ALERTS

Seventh Circuit Bars Bad Faith Asset Buyer Protection

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"Good-faith purchasers enjoy strong protection under [Bankruptcy Code ("Code")] § 363(m)," but the silent asset buyer ("B") with "actual and constructive knowledge of a competing interest" lacks "good faith," held the U.S. Court of Appeals for the Seventh Circuit on April 4, 2022. *Archer-Daniels-Midland Co. ("ADM") v. Country Visions Cooperative*, 2022 WL 998984 (7th Cir. Apr. 4, 2022). Affirming the lower courts' denial of B's motion to enforce a "free-and-clear sale" provision in a plan confirmation order, the Seventh Circuit cited the bad faith of both the debtors and B, the asset purchaser.

Relevance and Context

Bankruptcy court-approved asset sales are common. To encourage its participation in bankruptcy sales, Code § 363(m) provides that a purchaser of a debtor's assets will be protected from reversal of the sale on appeal so long as the purchaser acted in "good faith." But the Code does not define "good faith" purchaser. *In re Gucci*, 126 F.3d 380, 390 (2d Cir. 1997). According to the traditional equitable definition, a good faith purchaser is "one who purchases the assets for value, in good faith and without notice of adverse claims." *Id.*, quoting *Willemain v. Kivitz*, 764 F.2d 1019, 1023 (4th Cir. 1985). A buyer's good faith is evidenced "by the integrity of [its] conduct during the course of the sale proceedings." *Id.* In *Gucci*, a fiercely litigious competitor of the Chapter 11 debtor bought the debtor's assets (trademark and licensing rights). The court held the buyer to be a "good faith" purchaser under Code § 363(m), explaining how the "good faith" principle applied to asset sales.

A disgruntled bidder had appealed from the bankruptcy court's order approving the sale in *Gucci*, but failed to obtain a stay pending appeal, resulting in the consummation of the sale. According to the court, the buyer's "conduct during the course of the sale proceedings" was entirely proper. Good faith could be lost, however, by "fraud, collusion between the purchaser and other bidders or the trustee, or an attempt to take grossly unfair advantage of other bidders." *Id.* The court rejected the disgruntled bidder's arguments in *Gucci* that the buyer had acted in bad faith by waging a worldwide litigation strategy against the debtor for the purpose of devaluing the debtor's trademarks as assets. The buyer's litigation and alleged harassment campaign, said the court, was not aimed at "controlling the sale price or taking unfair advantage of the bidders." *Id.*, at 391. Instead, the successful purchaser was a competitor who had adopted "an aggressive litigation strategy" before bankruptcy "to protect its own trademarks from infringement," and the litigation was a continuation of its "established business strategy." *Id.* According to the court, "aggressive protection of trademarks is the reality of the designer retail business," not "flagrant misconduct" during the sales transaction. *Id.*, at 392. See also *In re Old Cold LLC*, 819 F.3d 376 (1st Cir. 2018) (good faith purchaser must not have knowledge of adverse claims); *In re R.B.B., Inc.*, 211 F.3d 475 (9th Cir. 2000) (good faith status may be negated if "shell game" conducted); *In re Burgess*, 246 B.R. 352 (8th Cir. BAP 2000) (bad faith shown by misconduct surrounding the sale).

Facts

The debtors in the *ADM* case granted a right of first refusal (the "Right") on their land to the entity known as C. The Right had a term of 10 years that entitled C to buy the land by matching any other person's offer at a sale. The debtors started distributing their assets prior to bankruptcy but never notified C of the bankruptcy, never listed it as a creditor and never attempted to make it a party to the bankruptcy case. Nor did the debtors tell the bankruptcy court about the Right.

The bankruptcy court confirmed a chapter 11 plan in 2011. In that plan, the parcel's buyer, B, became the owner of the land "free and clear of all other interests." But "[n]o one offered [C] an opportunity to match the price that [B] paid." 2022 WL 998984, at *1.

B later tried to sell the property again in 2015 without offering it to C. C sued in state court, "demanding compensation for the violation of the

Right." *Id.* B then asked the bankruptcy court "to enforce the free-and-clear aspect of the 2011 sale by barring [C] from seeking any remedy in state court," relying on the terms of Code § 363(m). The bankruptcy court and district court rejected B's request, holding that B "had not acquired the parcel in good faith, because it knew of the Right" and "failed to alert the bankruptcy judge." *Id.*

The Seventh Circuit

The Seventh Circuit stressed the facts. First, C had "filed a copy of the Right in the local real estate records; even a cursory title search would have turned it up – indeed, did turn it up." *Id.* Not only had B obtained the title report, but it also "knew that [C] was not a party to the bankruptcy." It also knew that "about a week before the sale, counsel for [C] sensed that something was happening" and began to inquire how to protect "his client's rights." Although the bankruptcy court suspected "a form of fraud on the court," she merely denied B's motion to "stop the state litigation, which is ongoing." *Id.*

The Court of Appeals said this was a "statutory case": [i]f "ADM did not buy the parcel in 'good faith' in 2011, then it loses no matter what the Constitution has to say about the sort of notice [C] should have received." *Id.* at *2.

First, the debtors had acted in bad faith. "They knew of the Right yet they did not notify [C] about the bankruptcy." *Id.* Nor did they serve C "with process," as required by both the Code and Bankruptcy Rules. Code § 363(b)(1), (d)(f); Fed. R. Bankr. P. 2002(f). The debtors also failed to tell the bankruptcy court about C's interest in the property being sold.

The dispute in the Seventh Circuit, though, was between B and C, not against the debtors. In the end, B never "bought the parcel in good faith." *Id.* "[S]omeone who has both actual and constructive knowledge of a competing interest, yet permits the sale to proceed without seeking the judge's assurance that the competing interest-holder may be excluded from the proceedings, is not acting in good faith." *Id.* Constructive knowledge was "established by the Rights' presence in the real estate records. Actual knowledge was established by [B's] possession of a title search report showing the Right, plus the fact that B learned of [C's] inquiries." *Id.*

The bankruptcy court could have resolved any competing claims to the debtor's assets, "even to extinguish them, but only if the claimants received proper notice as litigants." *Id.* Here, the bankruptcy court had never learned of the Right in 2011 and "did not purport to extinguish it without compensation to [C]." Because B was not a good-faith purchaser, it must "defend the state litigation" brought by C. *Id.*

Comments

The *ADM* decision is sensible, based on indisputable facts. B's conduct during the course of the sale – concealment of known material facts in an attempt to impair the rights of C – was fatal.

Authored by Michael L. Cook.

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

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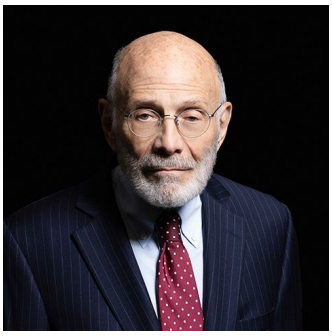

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