 363 of the Bankruptcy Code.

Before the bankruptcy filing, the debtor’s
investment banker developed and implemented a marketing strategy to locate a stalking horse bid for use in a bankruptcy auction. The investment banker contacted five parties and received some interest, but ultimately no offers. Afterwards, the investment banker contacted S&S as a potential acquirer of the debtor’s assets. The debtor and S&S reached agreement on a bid of approximately $7 million (the majority of which constituted a credit bid of S&S’ secured debt), which the parties negotiated through their counsel. After the debtor and S&S entered into the stalking horse agreement, the debtor filed for Chapter 11 relief.

Once the debtor entered into bankruptcy, the bankruptcy court approved $250,000 of debtor-in-possession financing provided by S&S. In addition, the debtor filed a motion seeking approval of procedures for the auction, and a motion to reject its marketing and distribution agreement with Mission Product Holdings, Inc. (“Mission”), under which the debtor previously granted to Mission distribution rights to certain of the debtor’s products, along with a license to exploit the debtor’s intellectual property for commercial purposes. The debtor’s relationship with Mission had deteriorated and become contentious, and the debtor no longer wished to continue their business partnership. In response, Mission objected to both of the debtor’s motions, and filed its own motion to appoint an examiner to oversee the sale process.

After a contested hearing, the bankruptcy court granted both of the debtor’s motions, and Mission’s motion to appoint an examiner. At the hearing, S&S agreed to reduce its stalking horse bid to $1.05 million, consisting of a credit bid of a portion of S&S’ prepetition secured debt. In response, Mission submitted higher bids which were inclusive of certain of the debtor’s assets (i.e., the bid would leave certain assets in the debtor’s estate for distribution to the debtor’s creditors). After Mission altered its bidding strategy to include in its bids certain assets of the debtor, the debtor announced that those assets’ auction values would be reduced from the values that the debtor represented at the auction’s outset. The debtor’s investment banker later testified that this was done because the investment banker determined that it would not be appropriate to value the debtor’s assets at their book value in the context of evaluating bids.

To promote interest in the auction, the debtor’s investment banker sent materials to over 150 potential buyers. The investment banker developed the list of parties to contact in customary fashion, using a database of companies in similar or complementary industries. The list included liquidators, strategic purchasers, and investment funds. Notably, the debtor provided its investment banker with a “do not contact” list consisting of major existing or prospective customers of the debtor. The investment banker did not directly contact entities on the “do not contact list,” but did issue a general press release to all customers, distributors, and certain other entities. The investment banker’s marketing initiative yielded over 100 follow-up calls, but ultimately only four parties signed nondisclosure agreements. Three days prior to the auction, Mission submitted the only bid other than the stalking horse, a qualified overbid of $1.3 million in cash.

At the auction, S&S opened bidding with a new, higher credit bid of $1.4 million, which this time included a credit bid of a portion of S&S’ prepetition secured debt. In response, Mission submitted higher bids which were inclusive of certain of the debtor’s assets (i.e., the bid would leave certain assets in the debtor’s estate for distribution to the debtor’s creditors). After Mission altered its bidding strategy to include in its bids certain assets of the debtor, the debtor announced that those assets’ auction values would be reduced from the values that the debtor represented at the auction’s outset. The debtor’s investment banker later testified that this was done because the investment banker determined that it would not be appropriate to value the debtor’s assets at their book value in the context of evaluating bids.
Ultimately, Mission submitted a final bid of $2.6 million, which included: (i) $1.8 million in cash, (ii) $600,000 of the debtor’s cash, (iii) $80,000 of the debtor’s accounts receivable, and (iv) $120,000 of the debtor’s inventory. S&S then submitted its final bid of $2.7 million, which consisted of (a) a $750,000 credit bid of S&S’ claim under the DIP facility, (b) S&S’ assumption of (1) $650,000 of prepetition unsecured debt and (2) $50,000 of postpetition accounts payable, (c) an approximately $450,000 credit bid of S&S’ prepetition secured debt, and (d) the same cash, accounts receivable, and inventory to be left in the estate as in Mission’s final bid. S&S’s representative later testified that S&S altered its bidding strategy to make it more easily comparable to Mission’s bid.

The debtor accepted S&S’ bid. Mission declined to bid further, instead choosing to file objections with the bankruptcy court.

The Bankruptcy Court Decision

After the auction, the debtor sought approval of the sale to S&S. Mission raised a litany of objections, most of which centered on painting the debtor and S&S as engaged in a collusive effort to use the bankruptcy filing to reject Mission’s agreement with the debtor and prevent Mission from successfully acquiring the debtor’s assets. Mission alleged that:

- Using its control over the debtor, S&S coerced the debtor into agreements with S&S without negotiation and on terms favorable to S&S;

- S&S’ prepetition secured debt should be recharacterized as equity because the debtor was inadequately capitalized, S&S controlled the debtor, and the debtor had no other financing options in the credit markets given the debtor’s deteriorating financial circumstances;

- The debtor’s investment banker insufficiently marketed the proposed sale, as evidenced by the fact that the investment banker did not directly contact certain of the debtor’s customers, which the investment banker later admitted in testimony are often some of the most active bidders in bankruptcy auctions;

- The debtor improperly allowed S&S to “park” an “unnecessary” advance of an additional $500,000 under the DIP facility to inflate the size of S&S’ secured claim for credit bidding purposes;

- The debtor should not have allowed S&S to include in the same bid both the cash in the debtor’s estate and a credit bid of S&S’ secured claim under the DIP facility. By doing so, S&S double counted the cash that it loaned to the debtor under the DIP facility, allowing S&S to inflate the credit bidding value of the DIP facility in excess of its net economic value of $750,000; and

- The debtor lowered the auction values for certain of its assets mid-auction after Mission submitted a bid that included those assets in order to devalue Mission’s bid.

For these reasons, Mission calculated that S&S should only have been allowed to credit bid the $250,000 of DIP financing that S&S had transmitted to the debtor at the time that it submitted its stalking horse bid, which would mean that Mission’s bid was the best and highest bid at the auction.

The bankruptcy court overruled Mission’s objections and approved the sale, concluding that the marketing and auction process was not procedurally defective, that the debtor had a valid business justification to accept S&S’ bid, and that the debtor and S&S did not collude to prevent Mission from acquiring the debtor’s assets. Specifically, the court found:

- When it became clear, prepetition, that the debtor would need to engage in a
deleveraging transaction, S&S’ representatives resigned from the debtor’s management committee;

- Contrary to Mission’s allegations, the debtor and S&S negotiated their agreements at arm’s length through counsel, including the forbearance agreement that required the debtor to file for Chapter 11 relief and execute a 363 sale;

- Given the size of S&S’ prepetition secured claim ($5.5 million) relative to the amount of S&S’ credit bid of its prepetition debt (approximately $450,000), the recharacterization of even a majority of S&S’ debt as equity would not alter the result of the auction. The court-appointed examiner previously found that at best, only $2 million of the debtor’s prepetition secured claim was vulnerable to recharacterization;

- The marketing process was sufficient and appropriate under the facts, and the debtor’s investment banker had a valid business justification for declining to directly market to all of the debtor’s customers—that directly marketing a bankruptcy sale to the debtor’s customers might jeopardize the parties’ ongoing business relationship;

- S&S’ bid did not “double count” the cash that S&S advanced to the debtor under the DIP facility. Moreover, excluding such cash from the debtor’s assets would not result in a different auction result, as it would equally discount Mission’s bid; and

- The debtor’s mid-auction decision to reduce the auction value of certain assets did not support a finding of collusion between the debtor and S&S because it did not benefit S&S at the expense of Mission. Both S&S’ and Mission’s bids included the assets that the debtor devalued, meaning that both bids took an equal hit.

In sum, the bankruptcy court found no collusion or any other basis to invalidate S&S’ right to credit bid its pre- or postpetition secured debt, and entered an order approving the sale.

Section 363(m)

In addition to the findings above, the bankruptcy court applied section 363(m) of the Bankruptcy Code. Section 363(m) states:

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.

Section 363(m) establishes that a court exercising appellate jurisdiction over a bankruptcy court order approving a 363 sale may not invalidate the sale if the appellant failed to obtain a stay and the buyer purchased the debtor’s assets in good faith. Stated differently, if the appellant fails to obtain a stay of the sale order pending appeal, the sale order is “statutorily moot” on appeal as to all issues other than whether the buyer purchased the assets in good faith.

The bankruptcy court found that S&S was a good faith purchaser. Facts that the court found supported this holding included that S&S’ representatives removed themselves from the debtor’s management committee when the debtor began to posture towards a deleveraging transaction, that the debtor and S&S negotiated each applicable agreement through separate counsel, and that the examiner and the U.S. Trustee oversaw the sale process and did not object.

Bankruptcy Appellate Panel Review

Mission did not seek to stay the sale order. Instead, Mission filed a notice of appeal with the Bankruptcy Appellate Panel for the First Circuit. Because Mission failed to obtain a
stay, the sale closed prior to the BAP issuing its decision on appeal.

The BAP began by addressing whether the appeal was statutorily moot pursuant to § 363(m). Because Mission failed to obtain a stay of the sale pending appeal, the only question that remained was whether S&S purchased the assets in good faith. “[I]n the absence of a stay, § 363(m) operates to limit appellate review of a sale order to the specific question of whether the purchaser was a good faith purchaser.”

To determine whether S&S was a good faith purchaser, the BAP applied the law of the First Circuit. “[A] good faith purchaser is one who purchases property (1) in good faith; (2) for value; and (3) without knowledge of adverse claims.” “[G]ood faith’ . . . concerns the integrity of the buyer’s conduct . . . ‘Typically, the misconduct that would destroy a purchaser’s good faith status . . . involves fraud, collusion between the purchaser and other bidders or the trustee, or an attempt to take grossly unfair advantage of other bidders.’” Furthermore, with respect to sales to insiders, the BAP noted that, although 363 sales to insiders are not in bad faith per se, courts should apply “higher scrutiny [to such transactions] because of the opportunity for abuse.”

The determination of whether someone is a good faith purchaser is a mixed question of law and fact and thus is reviewed for “clear error.”

The BAP agreed with the bankruptcy court that S&S was a good faith purchaser. In addition to the reasons stated by the bankruptcy court, the BAP considered and rejected other claims by Mission. For example, Mission argued that the debtor’s acceptance of a bid that was underfunded at the time it was made was evidence of collusion. The BAP observed, however, that S&S agreed to a modification of the auction procedures that would only allow S&S to credit bid the amount of its postpetition loans advanced to the debtor prior to the auction. S&S made this concession to resolve Mission’s objection to the auction procedures. Thus, S&S’ bid was consistent with auction procedures that reflected Mission’s input. In addition, Mission had argued that the additional $500,000 that S&S advanced to the debtor under the DIP facility was unnecessary, and that the parties only agreed to this additional amount to increase S&S’ ability to credit bid during the auction. The BAP concluded that the additional funding was necessary for operational reasons as well as to fund the payment of the debtor’s restructuring professionals. The BAP further noted that only $60,000 of the $500,000 remained with the debtor at the time of the sale’s closing, which proved that the debtor required the funds.

Thus, the BAP found that S&S was a good faith purchaser in satisfaction of § 363(m), did not consider the remainder of Mission’s objections, and affirmed the bankruptcy court’s order approving the sale.

Analysis

363 Sales v. Plans

The BAP’s use of § 363(m) to shield the bankruptcy court’s sale order from appellate review was typical. The decision provides a good illustration of a distinction between 363 sales and Chapter 11 plans that should factor into strategic discussions regarding how best to structure deleveraging transactions.

Putting aside Article III, or “constitutional,” mootness, orders approving sales of substantially all of a debtor’s assets pursuant to § 363 of the Bankruptcy Code generally are subject to two theories of mootness: “statutory” mootness, described in § 363(m), and “equitable” mootness, which bars appellate relief “when, even though effective relief could conceivably be fashioned, implementation of that relief would be inequitable.” As discussed, the applicability of statutory mootness turns on the
good faith of the purchaser. In contrast, analysis of equitable mootness focuses on whether events have occurred between the Bankruptcy Court’s approval of the sale (or confirmation of the plan) and initiation of appellate proceedings that would make unwinding the transaction prejudicial to parties in interest. Thus, “[e]quitable mootness . . . is presumed when the reorganization plan has been substantially consummated during the pendency of the appeal.” “Substantial consummation” is defined in the Bankruptcy Code as the “(A) transfer of all or substantially all of the property proposed by the plan to be transferred; (B) assumption by the debtor or by the successor to the debtor under the plan of the business or of the management of all or substantially all of the property dealt with by the plan; and (C) commencement of distribution under the plan.” Once substantial consummation occurs, an appellant can only rebut the presumption of equitable mootness by making a substantial showing.

As stated, 363 sale orders are subject to both statutory and equitable mootness. In contrast, plan confirmation orders are not subject to § 363(m) and thus are subject only to the doctrine of equitable mootness. Thus, 363 sale orders enjoy a strategic advantage over confirmation orders to the extent statutory mootness is broader or simply distinct in application from equitable mootness.

There is significant overlap between the two mootness doctrines. Under both doctrines, for example, failure of the appellant to obtain a stay and subsequent consummation of the transaction are significant factors in support of mootness. However, courts assess statutory and equitable mootness in different ways. As discussed, statutory mootness focuses on whether the purchaser acted in good faith during the sale process, which includes evaluation of the parties’ behavior prior to the sale. This lies in distinction with equitable mootness, which focuses on actions that occurred after entry of the sale order. In Old Cold, the BAP wrote:

The doctrine of equitable mootness allows an appellate court to dismiss a bankruptcy appeal if “‘an unwarranted or repeated failure to request a stay enabled developments to evolve in reliance on the bankruptcy court order to the degree that their remediation has been impracticable or impossible,’ ” or if “‘the challenged bankruptcy court order has been implemented to the degree that meaningful appellate relief is no longer practicable even though the appellant may have sought a stay with all due diligence.’”

This difference in focus suggests that there will be cases in which one doctrine would moot an appeal, but the other would not. For example, statutory mootness might protect a sale order from appeal even when there has been no reliance on the sale order for purposes of equitable mootness. Conversely, equitable mootness might protect a sale order from appeal even when the buyer acted in bad faith. Thus, 363 sales benefit from two distinct doctrines of mootness that insulate orders approving sales from appellate review, whereas plan confirmation orders only enjoy protection from one of the doctrines.

More than just a different kind of protection, the doctrine of statutory mootness may provide more substantial protections than equitable mootness. Unlike statutory mootness, which bars review of all issues other than good faith, equitable mootness depends on the effect that a successful appeal would have on the sale or plan. Equitable mootness only protects a sale or confirmation order from appellate review when reversal or modification would be difficult to administer.

Perhaps the best example of how statutory mootness may provide protection from appellate review when equitable mootness falls short is Old Cold itself: The BAP protected the underlying sale order by applying the doctrine
of statutory mootness, while simultaneously finding that the appeal fell short of being equitably moot.\textsuperscript{16}

Thus, there are clear differences between the doctrines of statutory and equitable mootness, and reasons to believe that statutory mootness provides more significant protections. Certain courts have even called into question the validity of the doctrine of equitable mootness altogether.\textsuperscript{17} This should factor into decisions whether to structure transactions as 363 sales or plans of reorganization, as 363 sales, unlike plans, enjoy the benefit of both doctrines.

The decision between a 363 sale and a plan often manifests when a lien holder is the debtor’s fulcrum creditor. In such circumstances, the secured creditor likely will be the party that dictates the transaction’s structure, and usually will pick the structure that provides the most certainty that the transaction will consummate as planned. The decision is often between a plan that would provide a debt-for-equity exchange with the secured creditor, and a 363 sale of substantially all of the debtor’s assets to the secured creditor, with the secured creditor credit bidding the face value of its claim.

In making this decision, the secured creditor (as well as the debtor) should consider a number of factors. On the sale side, for example, there is the risk that the bankruptcy court will disallow the creditor’s right to credit bid its claim. On the plan side, the parties must assess the likelihood that the proposed plan will satisfy the statutory requirements for confirmation. The availability of § 363(m), especially against the backdrop of increasing limits to the doctrine of equitable mootness, also should inform this analysis.

**Difficulty of Obtaining a Stay**

In *Old Cold*, Mission did not seek a stay of the sale order pending its appeal, which triggered § 363(m) once the sale closed. A simple way for objectors to avoid statutory mootness is to obtain a stay. However, obtaining a stay can be difficult as a matter of law, and cost-prohibitive as a practical matter. The tortured history of the Adelphia Communications bankruptcy demonstrates this challenge.

In *In re Adelphia Communications Corp.*, the Bankruptcy Court for the Southern District of New York confirmed a plan over the objections of creditors that the “death trap” concept built into the plan’s class treatment structure was inconsistent with the Bankruptcy Code. The objecting creditors moved the district court for a stay pending appeal and for an expedited appeal. The district court granted the stay, applying the following factors:

The decision as to whether to issue a stay of an order pending appeal lies within the sound discretion of the district court. “[F]our factors are considered” in exercising that discretion: “(1) whether the movant will suffer irreparable injury absent a stay, (2) whether a party will suffer substantial injury if a stay is issued, (3) whether the movant has demonstrated a substantial possibility, although less than a likelihood, of success on appeal, and (4) the public interests that may be affected.”\textsuperscript{18} Although the district court in *Adelphia* granted the appellant’s request for a stay, the decision suggests why obtaining a stay is challenging. First, the factors bearing on a stay are fact-intensive. Preparing and briefing a motion requesting a stay will be expensive—a transaction cost that will be cost-prohibitive for many appellants. Second, the substance of the test for granting a stay is no lay-up. The standard for a stay is similar to the challenging standard for seeking a preliminary injunction.\textsuperscript{19} Third, and perhaps most importantly, if the district court grants a stay pending appeal, the district court is likely to require the appellant to post a bond to secure losses.
that might result from the stay. Such a bond may be extremely expensive, and may undermine the appeal wholesale.

A cost-prohibitive bond requirement ultimately doomed the objecting creditors’ appeal in *Adelphia*. Although the district court granted the request for a stay, the district court required that the appellant post a $1.3 billion bond, which represented the potential loss that the appellees might suffer as a result of the stay. The district court noted that a presumption lies in favor of the bond requirement. “Appellants [must] post a bond . . . absent ‘exceptional circumstances.’ . . . The party seeking a stay without bond has the burden of providing specific reasons why the court should depart from the standard requirement . . . .” The Second Circuit refused to vacate the bond, stating, “[w]e know of no authority that supports appellate jurisdiction over a bond requirement on the theory that, in this case, posting the required bond is not an investment that the party pursuing the appeal would prudently make . . . .” The *Adelphia* creditors were unwilling to incur the costs to post the bond. As a result, the Second Circuit vacated the stay and the plan went effective before the district court heard the substance of the appeal. The district court then dismissed the appeal as equitably moot because the plan was substantially consummated by the time the district court rendered its decision.

Thus, although statutory mootness does not apply to 363 sales when the appellant obtains a stay, there are legal and practical hurdles that may impede or outright prevent the appellant from obtaining a stay pending appeal. *Adelphia* illustrates how even after obtaining a stay, posting a bond may be cost-prohibitive, especially in large bankruptcies. In many cases, then, parties seeking to appeal sale orders will be limited by § 363(m) to challenging the good faith of the buyer.

### Establishing a Record of Good Faith

Given the potential difficulty of obtaining a stay, it should be clear how important it is, as a debtor or as a buyer, to establish a record of good faith during sale proceedings. In *Old Cold*, the debtor and S&S each took actions that protected the sale from challenge:

- S&S removed its representatives from the debtor’s management committee when it became clear that the debtor would need to engage in a deleveraging transaction;
- The debtor and S&S negotiated all agreements through counsel to preserve the arm’s-length nature of the transaction;
- The debtor did not request DIP financing in excess of what was necessary to fund its operations and to pay its professional fees;
- S&S agreed to a modification of the auction procedures to accommodate an objection from Mission;
- S&S ensured that its postpetition loan under the DIP facility was fully funded before credit bidding its full amount;
- S&S structured its final bid to mirror Mission’s in order to make clear that S&S’ bid was highest and best;
- The debtor and S&S engaged in off-the-record negotiations only to the extent expressly contemplated and sanctioned by the auction procedures; and
- The debtor only altered the auction values of certain of its assets in a way that would affect S&S’ and Mission’s bids equally.

Thus, a careful curation of the record enabled the debtor and S&S to insulate the sale from appellate review of a majority of the issues that Mission raised in its objections.
Conclusion

Bankruptcy sales offer investors the opportunity to realize significant returns on their investments. The dark cloud of a bankruptcy proceeding often will depress market perceptions of a debtor’s business, which can create large discrepancies between the market’s pricing of the debtor’s assets and the assets true value. Missing such a profit opportunity will sometimes drive losing bidders in a bankruptcy auction to take action to block a sale, either to recoup some of their transaction costs and lost profit through a settlement, or as a last ditch effort to purchase the assets. It is important that debtors and their sale counterparties protect their transactions from such attack.

Section 363(m) is a tool that debtors and buyers can use to shield their deals from obstruction. By structuring a deleveraging transaction as a 363 sale rather than as a plan, debtors and buyers limit appellate review of the deal. The debtor in Old Cold, along with the prepetition secured creditor and buyer, laid out an effective blueprint for this strategy. By building a record of good faith engagement with the various parties in interest, the debtor and S&S undermined Mission’s attempt to block their deal. Developing a strong record is especially important when the purchaser is an insider and any transaction will face heightened scrutiny. Debtors and distressed debt investors should look at Old Cold as a model for how to properly cloak a deal with the protection of § 363(m) when using a 363 sale as the vehicle for a distressed debt transaction.

ENDNOTES:


211 U.S.C.A. § 363(m).


4In re Old Cold, LLC, 558 B.R. at 515.

5In re Old Cold, LLC, 558 B.R. at 515 (quoting In re Cable One CATV, 169 B.R. 488, 493 (Bankr. D.N.H. 1994)).


8See In re Chateaugay Corp., 988 F.2d at 326 (“Completed acts in accordance with an unstayed order of the bankruptcy court must not thereafter be routinely vulnerable to nullification if a plan of reorganization is to succeed.”).


11See, e.g., In re Adelphia Commc’ns Corp., 367 B.R. at 93 (to rebut presumption of equitable mootness, appellant must establish each of five factors).


13Compare 11 U.S.C.A. § 363(m) (failure to obtain a stay is a necessary element to establish statutory mootness), with In re Adelphia Commc’ns Corp., 367 B.R. at 91 (equitable mootness presumed when plan has been substantially consummated).

14In re Old Cold, LLC, 558 B.R. at 513 (citations omitted).
See, e.g., One2One Commc’ns, LLC, 805 F.3d 428, 435 (3d Cir. 2015) (appeal was not equitably moot; “the doctrine [of equitable mootness] must be construed narrowly and applied in limited circumstances . . . the doctrine’s ‘judge-made origin, coupled with the responsibility of federal courts to exercise their jurisdictional mandate, obliges us to proceed most carefully before dismissing an appeal as equitably moot.’”) (quoting Samson Energy Res. Co. v. Semcrude, L.P. (In re Semcrude, L.P.), 728 F.3d 314, 318 (3d Cir. 2013)); United States Tr. v. Official Comm. of Equity Security Holders (In re Zenith Elecs. Corp.), 329 F.3d 338, 346 (3d Cir. 2003) (Appeal seeking disgorgement of professional fees not equitably moot because reversal “would not ‘knock the props out from under the authorization for every transaction that has taken place,’ and in fact would leave the plan entirely intact”); United Artists Theater Co. v. Walton, 315 F.3d 217, 228 (3d Cir. 2003) (Notwithstanding that appellant failed to obtain a stay, appeal challenging an indemnity provision in a plan not equitably moot because if the appeal were successful, “the Plan otherwise would survive intact”); In re PWS Holding Corp., 228 F.3d 224, 236-37 (3d Cir. 2000) (appeal challenging releases in plan not equitably moot because “the plan could go forward even if the releases were struck”); LTV Corp. v. Aetna Cas. & Sur. Co. (In re Chateaugay Corp.), 167 B.R. 776, 779 (S.D.N.Y 1994) (appeal seeking reversal of a settlement order which released certain parties from liability to the debtor in exchange for multimillion dollar payment from the debtor not equitably moot because it would not unravel the plan of reorganization).

In re Old Cold, LLC, 558 B.R. at 514 (“We are not convinced that transactions which have occurred since the closing of the sale are incapable of being unwound. Thus, we conclude this appeal is not equitably moot.”).

In re Old Cold, LLC, 558 B.R. at 514 n.5 (“It is important to note that, in 2015, a series of significant courts of appeals decisions addressed the equitable mootness doctrine, with some debate as to whether the doctrine should continue to exist.”).


In re Adelphia Commc’ns Corp., 367 B.R. at 94.
to hinder, delay or defraud creditors. Trustee later sold the home, paid off all creditors, and paid the debtor his homestead exemption. Although debtor argued that he meant only to preserve his wife’s homestead interest by the partition, the Fifth Circuit remarked that, whether debtor’s intentions were noble or not, “[k]eeping property in the hands of his wife is the mirror of keeping property out of the hands of creditors” and held that the bankruptcy court did not clearly err in finding that the debtor had acted with intent to hinder or delay his creditors. The court next rejected the wife’s claim that she was entitled to compensation for the loss of her homestead rights in the marital property. The court applied Fifth Circuit precedent and held that nondebtors who acquired homesteads after the passage of § 522(p), which capped Texas’ unlimited homestead exemption along with all other state law homestead exemptions, are “foreclosed from pressing a Takings Clause claim . . . .”

**SIXTH CIRCUIT**

*Meolie v. Huntington National Bank*, 848 F.3d 716 (6th Cir. 2017). Excess deposits in an account located at a transferee bank but held by the debtor-transferor could not be recovered as fraudulent transfers, as the transferee did not have dominion and control over those deposits. Debtor’s right to withdraw funds kept the transferee bank from having dominion and control. The funds were not the bank’s, and debtor did not grant the bank a security interest in those funds. Additionally, the Sixth Circuit held that not all funds received by a transferee could be received in good faith, and therefore were avoidable as fraudulent transfers, when the transferee bank’s own records and employee’s knowledge indicated it should have been aware of the fraudulent nature of the transactions. However, when the transferee bank only had inquiry notice of the fraudulent nature the affirmative defense of good faith was available. Good faith, in this instance, meant that the transferee bank legitimately continued to believe that the transfers were of the nature described by the transferor. Lastly, the Sixth Circuit found that the statutory, rather than market, rate of interest was permissible when the bankruptcy court considered case-specific factors.

**SEVENTH CIRCUIT**

*Lardas v. Grsic*, 847 F.3d 561 (7th Cir. 2017). The Seventh Circuit rejected four appeals arising from a business dispute between debtor and his aunt on one side and their business associates on the other over a shopping mall. The dispute was settled prior to debtor’s Chapter 7 case in a deal whereby the debtor purchased a 99% stake in the shopping mall, with the associates retaining 1% and a lien on debtor’s interest to secure a loan to debtor. The aunt claimed that the associates tricked her into participating in the settlement and brought a claim against them for fraudulent inducement. The Seventh Circuit upheld the dismissal of her claim on standing grounds, given that she sold her interest in the LLC in 2000 and thus could not allege a direct injury. The second appeal arose from debtor’s attempt to invalidate the trustee’s sale of debtor’s interest in the fraudulent conveyance action and debtor’s interest in the mall to the associates as good faith purchasers under 11 U.S.C.A. § 363(m). The Seventh Circuit held that debtor’s objection to the sale was moot given that he failed to move to stay the sale pursuant to Rule 8007(a)(1)(A) as required under Seventh Circuit precedent. Debtor also challenged the bankruptcy court’s bad faith discharge denial due to debtor’s “host of false statements and omissions in his schedules and statement of financial affairs.” The Seventh Circuit rebuffed debtor’s attempt to shift blame to incompetent bankruptcy counsel (who also submitted the brief before the Seventh Circuit). Finally, debtor moved to reopen his aunt’s fraudulent conveyance action, arguing that the trustee had abandoned the property. In denying debtor’s final appeal, the Seventh Circuit flatly
stated, “That assertion is simply wrong. As noted, the trustee sold [debtor’s] claim along with his interest in [the mall] . . . .”

*In re Kempff*, 847 F.3d 444 (7th Cir. 2017). The Seventh Circuit affirmed the bankruptcy court’s dismissal of a complaint to bar discharge under 11 U.S.C.A. § 727(a). The Seventh Circuit concluded: (i) a finding that debtor did not fraudulently transfer money paid by her accountant to the Illinois Department of Revenue without her knowledge or approval was not clearly erroneous, and (ii) a finding that misstatements contained on debtor’s bankruptcy schedules resulted from misunderstandings or incompetence of debtor’s attorney, and not any fraudulent intent by the debtor as required under § 727(a)(4) was not clearly erroneous. The court also concluded that the bankruptcy court did not err when it allowed debtor to testify about advice from her bankruptcy attorney because the advice was evidence that helped negate fraudulent intent.

**EIGHTH CIRCUIT**

*Diwan, L.L.C. v. Maha-Vishnu Corp. (In re Diwan, L.L.C.)*, 848 F.3d 1147 (8th Cir. 2017). The Eighth Circuit affirmed the dismissal of a Chapter 11 small business case in which the debtor could not pay, and could not succeed in objecting to, a large claim. Debtor argued that the large claim should be disallowed due to impairment of collateral, and that if the large claim were denied, it could find sufficient creditors to support its plan. The circuit affirmed the bankruptcy court’s finding that even without that claim, the plan would fail the requirements of feasibility according to debtor’s own monthly operating statements.

**NINTH CIRCUIT**

*Khan v. Barton (In re Khan)*, 846 F.3d 1058 (9th Cir. 2017). Claims arising from fraudulent conversion of stock were not subject to mandatory subordination under 11 U.S.C.A. § 510(b) as a claim “for damages arising from the purchase or sale of . . . a security.” The creditor had obtained a judgment for fraudulent conversion of the stock he held in the business he founded with the debtors. The creditor was awarded damages based on the value of the stock at the time it was converted in 2009, well after plaintiff’s purchase of the stock in 2001. Debtors filed Chapter 13 on the eve of damages valuation and failed to amend their schedules to reflect the judgment’s full amount. In the bankruptcy case, debtors argued that the creditor’s claim should be subordinated and thus subject to disallowance as the claim arose from the purchase or sale of a security. The Ninth Circuit noted that “[n]o doubt Barton did purchase securities . . . . However, Barton’s claims . . . are based upon the judgment entered against the Debtors by the Superior Court on account of their actions many years later (2009) when they fraudulently converted Barton’s stock.” To distinguish other cases in which the court had interpreted “arising from” broadly to find that § 510(b) subordination applied, the Ninth Circuit explained that damages were measured by the value of the converted property when the conversion occurred years after the sale of securities.

**ELEVENTH CIRCUIT**

*Appling v. Lamar, Archer & Cofrin, LLP (In re Appling)*, 848 F.3d 953 (11th Cir. 2017). The Eleventh Circuit joined the Fourth Circuit, and departed from the Fifth, Eighth, and Tenth Circuits, in holding that a statement about a single asset is a “statement respecting the debtor’s . . . financial condition” for purposes of 11 U.S.C.A. § 523(a)(2). Debtors made false statements orally regarding a large tax refund to a law firm providing legal services in reliance on being compensated from the tax refund. The bankruptcy court held the judgment obtained by the law firm against debtors was nondischargeable pursuant to § 523(a)(2)(A). The Eleventh Circuit reversed. The circuit held debtor’s statement about his
tax refund were statements respecting his financial condition, but were not in writing; therefore, the debt to the law firm was dischargeable.

_Lunsford v. Process Techs. Servs. (In re Lunsford),_ 848 F.3d 963 (11th Cir. 2017). The Eleventh Circuit held that nondischargeability of debts for the violation of federal or state securities under 11 U.S.C.A. § 523(a)(19)(A) applied regardless whether the violation was committed by the debtor or another party. Debtor sold unregistered securities in his company and misrepresented its financial condition, both violations of the Mississippi Securities Act. The bankruptcy court ruled that § 523(a)(19) prohibited discharge of the debt, relying on the findings of an arbitrator confirmed by the state chancery court. Debtor argued that the state court’s ruling did not provide an adequate basis for the bankruptcy court to find that debtor himself had violated securities laws. The Eleventh Circuit held that the text of § 523(a)(19)(A) indicates that “the statute applies irrespective of debtor conduct.” The statutory phrase, “debt that is for the violation of the [securities laws],” revealed that the key element for nondischargeability under § 523(a)(19)(A) is a causal link between the securities violation and the debt. The court supported its interpretation of the statute by noting that “If Congress had wanted to limit section 523(a)(19)(A) [by requiring debtor misconduct], it could have done so as it did with other provisions in the statute.”
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