THE
NATIONAL LAW REVIEW

Bankruptcy: To (Credit) Bid Or Not To (Credit) Bid, That Is The Question

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Basis Points

- Bankruptcy & Restructuring
- Litigation / Trial Practice

- Virginia
- Delaware
- 3rd Circuit (incl. bankruptcy)

Wednesday, August 27, 2014

If you're a secured lender, news of a **Chapter 11 filing** by your borrower can be unsettling. The commencement of a Chapter 11 case triggers an "automatic stay" which, with certain exceptions, operates as an injunction against all actions affecting the debtor or its property.[1] Under the automatic stay, a secured lender holding a security interest in the debtor's property may not repossess or foreclose on that property without the permission of the bankruptcy court.

Chapter 11 attempts to balance, however, the beneficial aspects of the automatic stay to the debtor against the corresponding enforcement delays imposed on secured lenders. One example of this is the requirement the secured lender be "adequately protected" against declines in collateral values during the pendency of, and as a result of, the Chapter 11 case. If the debtor is unable to provide adequate protection, then the secured lender is entitled to obtain relief from the automatic stay and enforce its collateral rights.[2] If the debtor is able to provide adequate protection, then the secured lender is relegated to wait for a reorganisation of the debtor or a sale of the lender's collateral. In the latter case, one of the most sacrosanct secured lender rights in a Chapter 11 proceeding will come into play—a secured lender's right to credit bid.

Credit Bidding 101

The right of a secured lender to credit bid is governed by section 363(k) of the Bankruptcy Code, which provides: "At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale."[3] A secured lender's ability to credit bid its claim arises when a Chapter 11 debtor seeks to sell the secured lender's collateral in the Chapter 11 case (a so-called "Section 363 Sale") outside of the ordinary course of business (i.e., sale of property which is not inventory), which requires court approval. Chapter 11 debtors pursue such sales to raise cash by disposing of nonessential assets, and are typically approved if the assets do not comprise a significant portion of the company's business and the terms of sale are fair. If the property is subject to security interests, it nevertheless can be sold "free and clear" of the security interests if the secured lender consents, or other statutory criteria are met. In such a case, the security interests are usually transferred to the proceeds of the sale.[4] Section 363(k) protects a secured lender whether the property is being sold on its own, or as part of a Chapter 11 plan.[5]

Extra Extra, Read All About It!

Credit bidding has been all over the bankruptcy news during the past two years. In 2012, the United States Supreme Court in RadLAX Gateway Hotel, LLC v. Amalgamated Bank[6] issued a unanimous (8-0) decision holding that the debtors may not obtain confirmation of a Chapter 11 plan that provides for the sale of a secured lender's collateral free and clear of the secured lender's lien, but does not permit the secured lender to credit bid at the sale. In so doing, the US legal system's highest court offered comfort to secured lenders around the world that they must be permitted to credit bid if their collateral is sold pursuant to a Chapter 11 plan.

Fast forward to January of this year, when the United

States Bankruptcy Court for the District of Delaware issued a decision in In re Fisker Automotive Holdings, Inc.[7] that turned on the language of section 363(k) of the Bankruptcy Code that a court may abrogate a lender's right to credit bid "for cause."[8] What constitutes cause is not defined in the Bankruptcy Code, and is thus left for courts to determine on a case-by-case basis. In Fisker, the court held that a secured lender with a partially disputed claim would only be allowed to credit bid its claim in an amount equal to the purchase price it had paid. The court's ruling, which was upheld on appeal, was premised on the notion that limiting the secured lender's credit bid to the amount the creditor paid for the claim would lead to an active auction, which was in the best interest of the debtor's estate, and exemplified the "cause" necessary pursuant to section 363(k) of the Bankruptcy Code for the court to limit the creditor's right to credit bid its claim.

Pre-Fisker, prevailing case law indicated that a credit bidder may bid up to the face amount of its secured claim—regardless of the actual value of the collateral securing the debt. As an example, the United States Court of Appeals for the Third Circuit stated that "it is well settled among district and bankruptcy courts that creditors can bid the full face value of their secured claims under [Section] 363(k) … In fact, logic demands that [Section] 363(k) be interpreted in this way; interpreting it to cap credit bids at the economic value of the underlying collateral is theoretically

nonsensical."[9] Post-Fisker, the amount of the credit bid is in question. For example, in May of this year the United States Bankruptcy Court for the Eastern District of Virginia, Richmond Division, issued a decision in In re Free Lance-Star Pub. Co. of Fredericksburg, VA[10] capping the amount of the credit bid at the price paid for the claim, relying on principles of fairness. In the words of Free Lance-Star:

The credit bid mechanism that normally works to protect secured lenders 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 lender]'s motivation to own the Debtors' business rather than to have the Loan repaid has interfered with the sales process. [The secured lender] 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 lender], and it would do so at the expense of the estate's other creditors. The deployment of [the secured lender]'s loan- to-own strategy has depressed enthusiasm for the bankruptcy sale in the marketplace.[11]

In both Fisker and Free Lance-Star, the secured lender was engaged in a loan-to-own strategy and was found to have participated in inequitable conduct. It remains to be seen if other courts will stretch these decisions to further limit credit bidding. So far, despite these rulings credit bidding seems to be alive and well in many US Chapter 11 proceedings. As one example, in the TMT Chapter 11 cases the debtors recently completed Section 363 Sales of all of the vessels implicated in the Chapter 11 proceedings. In many instances, the secured lenders on the vessels credit bid the full amount of the purchase price to protect the value of their collateral. As another example, in the Optim Energy Chapter 11 cases the debtors recently completed a Section 363 Sale of one of their power plants. Following a public auction, the debtors received an offer for the plant that caused the secured lender not to credit bid for the asset.

Wait a Second, If I Credit Bid What Happens to the Rest of My Claim?

As mentioned, credit bidding kicks in where the collateral pledged to the secured lender is being sold for less than the amount of such lender's secured claim. The idea is the secured lender gets the benefit of its bargain by being able to set off its secured claim against the current value of the collateral in a Section 363 Sale. But what if the value is woefully below the amount of the debt set off? What happens to the excess claim? The answer lies in section 506(a) of the Bankruptcy Code.

If a creditor's claim is secured by a lien on the debtor's property, it is a secured claim to the extent of the value of the collateral. If the value of a secured lender's collateral is set pursuant to a Section 363 Sale, and the value of the collateral is less than the debt, then the balance of the debt will be separately treated as an unsecured claim.[12] That unsecured claim may ultimately prove to be valuable to the undersecured creditor in the debtor's Chapter 11 case, depending on its size, as a

means of exerting leverage in a Chapter 11 plan and the debtor's reorganisation efforts.

Ok, Now I Get It, But Should I Do It?

Credit bidding is a business decision, not to be taken lightly, and unfortunately the authors cannot offer carte blanche investment advice. A credit bid enables a secured lender to utilise its secured claim as a means to obtain title to the asset and wait for the value of the property to increase. But, the value of the property may never increase or, worse yet, decline in value, leaving the secured lender potentially disappointed when it could have received cash from a willing third-party purchaser. A secured lender should evaluate its options carefully before credit bidding, and ultimately only time will tell if the decision to credit bid is the right one.

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[1] See 11 U.S.C. § 362(a).

[2] See 11 U.S.C. § 362(d)(1).

[3] 11 U.S.C. § 363(k).

[4] See 11 U.S.C. § 363(f).

[5] See 11 U.S.C. § 1129(b)(2)(A)(ii) (expressly contemplating a sale of assets under section 363(k) under a Chapter 11 plan).

6 132 S. Ct. 2065, 182 L. Ed. 2d 967 (2012).

[7] Case No. 13-13087 (Bankr. D. Del. Jan. 17, 2014) [Docket No. 483].

[8] See 11 U.S.C. § 363(k).

[9] Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Systems Corporation), 432 F.3d 448, 459-60 (3d Cir. 2006)

[10] Case No. 14-30315 (Bankr. E.D. Va. Apr. 14, 2014) [Docket No. 185].

[11] Id. at 13.

[12] See 11 U.S.C. § 506(a).