

# A Practical Approach to Credit Bidding in Bankruptcy

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Despite numerous well-publicized challenges and apparent erosions to the rights of secured parties to credit bid their first-position debt in sales conducted under Section 363 of the Bankruptcy Code, when a practical approach is used by parties seeking to sell assets in Bankruptcy, Section 363(k) should still grant secured parties the right to use their debt to protect their interests in collateral by credit bidding.

## Authority Guiding Credit Bid Rights

1. Section 363(k) provides the path for secured creditors to credit bid by stating that “[a]t 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, and if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.
  - a. The language “subject to a lien” is determinative and extremely important. An area where Courts and other parties can successfully minimize the use of credit bid rights by a secured creditor is where the secured creditor’s interest in collateral of the debtor is limited. Said differently, a creditor must have an interest (generally a senior interest) in the property being sold in order for its 363(k) credit bid rights to be recognized. In *Beal Bank, S.S.B., v. Waters Edge Limited P’ship*, 248 B.R. 668, 679-80 (D. Mass. 2000) the court held that if a creditor has a lien on other property that is not part of the sale, then there is no right to credit bid. Where a creditor seeks to make use of credit bid rights and its interest in the property (or priority) is challenged, a cloud on the right to credit bid can form or cause limitation.
  - b. Section 363(k) requires that a creditor’s right to credit bid be related to a claim that is “allowed.” In the case of a secured creditor with a senior position in the collateral, this may seem a formality, however, where challenge is posed by the debtor (or other parties), an expected to be allowed claim can create reason for delay or require determination from the Court. Despite the requirement that a claim be allowed, where a purported first position secured creditor’s claim is being challenged, Courts have developed ways for such party(ies) to make use of Section 363(k) without issuing an order allowing or disallowing a claim. *See, e.g.,*

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*In re Octagon Roofing*, 123 B.R. 583, 588 (Bankr. N.D. Ill. 1991) (an irrevocable letter of credit provided by the secured creditor/credit bidder created an avenue for the credit bid to be in play while allowance of the claim remained an open issue).

- c. Notably, notwithstanding the requirement that a credit bid be limited to a creditor's allowed claim and that it be tied to a genuine interest in collateral, in situations where a secured creditor is the holder of a "blanket lien," such creditor usually has great flexibility to use its credit bid, regardless of any perceived value of the collateral in question. *See, e.g. Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 459-60 (3d Cir. 2006) (holding that capping credit bids of a lender holding an interest in all the assets being sold is "nonsensical" because the lender's bid becomes the value of the collateral, up to the entire amount of its claim(s)).
- d. As a final note to the mechanics of credit bidding, in 2012 the United States Supreme Court settled a Circuit Court split by holding that credit bid rights under Section 363(k) extended to sales conducted in and through a plan of reorganization under Section 1129(b)(2)(A)(ii) & (iii) of the Bankruptcy Code. *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012) (holding that the specific language of Section 1129(b)(2)(A)(ii) trumps Section 1129(b)(2)(A)(iii) and that despite any "indubitable equivalence" that may be provided in a plan for the secured creditor, the secured creditor's right to choose its remedy by credit bidding remains in force).

**2. Recently, courts have expanded "cause" to limit the credit bid rights of some secured creditors.**

- a. In two relatively recent decisions, courts have used "cause" as a reason to promote bidding at an auction under Section 363. First, in *In re Fisker Automotive Holdings, Inc.*, 510 B.R. 55 (Bankr D. Del. 2014) the Court specifically stated that "cause" is not limited to situations where the creditor has engaged in inequitable conduct, holding that the "court 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." Fearing that a lender who purchased the claim at a deep discount, would use the credit bid rights as a shield to freeze out bidder interest, the Delaware court found cause existed and limited the credit bid rights of the lender. *See id.* Second, following the Delaware court's lead in *Fisker*, the bankruptcy court from the Eastern District of Virginia limited a secured creditor's right to credit bid when it found the creditor (i) had installed an "overly-zealous loan to own strategy," including a highly aggressive sales process; (ii) had mis-filed its UCC financing statements against the debtor

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(asserting interests in assets that were not granted); and (iii) created general confusion to the process. *In re Free Lance-Star Publishing Co.*, 512 B.R. 798 (Bankr. E.D. Va. 2014). The Virginia court used “cause” stating that a “perfect storm” was caused providing an environment for “curtailment” of the secured creditor’s credit bid rights.

- b. Collusion between bidders or a bidder and the debtor/trustee can create a situation for cause to be invoked by the court and limit or eliminate credit bid rights. *In re Theroux*, 169 B.R. 498, 499 (Bankr. D.R.I. 1994) (holding that when a procedure is proposed that can only benefit the secured creditor, while inflicting damage on other parties (in this case taxing authorities), may be evidence of collusion and justify modification to credit bid rights).
- c. Legitimate disputes as to the collateral interest of a secured party can serve as cause (although it could also result in a situation to fail to satisfy Section 363(k) generally). *Morgan Stanley Dean Witter Mortgage Capital, Inc. v. Alon USA, L.P. (In re Akard Street Fuels, L.P.)*, 2001 WL 1568332 at \*3 (N.D. Tex. Dec. 4, 2001) (holding that determination of the collateral secured by the security interest would be lengthy and credit bid rights could impair the sale process).
- d. Other circumstances have resulted in Courts deciding to modify, curtail or eliminate credit bid rights. Generally, each situation presents facts that indicate that the parties were attempting efforts that raised scrutiny and gave the courts reason for pause.
- e. Each of the referenced cases represent situations where the parties (generally secured parties) seeking to use credit bid rights had legitimate issues as to whether their credit bid rights were intact or justified. Moreover, at least one post-*Fisker* and *Free Lance-Star* court expressed that modification of credit bid rights for cause should be applied very carefully stating that it required “extraordinary circumstances” to order limitations. *In re RML Development Inc.*, 2014 WL 3378578 (Bankr. W.D. Tenn. July 10, 2014) (chill effect on bids is not enough to constitute cause under Section 363).

## Practice Pointers for Practitioners Addressing Credit Bid Rights

### 1. Secured Creditors

- a. A secured creditor considering a credit bid for the collateral assets should insist on providing any debtor-in-possession financing reasonably requested and/or needed to fund the debtor’s operations while in bankruptcy. A priming lien will almost certainly serve to block any credit bid rights. Notwithstanding any leg up created for the secured lender in a

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sale process, the provided financing presumably should operate to protect the assets by providing a funded Bankruptcy process. As a condition of any DIP financing, secured parties should insist that the debtor stipulate to (i) the collateral and validity and priority of the security; (ii) the amount of the claim; and (iii) the credit bid rights of the secured party.

- b. Most secured creditors considering a loan to own opportunity will be (i) in contact with the target and (ii) on reasonably friendly terms with the Debtor. Accordingly, in advance of the bankruptcy filing, the secured party should take all steps necessary to confirm the debts owed to it and its security interests in all the assets it has as collateral. This should include an internal audit of secured positions and any remedial actions needed. Any doubt or challenge to the lien or the allowed claim will lead to scrutiny and delay.
- c. Consider whether speed of sale is really a strategic advantage. Courts appear to be viewing sales under Section 363 through a speed lens, with expedited sales incurring higher scrutiny (requiring in some cases, extraordinary explanations as to why expedited speed is necessary). If speed is needed to preserve the business of the debtor, be certain to understand what the business reasons are for the speed required as opposed to creating a sale process full of possible bidders.

## **2. Debtors**

- a. When proposing a sale process, especially with a credit bidder likely to bid or serving as a stalking horse bidder, demand a process that allows the market to be tested and confirmed. A process designed to locate and secure the highest and best economic outcome is generally proof positive that value is being driven, regardless of any interested credit bidders.
- b. Consider using credit bid rights as a carrot or consideration for a secured lender to support a Chapter 11 and Section 363 sale process.
- c. If a debtor's senior secured creditor is not providing DIP financing or is a stalking horse bidder, consider the impact of seeking to limit or prohibit credit bidding as an effort to convince a lender to provide financing.
- d. Speed and exclusivity in a sale process are understood, even for a debtor. However, a debtor must remember its duties and role. Even if the debtor prefers the credit bid, balancing the alternatives and promoting an open process designed to achieve asset maximization and no business interruption are critical.

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### 3. Committees

- a. Committees generally have concerns and approaches that overlap with the debtor (maximizing value, maintaining operations, and/or ensuring future flow of product or services). Accordingly, Committees are interested in achieving a closed sale and want to be certain to not jeopardize this result.
- b. Notwithstanding the interest in a completed sale transaction, Committees also must consider whether greater value is achieved from a high credit bid (with certain close) or robust bidding (and possibly no credit bid). This decision is often a difficult choice therefore business and legal advisors are key to this evaluation.
- c. A Committee may be in a position to use consent to the credit bid as a lever to obtain other consideration for its constituency. The recent case law on application of cause can, at least, give a secured creditor pause if it believes its credit bid (and ultimately its strategy to maximize value) could come under expensive scrutiny and possibly even challenge or curtailment. The rulings expanding “cause” are just another tool in the toolbox of any Committee professional.

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