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Emerging uncertainties relating to credit bidding in bankruptcy

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Chapter 11 bankruptcy cases are often vehicles by which debtors sell all or substantially all of their assets, either through a confirmed reorganisation plan or through a sale prior to confirmation pursuant to section 363 of the Bankruptcy Code. In the bankruptcy sale context, a secured creditor may bid the amount of its secured claim on assets constituting its collateral and to offset such amount against the purchase price. This right to 'credit bid' is recognised specifically by section 363(k) of the Bankruptcy Code and often is employed by distressed investors holding secured debt (often obtained at a discount) as a tool to acquire the assets secured by that debt (a strategy known as 'loan to own'). Absent a bona fide dispute with respect to the liens or 'cause' to do otherwise (which courts have historically found only in rare circumstances), a secured creditor's right to credit bid under section 363(k) typically extends to the full face amount of its claim, thereby giving the creditor a significant advantage in an auction of the collateral assets. Indeed, it is often argued that the right to credit bid has a chilling effect on third-party bids for the assets. Until relatively recently, certain debtors sought to avoid the perceived chilling effect

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of credit bidding by proposing asset sales under reorganisation plans and arguing that the right to credit bid did not extend to such plan sales. In RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 132 S. Ct. 2065 (2012), however, the US Supreme Court held that a secured creditor's right to credit bid exists regardless of whether a sale is conducted in connection with or prior to confirmation of a reorganisation plan, thereby resolving a split on this issue among certain courts of appeal and bolstering the positions of 'loan to own' creditors.

More recently, various courts have tempered the efficacy of 'loan to own' by finding that 'cause' existed to limit credit bidding under certain circumstances. The first of these decisions is In re Fisker Auto. Holdings, Inc., 2014 WL 210593 at *6 (Bankr. D. Del. Jan. 17, 2014), leave to app. denied, 2014 WL 546036 (D. Del. Feb. 7, 2014) and certif. denied, 2014 WL 576370 (D. Del. Feb. 12, 2014). In Fisker, the Delaware bankruptcy court capped the secured lender's right to credit bid its claim (which had a face amount of $168.5m) at $25m (the price at which the secured lender had purchased the claim from the United States Department of Energy). The debtors had filed their bankruptcy cases intending to effect a private asset sale to the secured lender for consideration that included a $75m credit bid. The official committee of unsecured creditors opposed the private sale, however, and proposed an auction. A legitimate third-party bidder was interested in the debtors' assets but would not participate in an auction absent a $25m cap on the secured lender's credit bid. In analysing 'cause', the court rejected the assertion that inequitable conduct is required, explaining that courts "may deny a lender the right to credit bid in the interest of any policy advanced by the [Bankruptcy] Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment". In deciding to cap the secured lender's credit bid, the court noted the third-party bidder's unwillingness to participate in an auction without such cap, the disputes regarding the extent of the lender's liens in the assets to be sold, and that the lender had inappropriately hurried the sale process. The third-party bidder ultimately won the auction with a bid valued at approximately $149.2m.

In In re The Free Lance-Star Publ'g Co. of Fredericksburg, VA, 2014 Bankr. LEXIS 1611 at * 26 (Bankr. E.D. Va. April 14, 2014), denying motion for expedited appeal, DSP Acquisition, LLC v. Free Lance-Star Publ'g Co. of Fredericksburg, VA, 2014 U.S. Dist. LEXIS 63274 (E.D. Va. May 7, 2014), the Virginia bankruptcy court limited the lender's credit bid to $13.9m, despite the lender's asserted right to credit bid $39m, finding that such limitation was "necessary . . . in order to foster a fair and robust sale". Notably, the court found that the lender had engaged in inequitable conduct by, among other things, recording perfection documents for property on which it did not have liens and failing to disclose such filings (as well as filing a 'false declaration' with the court). The lender had also "frustrate[d] the competitive bidding process" by pushing the debtors toward an abbreviated sale process and insisting that its credit-bid rights be highlighted in applicable marketing materials. The lender had been pursuing openly a 'loan to own' strategy under which it purchased the debt with the intent to obtain ownership of the debtors' assets. The court cautioned that 'loan to own' strategies may impair the protections that credit bidding is intended to effect: "The secured party may attempt to depress rather than to enhance market value. Credit bidding

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can be employed to chill bidding prior to or during an auction, or to keep prospective bidders from participating in the sale process."

Not all recent cases, however, have been decided against the secured lender. In In re Charles St. African Methodist Episcopal Church of Boston, 2014 WL 1922862, the Massachusetts bankruptcy court declined to limit the lender's credit bid rights, finding that the existence of a bona fide dispute with respect to a secured claim (particularly where the dispute arose from counterclaims that might offset such secured claim rather than from challenges to the merits of the secured claim itself) did not necessarily supply the requisite 'cause'. Notably, the debtor in Charles St. relied solely on the asserted bona fide dispute, expressly disavowing reliance on the Fisker case and ignoring other potentially available grounds. In addition, other courts have also continued to approve full credit bids, including the court that issued the Fisker opinion.

The decisions described above may have significant implications for secured creditors, debtors, committees and others involved in bankruptcy asset sales. Although Fisker and Free Lance-Star may signal a greater willingness by courts to find 'cause' to limit credit bidding, the extent to which they have truly changed the credit-bidding landscape remains uncertain, with the case law in this area continuing to develop. Nonetheless, Fisker and Free Lance-Star underscore that, while not lightly set aside, the right to credit bid is not absolute and a court may find 'cause' to limit that right in a variety of circumstances based upon the applicable facts. Although not necessarily dispositive, factors that may inform a court's analysis include (without limitation) the following: the control exercised by a secured creditor over a sale process and perceived abuses of such control; the existence of 'loan to own' or another strategy and the manner in which that strategy is pursued; the (im)possibility of a competitive auction absent a limitation on credit bidding (and demands that third parties might make as a condition to participating in an auction); and other attendant value-maximisation considerations. Interested parties should remain mindful of such factors as they consider bankruptcy asset sales involving credit bids. ■