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CREDIT BIDDING CHALLENGES IN BANKRUPTCY

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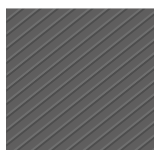

FW moderates a discussion on credit bidding challenges in bankruptcy between Nancy A. Peterman, a shareholder at Greenberg Traurig, LLP, Sarah R. Borders, a partner at King & Spalding, and Van Durrer, a partner at Skadden, Arps, Slate, Meagher & Flom LLP.

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FW: Could you outline some of the key trends and developments in credit bidding over the last 12 - 18 months? How prevalent has this practice been in recent bankruptcy cases?

Peterman: Credit bidding has been a prevalent practice in bankruptcy cases over the past several years. Typically, a distressed investor determines the fulcrum security in a company's capital structure, acquires a controlling interest in that fulcrum security and then implements a 'loan to own' strategy that results in a Section 363 sale with the distressed investor credit bidding its debt and acquiring the assets of the company. Over the past 12 to 18 months, a few courts have restricted a lender's right to credit bid for cause under Section 363(k). The lenders, whose credit bid rights have been restricted, generally have purchased the debt for purposes of executing a loan to own strategy. Courts have restricted their credit bid rights not because of the loan to own strategy, but due to aggressive sale timelines, other aggressive actions taken by those lenders and other unique circumstances in the cases.

Borders: After the Supreme Court's favorable opinion in the *RadLAX* case – which affirmed a secured lender's right to credit bid in the context of a sale pursuant to a Chapter 11 plan –recent case law has been, from a secured creditor's perspective, mostly negative, especially for distressed investors employing an aggressive 'loan-to-own' strategy. In two recent decisions – one issued by the Bankruptcy Court for the Eastern District of Virginia in *In re Free Lance-Star Publishing* and another issued by the Delaware Bankruptcy Court in *In re Fisker Automotive Holdings* – the courts severely restricted credit bidding. Those decisions, however, were very fact specific and do not appear to have slowed the use of credit bidding. Credit bidding continues to be a valuable tool for secured creditors in either taking ownership of its collateral in bankruptcy or serving as a stalking horse in a sale process to create a favourable sale outcome.

Durrer: Candidly, we have participated in an equal number of transactions where the secured creditor utilised a credit bid and where the secured creditor did not credit bid. In situations where a credit bid was utilised, we did not witness any particular controversy raised by the target or other creditors regarding the propriety of the credit bid.

FW: What are the benefits and drawbacks of credit bidding?

Borders: In terms of benefits, because bankruptcy sales generally occur on an expedited basis, the number of parties who have the ability to diligence and purchase the assets in a short timeframe can be limited. Credit bidding increases the pool of bidders by providing an efficient means of encouraging lenders who are familiar with the assets to participate in the bidding process. It also provides the secured creditor with a defensive mechanism against a process which might result in its collateral being sold for a low value. Finally, credit bidding reduces costs by allowing the secured creditor to use its claim against the debtor as consideration for the sale in lieu of cash and avoiding the time and expense of obtaining a loan to finance the purchase. In terms of drawbacks, there is a possibility that cash bidders will decide not to participate in the sale if the secured creditor is permitted to credit bid thus 'chilling' the bidding and driving down the potential for creditor recovery. In addition, because a secured creditor can only credit bid valid claims secured by its collateral, credit bidding can increase the likelihood for aggressive challenges to the secured creditor's claims and liens in the hope of knocking out a credit bid.

Durrer: Benefits and drawbacks are in the eye of the beholder. From the perspective of the target, credit bidding can facilitate the negotiation of a stalking horse bid, as the existing secured creditor is an

obvious candidate for purchaser. On the other hand, commentators have noted that a credit bid as stalking horse may tend to discourage other bidders because, in a distressed situation, the amount of the debt available to be credit bid may dwarf the value of the assets to be sold. From the perspective of the secured creditor, in the case of a syndicate or group of lenders, credit documents sometimes lack precise details as to the mechanics of the manner of credit bidding itself as well as the mechanics of taking title to the assets. This lack of detail may create tension among the members of the lender group.

Peterman: From a distressed buyer's perspective, credit bidding provides control of the process. If a distressed investor has guessed right and acquired a controlling interest in the fulcrum security in a debtor's capital structure, the distressed investor should have the ability to bid more for the assets than any other buyer -- since they would have purchased the debt/fulcrum security at a discount and the value of the company should not exceed the face amount of the debt. In addition, this distressed investor typically acts as the debtor's lender and can further control the timing of any sale process through the debtor in possession financing order. For other creditors and the debtor, the drawbacks of credit bidding include potentially discouraging other competing bidders from bidding on the assets and the risk of administrative insolvency given that such a sale typically does not result in any cash at closing.

FW: In what ways do time sensitivities shape the credit bidding process?

Durrer: The existence of a liquidity crisis at the target, and hence, a timing sensitivity, may limit entrants to the bidding process due to the lack of a meaningful opportunity for diligence. Inasmuch as the secured creditor already has an existing investment, albeit a debt investment, in the target, the exigencies render the secured creditor the most logical and expeditious buyer.

Peterman: Generally, a bankruptcy court attempts to ensure a fair sale process, allowing the debtor sufficient time to market the assets for sale and solicit competing bids. If, for example, a debtor is being pushed to complete a sale process in 30 days or less, has not marketed the assets pre-bankruptcy and has a third party ready to credit bid who is not willing to compromise on this timing, the court may push the distressed investor to extend the sale timeline or otherwise alter the process. The distressed investor may want to push a fast process because they are funding the company through the sale process or because they know, based on the face amount of the debt, practically no other party will outbid them. Notwithstanding all of these considerations, the process is important. And, ultimately, the sale process must be fair, with sufficient time to solicit competing bids, if any.

Borders: Timing is an important – and delicate – issue when it comes to credit bidding. The Section 363 sale process is attractive because of its speed and efficiency. Due to costs and adverse operational effects, companies often seek to minimize the amount of time in bankruptcy. That said, it is important not to rush a sale. Courts overseeing Section 363 sales want to know that the business has been sufficiently marketed through an open and thorough sale process. Courts will not look kindly on a secured creditor that rushes the process for its own benefit. *In Fisker*, for example, the court cited the secured creditor's efforts to expedite inappropriately the sale process as grounds, among other things, for limiting the credit bid.

FW: What challenges and criticisms has the practice of credit bidding faced?

Peterman: The main criticism is that credit bidding chills the bidding process. If the asset value does not exceed

the face amount of the secured debt, the credit bidder should be able to outbid any competing bidder who must pay with cash given that the credit bidder can chose to overpay for the assets by bidding more of the debt. For a distressed investor who has bought the debt at a discount, they have even more buying power since, for example, every dollar of credit bid may have only cost them 20 cents. Because of this dynamic, competing bidders are often reluctant to get involved in a sale process and spend the time and money doing due diligence and putting together a competing bid. This dynamic was at play in the Fisker Automotive case. Courts and creditors typically raise objections to the process in an effort to level the playing field.

Borders: A credit bid may face challenges from the debtor, other creditors or competing purchasers. Parties challenging a credit bid almost always argue that the credit bid will 'chill' bidding. Other potential buyers will be reluctant to participate, so the argument goes, because the secured creditor is not bidding with cash – the competition for the business is not fair because the secured creditor is playing with 'funny money'. The assumptions underlying this argument are questionable. Among other things, bidders are not deterred simply because another party has the ability to outbid them. An ability to outbid the competition does not translate to a willingness to do so. At the right value, most undersecured creditors would happily take the sale proceeds in lieu of the collateral. Nonetheless, this argument is ubiquitous. And some courts have held that the need to foster a competitive bidding process is sufficient justification to limit credit bidding.

Durrer: Some have sought to limit credit bids because of a perceived chilling of other bids. The notion is that by requiring all bidders to submit cash-only bids, the playing field will be more level as between bidders. In addition, credit documents may simply be silent as to the logistics of the execution of the bid and acquisition of the underlying collateral. This creates challenges with respect to making and consummating a credit bid.

FW: Could you explain the impact that recent rulings will have on the risk analysis of secured creditors for credit bidding going forward?

Durrer: We are already seeing secured creditors showing greater than normal risk adversity in connection with credit bidding. In addition, we are seeing secured creditors take steps to clarify all aspects of credit bidding during the early phases of originating new credits.

Borders: In most cases, the recent rulings should not have a significant impact on the risk analysis because the holdings in *Fisker* and *Free Lance-Star Publishing* were very fact specific. If a secured creditor's pre-petition behaviour is above board and it has perfected liens on all of the debtor's assets, the legal landscape is, for the most part, unchanged and the risk analysis remains the same. However, if the creditor's liens are suspect or if the creditor engaged in questionable pre-petition conduct, there is a substantial risk that its credit bidding rights will be limited. If nothing else, the recent decisions should lead distressed investors to be more cautious and thorough when diligencing potential loan acquisitions. Buying debt with a view towards a 'loan-to-own' strategy simply will not work if there are material lien defects.

Peterman: The recent cases do not evidence any trend to generally prohibit or restrict credit bidding and should not materially alter a secured creditors' risk analysis for credit bidding. The recent cases involved very unique sets of facts that drove the courts' decisions. Based on those facts, the courts limited credit bid rights 'for cause', which has always been allowed by Section 363(k) of the Bankruptcy Code. The main additional risk for a secured lender is how unsecured creditors, who are out

of the money, can use these recent decisions to leverage a better recovery or better 'tip' in the case than they would otherwise be able to achieve. Creditors have always looked at ways to attack a credit bid to attempt to leverage a recovery. Now, creditors actually have some cases that help define what constitutes 'cause' to limit a credit bid right.

FW: To what extent are secured creditors willing to be more accommodating with their bids, and actually compromise with other creditors to help reach a speedier conclusion?

Borders: A secured creditor with rock solid first-priority liens that has always dealt at arm's-length with the debtor is unlikely to compromise by foregoing a right to credit bid. Even if the issue is litigated and the creditor loses, it can bid cash at the auction with the confidence that the proceeds will be 'round-tripped' back to it. Remember, a secured creditor is not barred from bidding in cash at the auction simply because its credit bid is prohibited. On the other hand, if there are factual uncertainties with respect to the perfection or extent and validity of the secured creditor's claims or liens, the secured creditor may be willing to limit its credit bid or carve out a portion of cash for distribution to the debtor's unsecured creditors.

Peterman: Generally, a secured creditor exercising credit bid rights understands that part of the transaction cost is the 'tip' to the unsecured creditors, who are out of the money, in order to ensure a smooth transaction. Absent a 'tip', the unsecured creditors will likely engage in a litigation strategy, which costs money and potentially delays the sale process. In most cases, a secured lender will be asked to fund a wind-down budget post-sale and leave some other assets for creditors, whether litigation claims or otherwise – they 'pay the rent' to use the bankruptcy court to effectuate a change of ownership. Gaining the support of most parties to ensure a smooth sale process before the court is important, especially if the sale process is aggressive. Recent cases highlight the importance of attempting to gain the support of all parties and attempting to address the court's concerns.

Durrer: We have not witnessed secured creditors showing much flexibility with respect to credit bidding in general. This should be distinguished from situations where secured creditors recognise that certain obligations of a target – for example, wages of the target's employees or assumption of liabilities of key vendors – must be satisfied in connection with, or parallel to, a credit bid in order to ensure the success of the transaction.

FW: In light of the points discussed, what general advice can you offer to creditors that undertake credit bidding in bankruptcy scenarios?

Peterman: First, develop a fair process. If you push the process too fast and do not accommodate reasonable requests for a fair sale process, a court will be less likely to approve the process and more likely to look closely at challenges to a credit bid. Second, know your collateral package. You can only credit bid for those assets against which you hold a lien. If you don't hold a valid lien against an asset, you will have to pay cash. Third, engage in discussions with the constituents. It is always best to attempt to reach a deal and not simply launch a process that will lead to litigation and encourage creditors to attack your credit bid rights in an effort to leverage a recovery. Finally, don't overplay your hand. If, as the credit bidder, no one will outbid you, develop a fast, but fair process to avoid any challenges that could weaken your position.

Durrer: The best advice in these situations is to inform oneself well in the context and dynamics of the transaction. Following sufficient diligence, areas of concern will become more transparent, and the secured creditor

can address them directly. Although a credit bid may be legally permissible, it may be functionally unavailable for certain aspects of a transaction. Sensitivity to those aspects will enable a secured creditor to tailor its bid to the target in a manner that maximises the opportunity for credit bidding.

Borders: First, confirm the validity and priority of your liens well in advance of a possible restructuring. Similarly, a potential loan purchaser must thoroughly diligence the loan documents and public filings prior to buying distressed debt. Once the bankruptcy is filed, if there is a potential defect in the creditor's liens, other parties will seek to limit credit bidding. Second, secured creditors should avoid the appearance of rushing or otherwise limiting the sale process. Courts want to ensure that any sale is the result of a thorough and open marketing process. Finally, be prepared to bid with cash. secured creditors should recognise that there is always a chance that its credit bid right will be limited. ■