

DEC 24 2008

HAROLD S. MARENUS, CLERK
U.S. BKCY. APP. PANEL
OF THE NINTH CIRCUIT

NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE NINTH CIRCUIT

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

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.

1 **SUMMARY**

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

10 As a condition of making the loan, the lenders received
11 superpriority protection for their loan and guaranties under
12 § 364(c) of the Bankruptcy Code and cross-collateralization of
13 their security among the various debtors.

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

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

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

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

18 At the time of the bankruptcy filing, the Debtors had no
19 cash and were six weeks behind in payroll. The bankruptcy court
20 held three hearings to consider the financial condition of
21

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

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

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

3 Whorl LLC, the appellant in this case, was one of Solidus's
4 largest prepetition creditors. Solidus owed Whorl more than \$67
5 million as the result of an unsuccessful patent-infringement
6 action by Solidus against Whorl, which was settled in December
7 2005. In the settlement, Whorl agreed to sell its biometric-
8 transaction-payments business, including intellectual property,
9 patents, and software, to Solidus in exchange for Solidus's
10 promise to make payments over time.

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

24
25 ⁵This lien, however, may be in dispute. In re Solidus
26 Networks, Inc., Schedule D1- Creditors Holding Secured Claims,
27 Summary of Schedules (Docket #313, Feb. 12, 2008); Appellee's
28 Motion to Dismiss Appeal at 6 n.5.

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

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

3 Because of the Debtors' precarious financial condition when
4 they filed bankruptcy, potential postpetition lenders were
5 extremely reluctant to extend the credit that the Debtors
6 desperately needed. Ultimately, the postpetition lenders lent
7 \$13.5 million to Solidus, but only on condition that their loan
8 receive superpriority status, which the bankruptcy court
9 approved. Citing credible evidence, the bankruptcy court found
10 that the interests of all the Debtors and their creditors were
11 best served by arranging the postpetition financing, which in the
12 long run would increase the value of the Debtors' estates.

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

19 Whorl argues that Pay By Touch, which guaranteed the \$13.5
20 million loan, needed only \$25,000 to preserve its assets, which
21 it could have obtained on an unsecured, nonsuperpriority basis.
22 It contends that requiring Pay By Touch to guaranty the full
23 \$13.5 million superpriority loan was a ruse to disadvantage Whorl
24 and deprive it of its legitimate property rights. The nub of
25 Whorl's argument is that its carefully crafted 2005 settlement,
26 which effectively gave it a first lien on the equity in Pay By
27 Touch (whose assets consisted of the property Whorl transferred
28 as part of the settlement), was intentionally undermined by

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

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

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

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

1 financing arrangements designed to allow a chapter 11 debtor to
2 obtain financing after filing bankruptcy. Burchinal v. Cent.
3 Wash. Bank (In re Adams Apple Inc.), 829 F.2d 1484, 1488 (9th
4 Cir. 1987). To facilitate such potentially risky financing,
5 § 364(e) allows postpetition lenders to rely on the bankruptcy
6 court's authorization. Id.⁷ This provision prohibits modifying
7 financing under § 364 on appeal unless the postpetition lender
8 did not act in good faith. Whorl, the appellant, has not shown
9 that the bankruptcy court clearly erred when it found that the
10 postpetition lenders were acting in good faith.

14 ⁷Section 364(e) provides that:

15 [t]he reversal or modification on appeal of an authorization
16 under this section to obtain credit or incur debt, or of a
17 grant under this section of a priority or a lien, does not
18 affect the validity of any debt so incurred, or any priority
19 or lien so granted, to an entity that extended such credit
20 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.

21 See also Burchinal at 1489 ("An appellate court may not reverse
22 the authorization to obtain credit or incur debts under section
23 364 if the authorization was not stayed pending appeal unless the
24 lender did not act in good faith."). Because the bankruptcy
25 court's order was not stayed pending appeal, this panel can alter
26 the postpetition financing arrangement only if the evidence
27 adduced in the bankruptcy court establishes that the postpetition
28 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).

1 A. Good Faith

2 The Bankruptcy Code does not define "good faith." Id. at
3 1489. Although courts have provided various definitions and
4 examples of good faith under § 364(e), they have not established
5 a comprehensive test. But the essence of good faith requires a
6 court to look "to the integrity of an actor's conduct during the
7 proceedings." Id.

8 While there is little precedent regarding the "good faith"
9 of § 364(e), there is substantial BAP precedent regarding the
10 "good faith" of § 363(m), which is indistinguishable from
11 § 364(e) "good faith" in procedure and meaning. In Thomas v.
12 Namba (In re Thomas), 287 B.R. 782 (9th Cir. BAP 2002), and T.C.
13 Investors v. Joseph (In re M Capital Corp.), 290 B.R. 743 (9th
14 Cir. BAP 2003), this panel emphasized that deciding whether or
15 not there was good faith is the job of the bankruptcy court and
16 that the proponent of good faith bears the burden of proof. The
17 BAP's role, in turn, is to review the determination of the
18 bankruptcy court on a clearly erroneous basis. We adopt that
19 approach here.

20 Courts making this inquiry often find and report on conduct
21 that negates good faith rather than supports or establishes it.
22 In particular, courts have found good faith lacking if there is:
23 (1) "'fraud, collusion . . . , or an attempt to take grossly
24 unfair advantage of other[s],'" Id. (quoting Cnty. Thrift & Loan
25 v. Suchy (In re Suchy), 786 F.2d 900, 902 (9th Cir. 1985)); see
26 also Paulman v. Gateway Partners III (In re Filtercorp, Inc.),
27 163 F.3d 570, 577 (9th Cir. 1998); (2) "act[ing] for an improper
28 purpose," Burchinal, 829 F.2d at 1489 (citing Matter of EDC

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

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

11 The record does not establish the elements required to prove
12 that the lenders committed fraud, see Tallant v. Kaufman (In re
13 Tallant), 218 B.R. 58, 64 (9th Cir. BAP 1998);⁸ engaged in
14 collusion, see BLACK'S LAW DICTIONARY 240 (8th ed. 2004) and
15 Point Pleasant Canoe Rental, Inc. v. Tinicum Twp., 110 F.R.D.
16 166, 169 (E.D. Pa. 1986) (using BLACK'S LAW DICTIONARY to define
17 collusion); or took unfair advantage of Whorl or the Debtors.⁹

18 _____
19 ⁸Tallant provides the definition of fraud under section
20 523(a) (2):

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

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

⁹Although "unfair advantage" is a general term, its
inclusion in a list of illegal acts such as "fraud" and
(continued...)

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

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

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

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

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

21 _____
22 ⁹(...continued)
23 "collusion" suggests that "unfair advantage" similarly implies an
24 advantage gained or exercised without legal justification.

25 ¹⁰A brief survey of Supreme Court and Ninth Circuit opinions
26 shows the term "improper purpose" used in cases of:
27 veil-piercing, United States v. Bestfoods, 524 U.S. 51, 64 n.10
28 (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).

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

4 A lender that knowingly engages in an illegal transaction
5 does not act in good faith. See Burchinal, 829 F.2d at 1489. Yet
6 the good faith requirement does not deny protection to lenders
7 who can support their actions with reasonable legal arguments,
8 even if these arguments are ultimately unsuccessful. Burchinal,
9 829 F.2d at 1490 (citing EDC Holding Co., 676 F.2d at 947).

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

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

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

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

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

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

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

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

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

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

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

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

23 To the extent that further review is required, the facts in
24 this appeal are similar to those in Babcock. Here, the
25

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

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

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

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

22 Evidence in the record supports a finding that Pay By Touch
23 benefitted from the "continued vitality" of the other Debtors.
24 Furthermore, the Final DIP Order did not consolidate the Debtors'
25 assets and liabilities. As a result, the lenders can support
26 their actions with reasonable legal arguments. Following the
27 Ninth Circuit's holding in Burchinal, the good faith requirement
28

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

3
4 **CONCLUSION**

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

8 Although the Ninth Circuit has not ruled on the propriety of
9 collective postpetition financing in jointly administered cases,
10 the lenders have supported the Final DIP Order with convincing
11 legal arguments. As a result, under the Ninth Circuit's decision
12 in Burchinal, the lenders are entitled to protection under
13 § 364(e). Because Whorl failed either (1) to establish that the
14 postpetition lenders lacked good faith, or (2) to obtain a stay
15 pending appeal, § 364(e) protects the lenders from a court-
16 ordered change in the terms of the financing that they provided.
17 The Final DIP Order authorized financing under § 364 and cannot
18 be modified to grant Whorl relief.

19 Thus, the appeal is moot and is therefore DISMISSED.
20
21
22
23
24
25
26
27
28