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Client Alert

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Recent Challenges to Credit Bidding - A New Trend?

*Two recent bankruptcy court decisions from the District of Delaware and Eastern District of Virginia raise serious concerns for secured lenders and purchasers of secured loans in the secondary market. These decisions capped the secured lender's right to "credit bid" (i.e., to bid the amount of debt owed rather than cash) in a sale process commenced by a debtor pursuant to Section 363 of the Bankruptcy Code (a "**363 Sale**"). In the most recent case, Free Lance-Star,[1] the bankruptcy court limited the secured creditor's credit bid amount to $13.9 million, approximately one third of the face amount of the claim. This decision followed on the heels of Fisker Automotive,[2] which capped the secured creditor's right to credit bid its $169 million secured claim at the $25 million purchase price paid by the secured creditor for the secured claim.*

While some view these decisions as limited to their unique facts, we disagree. Upon a closer examination, these rulings appear to break new ground from prior case law in their application of fundamental bankruptcy principles and significantly undermine the protections afforded secured creditors under the Bankruptcy Code. Therefore, purchasers of loans in the secondary market, especially those investors seeking to effect a "loan to own" strategy, and even original lenders seeking to exercise the right to credit bid in order to maximize their recovery, should be mindful of these decisions and how they may impact their rights to credit bid in 363 Sales.

Right to Credit Bid Prior to Fisker Automotive

The Bankruptcy Code in Section 363(k) provides that a holder of an allowed secured claim may credit bid its loans in a 363 Sale, unless the court for "cause" orders otherwise.[3] Prior to *Fisker Automotive*, only a small number of cases directly addressed the issue of what constitutes "cause" under Section 363(k) of the Bankruptcy Code. In those cases, "cause" was generally limited to cases where secured creditors engaged in misconduct.

For example, in *Aloha Airlines,*[4] the court denied the secured creditor the right to credit bid its loans because the secured creditor had entered into an intellectual property license with a competing airline that had sought to force the debtor out of business and had engaged in misconduct by improperly using the debtor's confidential information and destroying evidence. Similarly, in *Theroux,*[5] the court refused to approve the sale of assets to the secured creditor because the sale price was artificially set at 10% of the market value of the assets and the sale was designed to wipe out superior tax liens and to allow the secured creditor to retain for itself all of the value in excess of the credit bid amount.

Moreover, prior to *Fisker Automotive*, the price paid by a purchaser of a loan or claim was irrelevant to the amount of the creditor's claim and its rights to enforce such claim.

Finally, prior to *Fisker Automotive*, if issues were raised as to the scope or validity of a secured creditor's lien and such issues could not be resolved prior to the auction, courts would generally permit the secured creditor to credit bid up to the full amount of the secured claim with respect to the collateral, but would require the secured creditor to agree to pay cash or assume liabilities equal to the value of any unencumbered assets ultimately determined to have been included in the credit bid.

The Recent Cases Limiting Credit Bidding

Fisker Automotive

As mentioned in our previous alert on this topic,[6] the court in *Fisker Automotive* ruled that "cause" existed under Section 363(k) of the Bankruptcy Code to limit the secured creditor's right to credit bid its $169 million secured claim to the $25 million paid for such claim. Relying on a footnote in dicta from the *Philadelphia Newspapers*[7] decision that

> a court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment,

the court found that "cause" existed due to: (i) the desire to foster a competitive bidding process, and (ii) concerns

raised by the unsecured creditors committee regarding the extent and validity of the secured creditor's liens on some of the assets that were being sold.

In addition, the Bankruptcy Court was deeply concerned with the speed at which the proposed sale was proceeding and believed that the secured creditor's actions were designed to put pressure on other creditors. The Court thus determined that the rush to sell the assets was "inconsistent with the notions of fairness in the bankruptcy process."[8]

Free Lance-Star Case

Clearly influenced by *Fisker Automotive*, the bankruptcy court's decision in *Free Lance-Star* also significantly limited the secured creditor's right to credit bid. In *Free Lance-Star*, the secured creditor purchased an existing loan in the amount of $50.8 million. In January 2014, approximately seven months after the purchase of the loan, the Company and one of its affiliates (collectively, the "***Debtors***") commenced bankruptcy proceedings and filed two motions to sell their assets and establish bidding procedures for such sales. The first motion related to the sale of operating assets, which the Debtors confirmed were covered by the secured creditor's liens.[9] The second motion related to the sale of certain "***Tower Assets***" (*i.e.*, certain real property, equipment, permits, related insurance policies and other rights), which assets, the Debtors argued, were not covered by the secured creditor's liens.[10]

In March 2014, the Debtors filed a motion to limit the secured creditor's credit bid to the amount paid by the secured creditor to purchase the debt and to prevent the secured creditor from credit bidding on the Tower Assets, certain motor vehicles and other assets.[11] The Official Committee of Unsecured Creditors filed a memorandum in support of the Debtors' motion.

On April 14, 2014, the Bankruptcy Court entered an order limiting the secured creditor's right to credit bid its $38 million secured claim to $13.9 million.[12] The court concluded that

> [t]he confluence of (i) [the secured creditor's] less than fully secured lien status; (ii) [the secured creditor's] overly zealous loan to own strategy; and (iii) the negative impact of [the secured creditor's] misconduct has had on the auction process has created the perfect storm, requiring curtailment of [the secured creditor's] credit bid rights.

As evidence of the secured creditor's "inequitable conduct", the court pointed to (i) the secured creditor's request for new liens on the Tower Assets as adequate protection for the Debtors' use of cash collateral without disclosing to the court that it had already recorded financing statements against such assets prior to the bankruptcy filing which had been done without the knowledge of the Debtors and without obtaining court approval; (ii) the secured creditor's efforts to "frustrate" the competitive bidding process by asking the Debtors to add to the marketing materials that the secured creditor would be entitled to credit bid at the amount of approximately $39 million and (iii) the secured creditor's pursuit of a "loan-to-own" strategy that depressed enthusiasm for the bankruptcy sale in the marketplace.[13]

The Bankruptcy Court also held that the secured creditor did not have a valid and properly perfected lien on all the assets being sold and, therefore, the "credit bid amount must be configured to prevent [the secured creditor] from credit bidding its claim against assets such as the FCC licenses that are not within the scope of its collateral pool."[14]

Because the secured creditor did not disclose the purchase price paid for its claim, the $13.9 million credit bid cap determined by the court was based on an analysis by the Debtors' financial advisor that was focused on what cap was appropriate in order to "foster a competitive auction process".[15]

Impact of Fisker Automotive and Free Lance-Star - Breaking New Ground

Fostering Competitive Auction as Cause

The recent decisions break new ground by interpreting "cause" in Section 363(k) of the Bankruptcy Code to limit a secured creditor's credit bid right when it is determined that capping or limiting the right to credit bid will foster a sale process that is "robust", "competitive" and "open" to maximize value for creditors of the estate. In addition, both decisions focused on the purchasers' pursuit of a "loan to own" investment strategy to justify the limitation on the right to credit bid.

Historically, courts limited "cause" to clearly egregious conduct by the secured creditor and not just to the fact that credit bidding could chill bidding in the 363 Sale. Thus, in *Aloha,*[16] the court denied the right to credit bid where the secured creditor partnered with a competitor seeking to force the debtor out of business. Similarly, the court in *Theroux*[17] refused to approve a sale to a secured creditor that had colluded with a trustee to purchase the assets at a fraction of market value in order to wipe out superior liens on the property and reap all of the excess value for itself. Although one may argue that the secured creditors in *Fisker Automotive* and *Free Lance-Star* were perhaps aggressive in pursuit of their contractual remedies under the loans, it would be hard to compare such conduct to the types of conduct that would have amounted to "cause" in the cases decided prior to *Fisker Automotive*.

This broad interpretation of "cause" to include fostering a competitive auction is troubling as the existence of a credit bid always has some chilling effect on a 363 Sale. This is because potential bidders do not know the price at which the secured lender will allow the assets to be sold to another bidder and forego its right to credit bid. Courts have always been required to balance this potential chilling effect against the protections afforded secured creditors under Bankruptcy Code Section 363(k) not to be forced to accept an unacceptable price for its collateral. Courts were content to reduce the risk of chilling the bid by ensuring that bidding procedures provided for a sufficient marketing period with adequate marketing materials and a fair and level playing field.

Courts have long recognized that, as long as the ultimate value of the collateral does not exceed the secured claim, the risk of a chilled bid would be borne by the secured creditor. Unsecured creditors or equity holders would only become relevant if the market value exceeded the amount of the secured claim. In fact, in *Fisker Automotive*, despite the capping of the credit bid in order to foster a robust auction, the winning bid in the auction did not exceed the $169 million secured claim.

Focus on Valuing Lien by Looking to Unencumbered Assets and Purchase Price

The reliance by *Fisker Automotive* and *Free Lance-Star* decisions on the existence of unencumbered (or in the case of *Fisker Automotive*, the mere allegation of the existence of unencumbered) assets to justify limiting the secured creditor's credit bid rights is also a departure from the prior case law. These courts could have fashioned a remedy that would have allowed the secured creditor to credit bid, but would have also required the provision of alternate consideration to the extent it was ultimately determined that some of the assets subject to the credit bid were unencumbered. Instead, the *Fisker Automotive* and *Free Lance-Star* decisions used concerns regarding the validity, perfection and value of the liens to justify restricting credit bid rights.

Fisker Automotive's and *Free Lance-Star's* focus on the purchase price paid to acquire the secured claim is also troubling. In *Fisker Automotive*, the court used the price paid for the claim as evidence of the value of the collateral and capped the amount of the credit bid at the purchase price or $25 million, notwithstanding the asserted claim of $169 million. Similarly, the court in *Free Lance-Star* was disturbed that the secured creditor refused to divulge its purchase price for the secured claim, clearly indicating that, had it been provided with such information, it would have been used to determine the cap on the secured creditor's credit bid rights. The focus on the value of encumbered assets and on the purchase price paid to acquire the secured claim represents a clear departure from two bedrock bankruptcy principles: (i) the price paid by a purchaser of a loan or claim bears no relationship to the amount of the creditor's claim in bankruptcy or the value of its lien and (ii) the value of a secured party's lien for purposes of credit bidding should be determined by the highest and best bid at the auction whether in cash or by credit bid and not in a court hearing prior to the auction. Putting a court-determined value on a lien in order to cap the secured creditor's credit bid undermines the very protections Section 363(k) was designed to afford – that a secured party unsatisfied with the highest bid obtained during an auction could elect to acquire its collateral in exchange for its loans.

Conclusions

By (i) significantly expanding "cause" to include fostering a competitive auction process, (ii) conflating the scope and validity of the lien and the value of the lien and (iii) introducing the price paid by the secured creditor for the secured claim as a factor in determining the credit bid amount, these decisions undermine the basic protections afforded secured creditors through the right to credit bid to ensure that their collateral will not be undervalued and that a secured creditor will not be forced to accept a recovery less than the amount of its loans.

These recent decisions are problematic for secured creditors because: (i) in some cases, such as public bondholders or a large syndicate of lenders, it may not be possible for lenders to fund a cash bid for the collateral in an auction and (ii) requiring the secured creditor to cash bid could result in a significant shift in leverage to the unsecured creditors because the cash will not be disbursed to the secured creditor, but rather will remain in an escrow account pending the resolution of claims asserted by the unsecured creditors against the secured creditor's liens and claims. The longer this resolution takes, the greater the leverage to the unsecured creditors. In fact, the unsecured creditors in *Fisker Automotive* likely benefitted from such leverage in being able to negotiate a $20 million settlement from the secured creditor despite the fact that the winning bid in the auction did not exceed the $169 million secured claim.

In view of these groundbreaking cases, more than ever, secured creditors must:

- diligence the validity and perfection of their liens;
- be proactive in offering non-credit bidding consideration (*i.e.*, cash or assumption of liabilities) to the extent they are seeking to acquire unencumbered assets; and
- avoid seeking overly aggressive timetables or constraints on the debtors' ability to fully and appropriately market the assets being sold.

Such prudent measures are especially sensible in light of the current debate among lawyers, judges and scholars

whether fundamental changes should be made in the way secured creditors are permitted to effect remedies and control bankruptcy cases. Secured creditors and secondary purchasers must, therefore, be more vigilant than ever as everything from the validity of their liens to their pre-petition and post-petition conduct is more likely to be heavily scrutinized to determine whether the secured creditor was using its leverage to depress a competitive marketing and auction process.

For More Information

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1. *In re Free Lance-Star Publishing Co. of Fredericksburg, Va et al.*, Case No. 14-30315 (KRH) (Bankr. E.D. Va. Apr. 14, 2014) [Docket No. 185]. [Hereinafter, *Free Lance-Star*].
2. *In re Fisker Automotive Holdings, Inc. et al.*, Case No. 13-13087 (KG) (Bankr. D. Del. Jan. 17, 2014) [Docket No. 483]. [Hereinafter, *Fisker Automotive*].
3. *See* 11. U.S.C. § 363(k).
4. *In re Aloha Airlines, Inc.*, 2009 LEXIS 4588 (Bankr. D. Haw., May 14, 2009).
5. *In re Theroux*, 169 B.R. 498 (Bankr. D. R.I. 1994).
6. *See* "New Challenge to Credit Bidding - Distressed Debt Purchasers Beware" (February 12, 2014) http://www.chapman.com/insights-publications-254.html
7. *In re Philadelphia Newspaper, LLC*, 539 F.3d 298 (3d Cir. 2010).
8. *In re Fisker Automotive Holdings, Inc. et al.*, Case No. 13-13087 (KG) (Bankr. D. Del. Jan. 17, 2014) at 10.
9. *Free Lance-Star* [Docket No. 17].
10. *Free Lance-Star* [Docket No. 18].
11. *Free Lance-Star* [Docket No. 122].
12. *Free Lance-Star* [Docket No. 185].
13. *Free Lance-Star* [Docket No. 185 at 13].
14. *Free Lance-Star* [Docket No. 185 at 145].
15. *Free Lance-Star* [Docket No. 185 at 14].
16. *In re Aloha Airlines, Inc.*, 2009 LEXIS 4588 (Bankr. D. Haw., May 14, 2009).
17. *In re Theroux*, 169 B.R. 498 (Bankr. D. R.I. 1994).