NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY APPELLATE PANEL

OF THE NINTH CIRCUIT

In re:	BAP No. CC-08-1046-MkKPa
SOLIDUS NETWORKS, INC., ET AL.,	Bk. No. LA 07-20027-TD
Debtors.	
WHORL, LLC,	
Appellant,	
v.	**MEMORANDUM**[*]
SOLIDUS NETWORKS, INC., ET AL.,	
Appellees.	

Argued and Submitted on September 19, 2008,
at Pasadena, California

Filed – December 24, 2008

Appeal from the United States Bankruptcy Court
for the Central District of California

Honorable Thomas B. Donovan, Bankruptcy Judge, Presiding

Before: MARKELL, KLEIN[**] and PAPPAS, Bankruptcy Judges.

[*]This disposition is not appropriate for publication. Although it may be cited for whatever persuasive value it may have (see Fed. R. App. P. 32.1), it has no precedential value. See 9th Cir. BAP Rule 8013-1.

[**]Hon. Christopher M. Klein, Chief Bankruptcy Judge for the Eastern District of California, sitting by designation.

SUMMARY

This appeal involves collective postpetition financing for related debtors in cases that are jointly administered but not substantively consolidated. The bankruptcy court authorized a postpetition loan of $13.5 million to debtor Solidus Networks, Inc. ("Solidus"), to be guaranteed and collateralized by Solidus's subsidiaries. These subsidiaries were also debtors in cases, and those cases were jointly administered with Solidus's case.

As a condition of making the loan, the lenders received superpriority protection for their loan and guaranties under § 364(c) of the Bankruptcy Code and cross-collateralization of their security among the various debtors.

The appellant, Whorl LLC, has an interest in and is owed money by only one of the subsidiaries, Pay By Touch Checking Resources, Inc. ("Pay By Touch"). It contends that Pay by Touch needed just $25,000 in financing, which it could have obtained on an unsecured basis. Whorl argues that the bankruptcy court erred in treating Solidus and its subsidiaries collectively, which effectively saddled Pay By Touch with the whole $13.5 million in postpetition debt. Whorl claims this cross-collateralization and imposition of priority severely harmed it.

Before we review the merits, however, the lenders have moved to dismiss the appeal under § 364(e) of the Code, which protects lenders who in good faith lend to debtors in possession. In response, Whorl argues that the postpetition lenders were not acting in good faith in making their loan and therefore should not receive § 364(e)'s protection.

The bankruptcy court heard testimony that Solidus and its subsidiaries were all in the same boat, and they would all float or sink together. The court explicitly found this testimony credible. Given this record, Whorl has made no showing that the bankruptcy court's findings – including the finding that the lenders were acting in good faith – were clearly erroneous, which is the standard of review that we must apply to a bankruptcy court's finding of fact on the existence of good faith.

In the face of this required deference to the bankruptcy court's findings, Whorl's argument, then, is that as a matter of law the Bankruptcy Code requires a bankruptcy court to take a debtor-by-debtor approach to postpetition financing for a group of related enterprises in jointly administered cases. We reject this position. The bankruptcy court acted within its authority and judgment in making all of the debtors jointly and severally liable for the entire $13.5 million debt. The bankruptcy court's factual findings were thus relevant to its good-faith determination, and that determination must stand.

Since this appeal does not admit of relief other than invalidating the debt and the concomitant lien, it is statutorily moot by virtue of § 364(e) and is therefore DISMISSED.

FACTS

On October 31, 2007, an involuntary chapter 11 petition was filed against Solidus in the United States Bankruptcy Court for the Central District of California. Solidus consented to the chapter 11 petition on December 14, 2007, and it filed further voluntary petitions for ten of its subsidiaries (collectively

with Solidus, "Debtors"), including Pay By Touch).[3] The bankruptcy court authorized joint administration, but not substantive consolidation, of the cases.

When they entered bankruptcy, the Debtors owed $159 million in secured financing to a group of lenders, including $109 million of first lien debt and $50 million of second lien debt. The first lien notes were secured by (1) a first priority security interest in and lien upon most of the assets of Solidus and its subsidiaries, (2) the stock of most of Solidus's subsidiaries, and (3) security interests in and second priority liens in other collateral. To the extent that a debtor was not directly liable on a loan, that debtor guaranteed the loan, thereby becoming contingently liable on that loan. The major negotiated exception to this structure was that Pay By Touch was not directly liable on and did not guarantee the loan.[4] The second lien notes were secured by second priority liens and security interests in other collateral.

At the time of the bankruptcy filing, the Debtors had no cash and were six weeks behind in payroll. The bankruptcy court held three hearings to consider the financial condition of

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[3]The motion to dismiss misstates the petition date as December 13, 2007. According to the docket, the petitions were filed on December 14, 2007. Other subsidiaries that filed for bankruptcy include: Pay By Touch Payment Solutions, LLC; Pay By Touch Processing, Inc.; Pay By Touch Check Cashing, Inc.; Check Elect, Inc.; Seven Acquisition Sub, LLC; Indivos Corporation; CardSystems Payment Solutions, LLC; Maverick International Services, Inc.; and ATMD Acquisition Corporation.

[4]Another affiliate, ATMD Acquisition Corporation, also did not guarantee the debt, but its involvement is irrelevant here.

Solidus and its subsidiaries and found that without an immediate infusion of cash, "the ball game [was] over."

Whorl LLC, the appellant in this case, was one of Solidus's largest prepetition creditors. Solidus owed Whorl more than $67 million as the result of an unsuccessful patent-infringement action by Solidus against Whorl, which was settled in December 2005. In the settlement, Whorl agreed to sell its biometric-transaction-payments business, including intellectual property, patents, and software, to Solidus in exchange for Solidus's promise to make payments over time.

Under the settlement agreement, Whorl's intellectual property was assigned to one of Solidus's subsidiaries, Pay By Touch, which was set up for that purpose. Solidus's debt to Whorl was then secured by a first priority lien on all of Solidus's equity securities of the new Pay By Touch subsidiary under a Pledge Agreement executed by the parties in January 2006 ("Pledge Agreement").[5] Under the Pledge Agreement, Solidus also agreed that it would not permit Pay By Touch to "contract, create, incur, assume or suffer or permit to exist any indebtedness of [Pay By Touch]."[6] As Pay By Touch was not liable on the lenders' prepetition loan, either directly or by guaranty, this arrangement effectively gave Whorl first claim on the value of Solidus's equity interest in Pay By Touch through

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[5]This lien, however, may be in dispute. In re Solidus Networks, Inc., Schedule D1- Creditors Holding Secured Claims, Summary of Schedules (Docket #313, Feb. 12, 2008); Appellee's Motion to Dismiss Appeal at 6 n.5.

[6]Pay By Touch is referred to as "IP Sub" in the Pledge Agreement.

its first lien on the stock of Pay By Touch and through Solidus's promise not to cause Pay By Touch to incur further debt.

Because of the Debtors' precarious financial condition when they filed bankruptcy, potential postpetition lenders were extremely reluctant to extend the credit that the Debtors desperately needed. Ultimately, the postpetition lenders lent $13.5 million to Solidus, but only on condition that their loan receive superpriority status, which the bankruptcy court approved. Citing credible evidence, the bankruptcy court found that the interests of all the Debtors and their creditors were best served by arranging the postpetition financing, which in the long run would increase the value of the Debtors' estates.

The financing agreement also required that all of Solidus's subsidiaries, including Pay By Touch, guarantee the $13.5 million postpetition loan, and that the guaranties provide that each of the companies was jointly and severally liable on their guaranties for the entire debt. Pay By Touch was required to pledge its assets as part of the loan guaranty.

Whorl argues that Pay By Touch, which guaranteed the $13.5 million loan, needed only $25,000 to preserve its assets, which it could have obtained on an unsecured, nonsuperpriority basis. It contends that requiring Pay By Touch to guaranty the full $13.5 million superpriority loan was a ruse to disadvantage Whorl and deprive it of its legitimate property rights. The nub of Whorl's argument is that its carefully crafted 2005 settlement, which effectively gave it a first lien on the equity in Pay By Touch (whose assets consisted of the property Whorl transferred as part of the settlement), was intentionally undermined by

making Pay By Touch incur contingent debt through the postpetition financing that eroded the value of Pay By Touch's equity, and hence Whorl's security.

After holding three hearings on the matter, during which it heard testimony from Thomas Lumsden, the Debtors' chief restructuring officer, regarding the reasons for the financing's structuring, the bankruptcy court held that the postpetition financing had been "negotiated at arms' length and in 'good faith' as that term is used in § 364(e) of the Bankruptcy Code," and it approved the arrangements. Whorl timely appealed.

After the appeal was filed, the appellee lenders filed a motion to dismiss the appeal. They alleged that the appellant had not sought a stay pending appeal, and that under § 364(e), if the postpetition lenders acted in "good faith" in extending the postpetition financing, they were protected from any change in the terms of the loan as a result of an appellate court's decision. That is, as long as the lenders were in good faith, the terms of the financing could not be changed even if the bankruptcy court's approval of the financing was subsequently overturned on appeal. This provision of the Code recognizes the fact that postpetition lenders, already reluctant to lend money to a bankrupt company, would not extend loans at all if they were not protected from unforeseeable adverse rulings by an appellate court.

That is exactly the situation that obtained in this case, and the appellees argue that as a result, as long as the lenders were in good faith, the appeal is moot under § 364(e). We discuss that issue below.

JURISDICTION

The bankruptcy court had jurisdiction under 28 U.S.C. §§ 1334 and 157(b)(2)(B). We have jurisdiction under 28 U.S.C. § 158.

ISSUES

1. Did the bankruptcy court clearly err when it found that the lenders providing postpetition financing were acting in good faith for purposes of § 364(e)?

2. Did the bankruptcy court err in deciding that all of the Debtors were jointly and severally liable for the $13.5 million in postpetition debt?

STANDARDS OF REVIEW

We review a bankruptcy court's legal conclusions, including its interpretation of the Bankruptcy Code and state law, de novo. Roberts v. Erhard (In re Roberts), 331 B.R. 876, 880 (9th Cir. BAP 2005), aff'd 241 Fed. Appx. 420 (9th Cir. 2007).

A bankruptcy court's findings of fact are reviewed for clear error. To reverse a court's findings of fact, we must have a definite and firm conviction that the court committed a clear error of judgment in the conclusion it reached. SEC v. Coldicutt, 258 F.3d 939, 941 (9th Cir. 2001); Hansen v. Moore (In re Hansen), 368 B.R. 868, 874-75 (9th Cir. BAP 2007).

DISCUSSION

The debtors obtained postpetition financing authorized by the bankruptcy court under § 364, which lists a variety of

financing arrangements designed to allow a chapter 11 debtor to obtain financing after filing bankruptcy. Burchinal v. Cent. Wash. Bank (In re Adams Apple Inc.), 829 F.2d 1484, 1488 (9th Cir. 1987). To facilitate such potentially risky financing, § 364(e) allows postpetition lenders to rely on the bankruptcy court's authorization. Id.[7] This provision prohibits modifying financing under § 364 on appeal unless the postpetition lender did not act in good faith. Whorl, the appellant, has not shown that the bankruptcy court clearly erred when it found that the postpetition lenders were acting in good faith.

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[7]Section 364(e) provides that:

> [t]he reversal or modification on appeal of an authorization under this section to obtain credit or 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.

See also Burchinal at 1489 ("An appellate court may not reverse the authorization to obtain credit or incur debts under section 364 if the authorization was not stayed pending appeal unless the lender did not act in good faith."). Because the bankruptcy court's order was not stayed pending appeal, this panel can alter the postpetition financing arrangement only if the evidence adduced in the bankruptcy court establishes that the postpetition lenders did not extend credit in good faith. But see Credit Alliance Corp. v. Dunning-Ray Ins. Agency, Inc. (In re Blumer), 66 B.R. 109, 113 (9th Cir. BAP 1986) (although the lenders satisfied the good faith requirement of 364(e), the appeal was not moot because the court's order violated the appellant's due process rights).

A. Good Faith

The Bankruptcy Code does not define "good faith." Id. at 1489. Although courts have provided various definitions and examples of good faith under § 364(e), they have not established a comprehensive test. But the essence of good faith requires a court to look "to the integrity of an actor's conduct during the proceedings." Id.

While there is little precedent regarding the "good faith" of § 364(e), there is substantial BAP precedent regarding the "good faith" of § 363(m), which is indistinguishable from § 364(e) "good faith" in procedure and meaning. In Thomas v. Namba (In re Thomas), 287 B.R. 782 (9th Cir. BAP 2002), and T.C. Investors v. Joseph (In re M Capital Corp.), 290 B.R. 743 (9th Cir. BAP 2003), this panel emphasized that deciding whether or not there was good faith is the job of the bankruptcy court and that the proponent of good faith bears the burden of proof. The BAP's role, in turn, is to review the determination of the bankruptcy court on a clearly erroneous basis. We adopt that approach here.

Courts making this inquiry often find and report on conduct that negates good faith rather than supports or establishes it. In particular, courts have found good faith lacking if there is: (1) "'fraud, collusion . . . , or an attempt to take grossly unfair advantage of other[s],'" Id. (quoting Cmty. Thrift & Loan v. Suchy (In re Suchy), 786 F.2d 900, 902 (9th Cir. 1985)); see also Paulman v. Gateway Partners III (In re Filtercorp, Inc.), 163 F.3d 570, 577 (9th Cir. 1998); (2) "act[ing] for an improper purpose," Burchinal, 829 F.2d at 1489 (citing Matter of EDC

Holding Co., 676 F.2d 945, 948 (7th Cir. 1982)); see also Butler Paper Co. v. Graphic Arts Lithographers, Inc. (In re Graphic Arts Lithographers, Inc.), 71 B.R. 774, 776-77 (9th Cir. BAP 1987); or (3) "[k]nowledge of the illegality of a transaction. . . ." Burchinal, 829 F.2d at 1489 (citing Matter of Chicago, Milwaukee, St. Paul & Pacific R.R. Co., 799 F.2d 317, 330 (7th Cir. 1986)).

1. The Bankruptcy Court Found That the Lenders Did Not Commit Fraud, Engage in Collusion, or Attempt to Take Unfair Advantage of the Debtors or Other Creditors

The record does not establish the elements required to prove that the lenders committed fraud, see Tallant v. Kaufman (In re Tallant), 218 B.R. 58, 64 (9th Cir. BAP 1998);[8] engaged in collusion, see BLACK'S LAW DICTIONARY 240 (8th ed. 2004) and Point Pleasant Canoe Rental, Inc. v. Tinicum Twp., 110 F.R.D. 166, 169 (E.D. Pa. 1986) (using BLACK'S LAW DICTIONARY to define collusion); or took unfair advantage of Whorl or the Debtors.[9]

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[8]Tallant provides the definition of fraud under section 523(a)(2):

> (1) that the debtor made a representation; (2) the debtor knew at the time the representation was false; (3) the debtor made the representation with the intention and purpose of deceiving the creditor; (4) the creditor relied on the representation; and (5) the creditor sustained damage as the proximate result of the representation.

Though the current dispute does not involve the dischargeability of debt, we are comfortable relying on this meaning of fraud in this context.

[9]Although "unfair advantage" is a general term, its inclusion in a list of illegal acts such as "fraud" and

(continued...)

The lenders articulated their reasons for requiring Pay By Touch to guarantee the financing on the record. Indeed, Debtors' motion explicitly states that "[t]he Debtors do not seek to prime the liens held by any other creditors" besides the liens primed with the consent of Prepetition and Gap Period Lenders. (Emphasis in original.) Neither Whorl nor the evidence suggests that the representations made by the lenders were false.

Under In re Thomas and In re M Capital Corp., these findings were not clearly erroneous.

2. The Bankruptcy Court Found That the Lenders Did Not Act for an Improper Purpose

"Improper purpose" is a generic term used in diverse legal contexts.[10] Under § 364(e), a purpose is improper if it intentionally conflicts with the Bankruptcy Code. See EDC Holding Co., 676 F.2d at 948. Such an improper purpose can be an intentional illegal act, but given the discussion of illegality in the following section, the actions here presented no conflict with other Code provisions.

Under In re Thomas and In re M Capital Corp., these findings regarding improper purpose were not clearly erroneous.

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[9](...continued)
"collusion" suggests that "unfair advantage" similarly implies an advantage gained or exercised without legal justification.

[10]A brief survey of Supreme Court and Ninth Circuit opinions shows the term "improper purpose" used in cases of: veil-piercing, United States v. Bestfoods, 524 U.S. 51, 64 n.10 (1998); sanctions under Fed. R. Civ. P. 11, Clinton v. Jones, 520 U.S. 681, 709 n.42 (1997); malicious prosecution, Tucker ex rel. Tucker v. Interscope Records, Inc., 515 F.3d 1019, 1030 (9th Cir. 2008); and, equitable estoppel, O'Donnell v. Vencor, Inc., 466 F.3d 1104, 1111 (9th Cir. 2006).

3. The Bankruptcy Court Found That the Lenders Did Not Know That the Postpetition Financing Transaction May Have Been Illegal

A lender that knowingly engages in an illegal transaction does not act in good faith. See Burchinal, 829 F.2d at 1489. Yet the good faith requirement does not deny protection to lenders who can support their actions with reasonable legal arguments, even if these arguments are ultimately unsuccessful. Burchinal, 829 F.2d at 1490 (citing EDC Holding Co., 676 F.2d at 947).

For example, in Burchinal, the Ninth Circuit held that a postpetition lender did not act in bad faith when the postpetition financing required cross-collateralization of the lender's prepetition lien. Burchinal, 829 F.2d at 1490. Although cross-collateralization is not permitted in some other circuits, the Ninth Circuit had yet to rule on the issue. Id. The Ninth Circuit found that the postpetition lenders did not act in bad faith merely because other circuits had held that cross-collateralization was illegal per se. Id.

Under In re Thomas and In re M Capital Corp., the bankruptcy court's findings regarding a lack of illegality were not clearly erroneous.

B. Collective Postpetition Financing in a Jointly Administered Case Is Not Illegal or Improper Under the Bankruptcy Code

Because of the bankruptcy court's findings, which we must respect because of the factual nature of good faith, Whorl contends that the standard applied by the bankruptcy court in making its good faith determination was flawed. In particular,

it contends that collective postpetition financing arrangements such as approved here are contrary to the Code, and thus cannot be approved.

The Ninth Circuit has not addressed the issue of collective postpetition financing arrangements in jointly administered cases. Other courts that have addressed this issue approve of collective postpetition financing, even when its effect leads to substantive consolidation of the debtors' estates. See, e.g., Clyde Bergemann, Inc. v. Babcock & Wilcox Co. (In re Babcock & Wilcox), 250 F.3d 955 (5th Cir. 2001); White Rose Food v. Gen. Trading Co. (In re Clinton St. Food Corp.), 170 B.R. 216, 221-22 (S.D.N.Y. 1994) (§ 364(e) may still apply even if a postpetition financing order substantively consolidates debtors' estates). See also William H. Widen, Prevalence of Substantive Consolidation in Large Bankruptcies from 2000 to 2004: Preliminary Results, 14 Am. Bankr. Inst. L. Rev. 47, 57-58 (in the capital market, a corporate group in bankruptcy may not be independently financeable on an entity-by-entity basis).

In Babcock, a judgment creditor of a single entity appealed an order granting collective postpetition financing to that entity and other related entities in a jointly administered chapter 11 bankruptcy case. Babcock, 250 F.3d at 957-58. The Fifth Circuit rejected the appellant's argument that the financing order was improper because it substantively consolidated the debtors. Id. at 959. An affidavit by the Debtors' chief restructuring officer stated "that the [postpetition] financing agreement was critical to the continued vitality of each of the Debtors." Id. at 959 n.8. Relying on this

testimony, the court noted that each of the debtors benefitted from the financing, including the entities that did not require the working capital that it made available. Id.[11]

We find the logic of Babcock and similar cases persuasive when dealing with postpetition lending to corporate groups. Against such an adoption, Whorl's contention that the bankruptcy court adopted the incorrect standard fails.

As a result, the bankruptcy court's finding of good faith stands as being not clearly erroneous, and the motion to dismiss the appeal should be granted.

C. The Bankruptcy Court's Order Would Be Affirmed Even if the Appeal Was Not Moot

Even if the appeal was not moot under § 364(e), we would not reverse. The analysis would be the same. Given our view that the Code permits the type of financing employed here, the bankruptcy court's finding that the Debtors' fates were inextricably linked was relevant and critical, and was based on competent evidence. Such findings are entitled to a clearly erroneous standard of review, and nothing in the record suggests any error, let alone clearly erroneous error on this point. The bankruptcy court thus properly found a sufficient basis to impose joint and several liability for the entire postpetition debt.

To the extent that further review is required, the facts in this appeal are similar to those in Babcock. Here, the

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[11]In addition, the postpetition financing order did not combine the assets or liabilities of the individual entities, "the lynchpin [sic] of any substantive consolidation order." Id. at 959.

bankruptcy court relied on testimony from Thomas Lumsden, the Debtors' chief restructuring officer. Lumsden testified that the value of Pay By Touch would decrease significantly without the "continued vitality" of the other Debtors, such as Pay By Touch Check Cashing, and that financing to the other entities would benefit Pay By Touch. Thus, Pay By Touch would benefit from the postpetition financing even though, on an individual basis, it did not need the entire $13.5 million. In addition, the Final DIP Order did not consolidate the assets and liabilities of Pay By Touch and the other Debtors.

In essence, Lumsden persuaded the bankruptcy court that the Debtors were all in the same sinking boat, and though the leak may have been in only one end of the hull, their fates could not be separated, and they would all go down together.

Whorl claims that Pay By Touch did not need $13.5 million in financing on an individual basis, but required only $25,000 to sustain its operations. While this may be true, Whorl did not counter Lumsden's testimony that Pay By Touch derived indirect benefits from the solvency of the other Debtors or establish how much the value of Pay By Touch would have decreased if the other Debtors had not received the financing.

Evidence in the record supports a finding that Pay By Touch benefitted from the "continued vitality" of the other Debtors. Furthermore, the Final DIP Order did not consolidate the Debtors' assets and liabilities. As a result, the lenders can support their actions with reasonable legal arguments. Following the Ninth Circuit's holding in Burchinal, the good faith requirement

should not deny protection to the postpetition lenders in this context.

CONCLUSION

Whorl has not demonstrated that the bankruptcy court clearly erred when it concluded that the postpetition lenders were acting in good faith.

Although the Ninth Circuit has not ruled on the propriety of collective postpetition financing in jointly administered cases, the lenders have supported the Final DIP Order with convincing legal arguments. As a result, under the Ninth Circuit's decision in Burchinal, the lenders are entitled to protection under § 364(e). Because Whorl failed either (1) to establish that the postpetition lenders lacked good faith, or (2) to obtain a stay pending appeal, § 364(e) protects the lenders from a court-ordered change in the terms of the financing that they provided. The Final DIP Order authorized financing under § 364 and cannot be modified to grant Whorl relief.

Thus, the appeal is moot and is therefore DISMISSED.