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NINTH CIRCUIT RULING IN BANKRUPTCY APPEAL HAS SIGNIFICANT IMPLICATIONS FOR LENDERS IN BANKRUPTCY CASES

To Our Clients and Friends:

I. Introduction

Section 364(e) of the Bankruptcy Code provides important protections to lenders that provide post-bankruptcy financing (known as "DIP Financing") to companies that are in chapter 11 bankruptcy cases (known as "Debtors"). By its plain terms, Section 364(e) provides a lender with material protections in the event that an order authorizing DIP Financing is later reversed or modified on appeal:

The 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* … unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.[1]

These protections have the practical effect of mooting appeals of orders authorizing DIP Financing where the order contained findings that the lender acted in good faith and the objecting party did not obtain a stay of the order pending appeal.

Many courts have held that Section 364(e)'s protections should be strictly limited to (a) lenders providing DIP Financing ("DIP Lenders") because Section 364 only applies to DIP Financing and (b) preserving the validity of debt incurred and priorities and liens granted by a Debtor to secure DIP Financing.[2] According to one leading decision, "[t]he questions which arise under this section are: (1) whether the creditor attempting to challenge an authorization of credit obtains a stay pending an appeal; and (2) whether the lender or group of lenders acts in good faith in extending the new credit."[3] In contrast to these other courts, on June 9, 2020, the Ninth Circuit took a more expansive view of the scope of Section 364(e) by applying that section's protections to pre-bankruptcy lenders that did not provide any DIP Financing. *See Official Committee of Unsecured Creditors of Verity Health System of California v. Verity Health System of California* ("*Verity*").[4] The Ninth Circuit applied Section 364(e) to moot an appeal seeking to revoke certain rights afforded to pre-bankruptcy lenders, even though (a) those rights were wholly unrelated to the validity of debt or any priority or lien granted to a DIP Lender, and (b) the DIP Financing had been paid in full.

II. Background

The Debtors in *Verity* owned hospitals and other healthcare facilities. On August 31, 2018, the Debtors commenced chapter 11 bankruptcy cases in the United States Bankruptcy Court for the Central District of California. To sustain their operations during the chapter 11 cases, the Debtors sought bankruptcy court approval of DIP Financing. If approved, the DIP Lender would receive a "superpriority lien" on the Debtors' assets pursuant to Section 364(d) of the Bankruptcy Code, giving the DIP Lender priority over the liens and claims held by the Debtors' pre-bankruptcy lenders (the "Pre-Bankruptcy Lenders"). The DIP Lender was not one of the Pre-Bankruptcy Lenders, and the Pre-Bankruptcy Lenders provided no DIP Financing in the chapter 11 cases.

The DIP Lender conditioned the DIP Financing on the Pre-Bankruptcy Lenders' agreement to subordinate their pre-bankruptcy liens and claims to the liens and claims that would secure the DIP Financing. The Pre-Bankruptcy Lenders conditioned that agreement upon, among other things, the bankruptcy court's approval of waivers of (a) the Debtors' right to surcharge the Pre-Bankruptcy Lenders' collateral for the costs and expenses of preserving or disposing of such collateral, and (b) the court's authority to exclude post-petition proceeds of the Debtors' assets from the Pre-Bankruptcy Lenders' collateral based on the "equities of the case," pursuant to Sections 506(c) and 552(b) of the Bankruptcy Code, respectively. The Official Committee of Unsecured Creditors appointed in the Debtors' chapter 11 cases (the "Committee") objected on the grounds that the waivers would undermine the unsecured creditors' prospect for a recovery by precluding their ability to obtain recoveries from the Pre-Bankruptcy Lenders. The bankruptcy court entered an order overruling the objection and approving the DIP Financing, and granted the waivers demanded by the Pre-Bankruptcy Lenders as necessary to induce the DIP Lender to extend DIP Financing. The bankruptcy court further held that the waivers constituted part of the "adequate protection" afforded pre-bankruptcy lenders under Bankruptcy Code Section 361, which is mandated by Section 364(d) to protect against any diminution in value of the Pre-Bankruptcy Lenders' claims as a result of the DIP Financing.[5]

The Committee appealed the bankruptcy court's order to the United States District Court for the Central District of California. Following Ninth Circuit precedent in *In re Adams Apple, Inc.*, 829 F.2d 1484 (9th Cir. 1987), the district court explained that "if the court's order 'is *within the purview* of section 364,' then the protections of § 364(e) apply."[6] The district court concluded that the waivers were "a condition that was necessary to obtain credit" and the court was "not persuaded that it can cause the modification of a necessary term in the DIP Agreement without implicating § 364(e)."[7]

Having determined that Section 364(e) applied to the appeal, the district court dismissed the appeal as moot because neither of the exceptions to Section 364(e) applied; the Committee had not obtained a stay of the bankruptcy court's order pending appeal or contended that the DIP Lender failed to act in "good faith."[8] The Committee timely appealed to the Ninth Circuit.

III. The Ninth Circuit Affirms the Dismissal of the Appeal as Statutorily Moot Pursuant to Section 364(e) of the Bankruptcy Code

On appeal, the Committee argued that Section 364(e) did not cover the waivers because the statute's plain language is limited to appeals regarding "any priority or lien … granted" to a DIP Lender. The Committee further argued that, whereas the purpose of Section 364(e) is to protect DIP Lenders in order to incentivize them to provide DIP Financing, the appeal could not adversely affect the DIP Lender because it had already been repaid in full and the Committee had stipulated that any ruling in the appeal would not affect the DIP Lender.

The Ninth Circuit affirmed the dismissal of the appeal as moot pursuant to Section 364(e). The court reasoned that, although the waivers were part of the Pre-Bankruptcy Lenders' adequate protection package that is authorized under Section 361 of the Bankruptcy Code and is "not expressly included in § 364," "the waivers are included in the Final DIP Order—a postpetition financing arrangement authorized under § 364."[9] The court also relied on Ninth Circuit precedent holding that Section 364(e) "broadly protects any requirement or obligation that was part of a post-petition creditor's agreement to finance."[10] According to the Ninth Circuit, "the waivers were 'part of a post-petition creditor's agreement to finance' and 'helped to motivate [the DIP Lender's] extension of credit'"[11] because (a) the DIP Lender conditioned the DIP Financing on the Pre-Bankruptcy Lenders' consent to subordinate their claims and liens, and (b) the Pre-Bankruptcy Lenders conditioned that required consent on receipt of the waivers at issue in the appeal.

The Ninth Circuit also rejected the Committee's argument that Section 364(e) was inapplicable because the DIP Lender had been repaid in full and the Committee stipulated that the appeal would not affect the DIP Lender. According to the Ninth Circuit, that argument "does not change the analysis" because "the [Pre-Bankruptcy Lenders] are also entitled to § 364(e)'s protections."[12]

IV. Conclusion

Verity is noteworthy because it extended Section 364(e) beyond its plain language to bar any appeal regarding waivers that were approved for the benefit of pre-bankruptcy lenders that did not provide DIP Financing. It remains to be seen whether courts will follow *Verity* and apply the protections of Section 364(e) to non-DIP Lenders or if courts will seek to distinguish *Verity* by limiting Section 364(e)'s protections to the plain language of the statute.

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[1] 11 U.S.C. § 364(e) (emphasis added).

[2] *See, e.g.*, *Kham Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1355 (7th Cir. 1990) (holding that the purpose of § 364(e) is to assure a post-petition lender that extends credit in good faith reliance upon a financing order that it is entitled to the benefit of the order regardless of whether it is later determined to be legally or factually erroneous); *Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.)*, 963 F.2d 1490, 1493, 1495 (11th Cir. 1992) (held that Section 364(e) did not moot appeal regarding cross-collateralization of pre-petition debt because, "[b]y its own terms, section

364(e) is only applicable if the challenged lien or priority was authorized under section 364(d)," and section 364(d) "appl[ies] only to future—i.e., post-petition—extensions of credit" and "do[es] not authorize the granting of liens to secure pre-petition loans"); *In re Joshua Slocum Ltd*, 922 F.2d 1081, 1085 n.1 (3rd Cir. 1990) ("Section 364(e) concerns the validity of debts and liens."); *In re Main, Inc.*, 239 B.R. 59, 72 (Bankr. E.D. Pa. 1999) (held that Section 364(e) did not moot appeal from order permitting payment of debtor's counsel because Section 364(e) "relates strictly to appeals from orders creating liens with preferential position or authorizing debt against the bankruptcy estate under 11 U.S.C. § 364(d)").

[3] *New York Life Ins. Co. v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 901 F.2d 1359, 1364 (6th Cir. 1990).

[4] Case No. 19-55997 (9th Cir. June 9, 2020). This opinion was not published and, therefore, is not considered precedential even in the Ninth Circuit, though it can be cited to other courts in the circuit. *See* Ninth Circuit Local Rule 36-3.

[5] Section 361 provides that, "[w]hen adequate protection is required under section … 364 of this title of an interest of an entity in property, such adequate protection may be provided by … (1) requiring the trustee to make a cash payment or periodic cash payments to such entity … (2) providing to such entity an additional or replacement lien … or (3) granting such other relief … as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property." 11 U.S.C. § 361. Section 364(d) provides that the bankruptcy court can approve a senior lien only if it finds that "there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted." 11 U.S.C. § 364(d).

[6] *In re Verity Health System of California, Inc.*, Case No. 2:18-cv-10675-RGK, at 6 (C.D. Cal. Aug. 2, 2019) (quoting *Adams Apple*, 829 F.2d at 1488) (emphasis added).

[7] *Id*. at 7–8.

[8] *Id*. at 7.

[9] *Verity* at 3.

[10] *Id*. at 2–3 (quoting *Weinstein, Eisen & Weiss, LLP v. Gill (In re Cooper Commons, LLC)*, 430 F.3d 1215, 1219 (9th Cir. 2005)).

[11] *Id*. at 3 (quoting *Cooper Commons*, 430 F.3d at 1219–20) (bracketed material in original).

[12] *Id*. at 4.

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