ALERTS

Fifth Circuit Vacates DIP Financing Order for Lack of Good Faith

September 15, 2014

The U.S. Court of Appeals for the Fifth Circuit, on Sept. 3, 2014, vacated bankruptcy court and district court Chapter 11 debtor-in-possession ("DIP") financing orders due to: (1) the lender's lack of good faith in relying on a third party's shares of stock as collateral; and (2) the bankruptcy court's lack of subject matter jurisdiction. *In re TMT Procurement Corp.*, 2014 WL 4364894 (5th Cir. Sept. 3, 2014). To vacate the orders, the Fifth Circuit rejected the debtors' argument that the consolidated appeals were moot because of the lower courts' repeated findings "that the DIP Lender … extended financing to the Debtors in good faith and was entitled to the full protections of sections 363(m) and 364(e) of the Bankruptcy Code ["Code"]." *Id.* at *3. Significantly, the court of appeals never found that the DIP lender acted in bad faith, but only that it lacked the statutory "good faith" to prevent the court from hearing the merits of the appeal.

Relevance

This decision is important to DIP lenders. Code sections 364(e) and 363(m) ordinarily will "moot … an appeal" from a financing or a Section 363 sale order when "the purchaser or lender acted in good faith," unless the appellant "obtain[s] a stay" pending appeal. *Id.* at *4.[1] The appellant here had not obtained a stay, making the lender's good faith a threshold issue.

The Code does not define "good faith," requiring courts to rely for guidance on standards employed in other contexts. *See, e.g.*, *In re Ellingsen MacLean Oil Co., Inc.*, 834 F.2d 599, 605 (6th Cir. 1987) (court looked to definition of good faith contained in Uniform Commercial Code).

As shown below, *TMT* provides a new test regarding the Code's "good faith" requirement for lenders and acquirors in reorganization cases — a test based on the lender's knowledge of possible insider manipulation of the bankruptcy process.

The Unrelated Vantage State Court Litigation

Facts

Vantage Drilling Company ("Vantage") appealed from three district court and two bankruptcy court orders entered during the course of the debtors' Chapter 11 cases. Vantage had unsuccessfully challenged court orders directing the deposit of Vantage stock ("Vantage Shares") with the clerk of the court by the debtors' non-debtor affiliate ("A") to, among other things, secure the debtors' obligations to the independent DIP lender.

Vantage had sued the debtors' sole shareholder ("P"), an individual, in the Texas state courts (the "Vantage Litigation") in 2012 for breach of fiduciary duty, fraud, unjust enrichment and related claims, asserting material misrepresentations that had allegedly induced Vantage to contract with P's affiliates. As a result, alleged Vantage, it had issued "approximately 100 million shares of Vantage stock to [A], an entity solely owned and wholly controlled" by P, and had also granted P three seats on Vantage's Board of Directors." Vantage sought a "[j]udgment imposing a constructive trust upon all profits or benefits, direct or indirect, obtained by [P]," presumably including the Vantage Shares. *Id.* at *1. A was *not* a party to the Vantage Litigation, where P was the sole defendant.

The Chapter 11 Cases

P's wholly-owned marine shipping companies filed Chapter 11 petitions one year later in the Southern District of Texas. When creditors moved to dismiss the reorganization cases on the ground of bad faith, the bankruptcy court held an evidentiary hearing. P "offered [at the hearing] to place approximately 25 million shares of Vantage stock held by" A, its non-debtor affiliate, "into an escrow to be administered by the bankruptcy court to secure" not only the debtors' "compliance with court orders," but also "to serve as collateral for post-petition borrowing or working capital." *Id.*

Through a series of later procedural moves between the bankruptcy court and district court, both courts ultimately entered interim and final orders approving secured DIP loans to the debtors by an independent, unrelated bank ("Bank"). All of the DIP financing orders, entered over Vantage's strong objections, recited the Bank's "good faith" in making the DIP Loan, entitling it to "the full protection of sections 363(m) and 364(e) of the … Code." Most significantly, both courts had required A to deposit a total of 29.9 million shares of Vantage stock in order to secure the DIP Loan and the debtors' use of cash collateral. A and P represented to the bankruptcy court that the court in the Vantage Litigation had not enjoined them from depositing the Vantage Shares with the bankruptcy court clerk as collateral for the DIP Loan. The bankruptcy court then found that: (1) A owned the stock; and (2) the stock was not subject to any constructive trust as a matter of law. *Id.* at *2-3.

Vantage was not a creditor in the pending Chapter 11 cases. It appeared in the bankruptcy and district courts as a "party in interest" to protect its rights in the unrelated Vantage Litigation,[2] where, among other things, it sought the return of the Vantage Shares.

Lack of Good Faith

Court of Appeals

The Fifth Circuit consolidated Vantage's direct appeals from the bankruptcy court orders and appeal from the district court orders. It first addressed the debtors' statutory mootness arguments seeking dismissal of the appeals because of Vantage's failure to obtain a stay pending appeal. The debtors relied heavily on the lower courts' repeated good faith findings. According to Vantage, however, it had challenged the DIP Lender's good faith by "repeatedly asserting that [A] had fraudulently obtained the Vantage Shares; Vantage had an adverse claim to the Vantage Shares; and Vantage's right to assert a constructive trust over the Vantage Shares would survive any attempt to pledge, sell or transfer the Vantage Shares *to a purchaser or lender who was on notice of Vantage's adverse claim, including the DIP Lender*" (emphasis added). Agreeing with Vantage, the court held that the Bank had not acted in good faith within the meaning of Code sections 363(m) and 364(e) because of what it knew at the time of its DIP loan. No party even suggested, however, that the Bank was guilty of bad faith by engaging in

"fraud, collusion, or an attempt to take grossly unfair advantage," but only that it "was on notice of Vantage's adverse claim to the shares." *Id.* at *4-5.

No Subject Matter Jurisdiction

The Vantage Shares never belonged to the Chapter 11 debtors. The court agreed with Vantage that even if the debtors had somehow acquired an interest in the stock, it did not constitute "property of the [debtors'] estate under [Code] § 541(a)(7) because that provision is limited to property interests that are themselves traceable to 'property of the estate' or generated in the normal course of the debtor's business." As the court explained, the shares "were not created with or by property of the estate, they were not acquired in the estate's normal course of business, and they are not traceable to or arise out of any [pre-bankruptcy] interest included in the bankruptcy estate." *Id.* at *7.

Nor could the debtors rely on the financing orders entered by the lower courts to support subject matter jurisdiction. In the words of the Fifth Circuit, the lower courts "could not manufacture *in rem* jurisdiction over the Vantage Shares by issuing orders purporting to vest" the debtors with an interest in the stock. These orders could not constitute "jurisdictional bootstraps" enabling the lower courts to "exercise jurisdiction" that was non-existent. *Id.* at *8.

The court also rejected the debtors' argument that the financing orders were based on the "related to" language contained in the jurisdictional provision of the Judiciary Code, 28 U.S.C. § 1334(b). According to the debtors, the granting of the lien on the Vantage Shares was somehow "related to" the pending bankruptcy cases. Not only was the dispute over the Vantage Shares unrelated to the pending cases, but the lower courts "lacked jurisdiction *to interfere* with [Vantage's] rights" in the stock, which was "the subject of the Vantage Litigation," the outcome of which "could not conceivably affect the Debtors' estates." (emphasis added). In short, bankruptcy jurisdiction does not extend to state law disputes "between non-debtors [Vantage and P] over non-estate property. By requiring P and A to deposit Vantage Shares with the clerk of the court, the lower courts "*interfered* with the [unrelated and independent] Vantage Litigation." *Id.* at *8-9 (emphasis added).

The court further rejected the debtors' argument that the financing orders here were "core" proceedings. Because the lower courts had "adjudicated a non-debtor's [i.e., Vantage's] right in non-estate property

[Vantage Shares]," and "because there was no 'related to' jurisdiction in this case," the debtors could not "confuse" the issue by making this argument. *Id.* at *9. The problem here was best summarized by the Fifth Circuit as follows:

[T]he orders authorized the imposition of liens on the Vantage Shares, subordinated Vantage's rights in the Vantage Shares to those of the DIP Lender, *prevented the … court in the Vantage Litigation from impairing the [Bank's] interest in the Vantage Shares*, and held that the Vantage Shares were not subject to a constructive trust as a matter of law.

Id. at *10 (emphasis added).

Comment

The DIP lender, according to the record, was wholly unaffiliated with the debtors, P and A. It was not a pre-petition lender; it made a new DIP loan knowing not only about Vantage's objections but also about the existence and status of the pending Vantage Litigation. Regardless of any apparent manipulation and forum shopping by the debtors and their affiliates, the DIP lender here was apparently in the wrong place at the wrong time.

Another relevant appellate decision on the subject of a lender's good faith in the financing context is *In re EDC Holding Co.*, 676 F.2d 945 (7th Cir. 1982). It held that the DIP lender had acted in bad faith because the purpose of its loan was to pay creditors' attorneys, an improper use of the loan proceeds. In the court's view, it was improper for the lender to have made the loan with the ulterior purpose of reducing the cost of settlement. The creditor in *EDC* was a union that wanted its legal fees paid ahead of the claims of other creditors. In the words of the Seventh Circuit:

We assume the statute [Section 364(e)] was intended to protect not the lender who seeks to take advantage of a lapse in oversight by the bankruptcy judge but the lender who believes his priority is valid but cannot be certain that it is, because of objections that might be upheld on appeal. If the lender knows his priority is invalid but proceeds anyway in the hope that a stay will not be sought or if sought will not be granted, we cannot see how he can be thought to be acting in good faith.

Id. at 947.

Because the loan agreement in *EDC* stated that $77,000 of the proceeds would be used to "pay the union for attorneys' fees and other legal expenses incurred in the prosecution of the union's action for the unpaid wages of its members," the lender's "priority meant that the burden would be borne by the bankrupt estate, in effect the general creditors, rather than by [the lender] itself." *Id.* In *TMT*, though, the DIP lender had no such improper purpose. Nothing in the record even suggested that the intended use of the new loan proceeds was improper.

The real problem for the DIP lender, having nothing to do with its own conduct, was the bankruptcy court's and the district court's "interference" with the Vantage Litigation, apparently engineered by P for his own benefit. The Fifth Circuit stressed that point. 2014 WL 4364894 at *8. And, in the Fifth Circuit's view, the DIP lender's knowledge of the litigation and the importance of the Vantage Shares to that litigation were sufficient to deprive the lender of good faith status under Code Section 364(e). Significantly, the court of appeals never described the DIP lender's conduct as bad faith. Instead, it found that it lacked the statutory "good faith" required by Section 364(e).

Third parties, such as insiders and corporate affiliates, should not be discouraged from using their assets to secure DIP loans in other cases. In *TMT*, the third-party collateral was the subject of litigation outside the bankruptcy court. P and A wrongly misrepresented to the lower courts that they had the power to transfer or otherwise encumber the Vantage Shares. That, however, is small comfort to the lender in *TMT*. It has no rights in the Vantage Shares.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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[1] According to the U.S. Court of Appeals for the Third Circuit, however, an appeal from a DIP financing order, when "a stay is not granted," will not be mooted by Code Section 364(e) if the "lender … has not disbursed" funds on the DIP loan. *In re Swedeland Dev. Group, Inc.*, 16 F.3d 552, 561 n.7 (3d Cir. 1994) (*en banc*).

[2] The Vantage Litigation began in the Texas state courts. P removed it to the federal court; after a successful appeal by Vantage, the Fifth Circuit

ordered the district court to remand the suit back to the Texas courts. 741 F.3d 535 (5th Cir. 2014).

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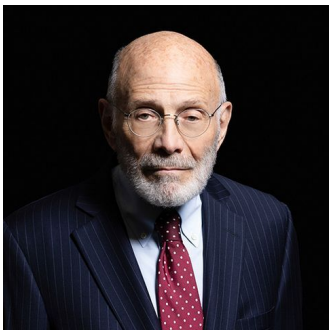

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