LJN LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist®

An ALM Publication

Volume 32, Number 6 • April 2015

Credit Bidding: Secured Creditor Beware

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Credit bidding has historically been a valuable right afforded to secured creditors under the Bankruptcy Code and state law. It permits the secured creditor who has a perfected lien on the debtor's property to bid the amount of its allowed claim in any sale of its collateral, without paying cash for its bid. Rather, the secured creditor can set off the amount of its secured claim against the purchase price. Secured creditors may credit bid, not only in the context of a section 363 sale, but also in the context of a Chapter 11 plan. The Supreme Court in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank,* 132 S.Ct. 2065 (2012) established that when collateral is sold free and clear of a creditor's lien through a Chapter 11 plan, the secured creditor must be permitted, subject to the provisions of section 363(k), to bid on the assets using its outstanding secured debt. The right to credit bid under section 363(k) of the Bankruptcy Code can be an important safeguard that protects a secured creditor against the risk that its collateral may be undervalued at an asset sale, and courts have traditionally described a secured creditor's right to credit bid as fundamental and near absolute. However, as some bankruptcy courts have recently reminded us, the right is not absolute, and may be limited by the bankruptcy court "for cause" under section 363(k) of the Bankruptcy Code.

Historically, courts have found "cause" to limit credit bidding pursuant to section 363(k) in cases where there is a bona fide dispute as to the validity or extent of the secured creditor's lien or where the secured creditor has engaged in misconduct. Two recent bankruptcy court decisions, however, suggest a trend by the courts to limit a secured creditor's right to credit bid by broadening the application of the "for cause" standard under section 363(k), all in furtherance of certain policy considerations and bankruptcy goals. The courts focused on fostering a competitive and robust bidding environment and to ensure the success of the reorganization process. Limiting a secured creditor's right to credit bid, as was recently done by the courts in the *In re Fisker Automotive Holdings, Inc.*, 2014 WL 210593 (Bankr. D.Del. Jan. 17, 2014) and *In re Free Lance-Star Publishing,* Case No.14-30315-KRH (Bankr. E.D.Va. April 14, 2014) bankruptcy cases, may ultimately have a dramatic impact not only on the market for secured claims but also on the overall sale and reorganization process in general, as the rights of secured creditors, especially those that purchase secured debt as a loan-to-own strategy, are becoming increasingly uncertain.

Can the Amount Of the Credit Bid Be Capped For 'Cause'?

Prior to Fisker Automotive's bankruptcy filing, Hybrid Tech Holdings, Inc., a Fisker affiliate, purchased the U.S. Department of Energy's $168 million senior secured claim on Fisker's assets for $25 million. The loan was sold to Hybrid on the secondary market after an auction sale process, where Wanxiang America Corporation also bid.

Fisker filed for relief under Chapter 11 on Nov. 22, 2013 and, among other relief, immediately sought approval of a private sale of its assets to Hybrid. The sale motion sought authority to sell Fisker's assets to Hybrid for: 1) a $75 million credit bid of a portion of the loan; 2) a waiver of a portion of the debtor in possession financing to be provided by Hybrid; 3) the assumption by Hybrid of certain liabilities; and 4) certain cash payments, a portion of which (approximately $500,000) would be left behind for unsecured creditors.

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The creditors' committee objected to the sale — arguing, among others, that Hybrid's credit bid should be capped at the $25 million it paid for the claim, because Wanxiang would only participate in an auction of Fisker's assets if Hybrid's credit bid were capped.

The parties had stipulated to certain relevant facts, including: 1) "if at any auction Hybrid either would have no right to credit bid or its credit bidding were capped at $25 million, there is a strong likelihood that there would be an auction that has a material chance of creating material value for the estate over and above the present Hybrid bid"; 2) "if Hybrid's ability to credit bid is not capped, it appears to both the Debtors and the Committee that there is no realistic possibility of an auction . … "; 3) "[the] limiting of Hybrid's ability to credit bid … would likely foster and facilitate a competitive bidding environment … "; and 4) "within th[e] entirety of the assets offered for sale are: i) material assets that … consist of properly perfected Hybrid collateral; ii) material assets that are not subject to properly perfected liens in favor of Hybrid; and iii) material assets where there is a dispute as to whether Hybrid has a properly perfected lien. … "

The Bankruptcy Court for the District of Delaware rejected the secured creditor's argument that "cause" pursuant to section 363(k) required some showing of inequitable conduct on the part of the secured creditor. Rather, in a footnote, Judge Kevin Gross found that a bankruptcy court may deny a 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 to cap Hybrid's credit bid at $25 million (the amount equal to what it paid to purchase the debt in the secondary market) because, if left uncapped, bidding would not just be chilled, it would be "frozen," and there would be no auction. In his bench ruling, Judge Gross stated that "there ought to be an auction and that the only way for there to be an auction was to … place a cap on the credit bidding." Wanxiang was the successful bidder at the auction for Fisker's assets with a $149.2 million cash bid.

The court was also troubled by more traditional factors, including the hurried sale timeline that was proposed, and that the validity of Hybrid's liens on certain of the Fisker's assets was subject to dispute. The court's emphasis in its ruling was, however, clearly on the effects that Hybrid's uncapped credit bid would have on the auction process. This rationale, on its own, is not one that a court has previously used to restrict credit bidding. While the *Fisker* court stated that its decision was non-precedential, and was predicated upon a number of case-specific factual issues, it is apparent from at least one decision rendered after *Fisker* that courts may be open to adopting its rationale, at least in part, to limit a secured creditor's right to credit bid.

The Perfect Storm To Limit Credit Bidding Rights

The Bankruptcy Court for the Eastern District of Virginia, citing to the *Fisker* decision in doing so, was the next court to cap a secured creditor's ability to credit bid. In *In re Free Lance-Star Publishing*, Judge Kevin R. Huennekens found that the "perfect storm" was created to require curtailment of the secured creditor's right to credit bid. That perfect storm consisted of: 1) the secured creditor's less than fully secured lien status; 2) the secured creditor's inequitable conduct and the negative impact that conduct had on the auction process; and 3) the secured creditor's "overly zealous loan-to-own strategy."

Prior to the bankruptcy filing, DSP Acquisition acquired the secured debt of Free Lance-Star and related debtor entities as a vehicle to acquire substantially all of the debtors' assets through a quick section 363 sale. The secured creditor did not attempt to hide its loan-to-own strategy and its intent to be the successful purchaser of the debtors' assets at the bankruptcy sale.

Prior to the bankruptcy filing, however, relations between Free Lance-Star and DSP began to decline when the latter insisted that the debtors' assets not be marketed, and that the sale of the debtors' assets should be on an expedited track. Further, DSP strongly objected to the debtors' engagement of a financial adviser, and required that any marketing materials contain a conspicuous statement that DSP had a right to a $39 million credit bid, which was the full amount of the debt owed to DSP. The debtors subsequently filed bankruptcy without the support of their secured creditor.

The debtors argued that DSP's credit bidding rights should be limited: 1) due to DSP's failure to have a lien on all of the assets being sold; 2) due to the inequitable conduct by DSP that "dampened interest in the auction"; and 3) to "restore enthusiasm for the sale and foster a robust bidding process." As described above, the court relied on all three rationales in its decision to cap DSP's credit bid at approximately $13.9 million.

Of significance in this case is the court's language directed at the use of the loan-to-own-strategy by the secured creditor and its impact on the importance of fostering a competitive sale process. The court stated that:

> [t]he credit bid mechanism that normally works to protect se-

> cured creditors against the undervaluation of collateral sold at a bankruptcy sale does not always function properly when a party has bought the secured debt in a loan-to-own strategy in order to acquire the target company. In such a situation, the secured party may attempt to depress rather than to enhance market value. Credit bidding can be employed to chill bidding prior to or during an auction, or to keep prospective bidders from participating in the sales process. [The secured creditor's] motivation to own the Debtors' business rather than to have the loan repaid has interfered with the sales process. [The secured creditor] has tried to depress the sales price of the Debtors' assets, not to maximize the value of those assets. A depressed value would benefit only [the secured creditor], and it would do so at the expense of the estate's other creditors. The deployment of [the secured creditor's] loan-to-own strategy has depressed enthusiasm for the bankruptcy sale in the marketplace.

Interestingly, Judge Huennekens did not take the less controversial approach and limit the secured creditor's ability to credit bid solely based on the perfection issues with the secured creditor's liens and its inequitable conduct. Instead, as in *Fisker*, the court also focused on the need to attract a renewed interest in the bidding process and the importance of fostering a robust and competitive auction process.

Where Does Credit Bidding Go from Here?

Both *Fisker* and *Free Lance Star* have left many questions unanswered. It is unclear from these decisions what factors are sufficient to create the so-called "perfect storm" warranting the limitation of a secured creditor's right to credit bid. Would inequitable conduct of the secured creditor or the employment of a loan-to-own strategy standing alone be sufficient to limit credit bidding rights? Would the perceived inability to foster a robust and competitive auction environment or the inability of the debtor to reorganize, without more, be sufficient cause under section 363(k) to restrict or cap credit bidding rights? These decisions may be an anomaly, as Judge Gross alluded to in *Fisker*, and based primarily on the specific facts of each case. In light of *Free Lance Star*, however, it appears there may be a trend to limit credit bidding rights, perhaps as a result of the growing use of the loan-to-own strategy to acquire distressed businesses.

On Dec. 8, 2014, the America Bankruptcy Institute Commission to Study the Reform of Chapter 11 issued a 400-page report recommending numerous changes to Chapter 11 of the Code, including proposed findings and recommendations relating to credit bidding pursuant to section 363(k). The Commission considered credit bidding under section 363(k) in light of recent case law, and suggested statutory changes to section 363(k) that would arguably broaden what constitutes "cause" for limiting credit bids.

The recommended principle from the Commission, as found in the report, is stated as follows: "In a sale under section 363 of the Bankruptcy Code involving a secured creditor's collateral, the secured creditor should be permitted to credit bid up to the amount of its allowed claim relating to such collateral unless the court orders otherwise for cause. For purposes of this principle, the potential chilling effect of a credit bid alone should not constitute cause, but the court should attempt to mitigate any such chilling effect in approving the process. Section 363(k) should be clarified accordingly." While the Commission ultimately agreed to maintain the current standard under section 363(k), it clearly recommended that courts should attempt to mitigate any chilling effect of credit bidding through the auction and sale procedures approved by the courts in bankruptcy cases. Thus, the Commission has only provided guidance as to one aspect of the confusion left from the wake of the *Fisker* and *Free Lance Star* storm.

Conclusion

Without having formal reform to Chapter 11, courts may take into account the Commission's recommendation set forth above for clarification of section 363(k). However, the only real clarity we have in light of these decisions and recommendations is that: 1) courts are likely to scrutinize more closely the sale and auction process in bankruptcy cases; 2) debtors may have more leverage in negotiations with secured creditors; 3) creditors' committees are more heavily armed to seek concessions from the secured creditor in the event of a section 363 sale battle; 4) equity funds and investors who purchase secured debt as part of a loan-to-own strategy may not be successful in achieving their goals of acquiring the company; and 5) the market and pricing for selling secured debt may deteriorate due to the uncertainty in credit bidding rights.