

I N S I D E   T H E   M I N D S

# Creditors' Rights in Chapter 11 Cases

*Leading Lawyers on Representing and  
Enforcing the Rights of Creditors in  
Bankruptcy Matters*

2012 EDITION



ASPATORE

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Credit Bidding Under the  
Bankruptcy Code:  
Recent Developments, a Case  
Study, and Suggested Strategies  
for the Secured Creditor

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ASPATORE

## Introduction

While representing senior secured creditors over the past thirty years, we have seen many attempts by debtors, equity holders, and junior creditors to develop and implement creative theories to deprive secured creditors of their contractual and statutory rights. For example, under the former bankruptcy law, debtors frequently attempted to confirm a plan of reorganization that cashed out a secured creditor at the judicially determined value of its collateral, leaving the upside in the assets for the debtor's equity holders. In some cases, debtors succeeded in this effort.

Fortunately, from a secured creditor's point of view, this practice was ended with the enactment of Section 1111(b) of the Bankruptcy Code. Similarly, courts interpreting the "fair and equitable" and "new value" standards in the cramdown provisions of the Bankruptcy Code initially permitted debtors to protect their equity holders' interests in return for "sweat equity" or without a full and fair sale process, while secured creditors received less than the full amount of their claims. Again, fortunately, from a secured creditor's point of view, these decisions were overruled by appellate courts going all the way to the US Supreme Court.

Recently, debtors and equity holders have tried to eliminate secured creditors' right to credit bid. This latest attempt by debtors and equity holders to retain control at the expense of secured creditors has been partially successful. Several courts have agreed that a debtor can confirm a Chapter 11 plan of reorganization that deprives a creditor of its right to credit bid for its collateral even if the primary beneficiary is an affiliate of the debtor. These cases have allowed the transfer of value to equity holders or other third parties over the objection of a secured creditor without giving a secured creditor who is not being paid in full in cash on confirmation the opportunity to protect the potential upside in its collateral in the hope of recovering on its claim in full.

In this chapter, we will focus on the use and potential abuse of the right to credit bid for assets proposed to be sold by a debtor either under Section 363 of the Bankruptcy Code or under a plan of reorganization. In addition, against the backdrop of a case in which our firm represented a group of lenders who successfully credit bid their debt and defeated a debtor's

attempt to sell its assets to an insider for less than fair value, we will discuss some of the potential complications that arise when secured creditors seek to use their right to credit bid. These complications include:

1. The judicially imposed requirement that secured creditors who credit bid leave the estate with sufficient cash to pay administrative claims
2. The effect of a challenge to a creditor's claim on its right to credit bid
3. The ability of a junior lien holder to interfere with a senior lien holder's attempt to credit bid
4. The result if one or more creditors in a multi-creditor group do not consent to a credit bid by their agent or other representative

At the conclusion of our discussion, we will offer some practical suggestions to protect a creditor's right to credit bid both under Section 363 and a Chapter 11 plan.

### **A Debtor's Right to Sell Its Assets**

A debtor has the right to sell assets outside of the ordinary course of business in one of two ways. A debtor can sell assets with the bankruptcy court's approval under Section 363 of the Bankruptcy Code. Alternatively, a debtor can sell assets as part of a plan of reorganization under Section 1123 of the Bankruptcy Code.

In the early days of the Bankruptcy Code, there was substantial debate over whether bankruptcy courts had the authority to approve sales of a debtor's assets outside a Chapter 11 plan or whether debtors should be permitted to use Section 363(b) only to sell extraneous assets. However, due to such factors as creditors' impatience with the potentially drawn-out plan process and debtors' desire to minimize administrative costs, the bankruptcy courts eased the standards for approval of sales under Section 363. For example, the bankruptcy courts in the Southern District of New York, recognizing the frequency of sales under Section 363, adopted specific guidelines for such sales in 2006 (amended in 2009). See *In the Matter of: Adoption of Amended Guidelines for the Conduct of Asset Sales*, Administrative Order M-383 (SDNY Nov. 18, 2009), available at <http://www.nysb.uscourts.gov/orders/m383.pdf>.

The enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) accelerated the trend toward the sale of assets under Section 363 by imposing stringent time requirements on debtors with respect to the assumption or rejection of leases of commercial property and the exclusive period within which to file a plan. The effect of these changes, particularly for retail debtors with numerous locations and several landlords, was to make a quick liquidation under Section 363 the only option in many cases.

Thus, the 363 sale has become ubiquitous. Cash-strapped debtors who are forced both by liquidity concerns and the hard deadlines imposed by BAPCPA to act quickly may have no alternative but to sell their assets. This necessity, in turn, draws the attention of bargain-seeking acquirers whose goal is to pay as little for the assets as possible. A sale at a price attractive to a “bottom-fishing” buyer (who may be an affiliate of the debtor) can potentially be detrimental to a secured creditor if the secured creditor has no right to protect its upside by exercising a right to credit bid the full amount of its secured claim.

### **A Secured Creditor’s Right to Credit Bid**

Section 363(k) of the Bankruptcy Code provides that in a sale conducted under Section 363, unless the court for cause orders otherwise, a secured creditor may credit bid at an auction of its collateral up to the full face amount of its claim. Thus, a creditor may “pay” the purchase price for its collateral by cancelling indebtedness in the amount of its bid. If the secured creditor is the winning bidder, the amount of the bid is offset against the amount of the outstanding debt and, at least in theory, no exchange of money occurs. (We will discuss below how in practice a creditor can rarely avoid adding some amount of cash to its bid.)

Although traditionally credit bidding has been used defensively, some investors and secured creditors have also sought to use it as a means of acquiring a business. These acquirers have bought secured debt (at varying discounts) and then have sought to credit bid the full face amount of the debt in a 363 sale. When successful, the investor ends up with title to the assets that secured its claim for the amount it paid for the debt.

With expedited sales under Section 363 becoming commonplace, secured creditors must be diligent in protecting their right to credit bid, ensuring that they are given sufficient time to formulate a bid and preventing a debtor from using the bankruptcy process to quickly transfer its assets to an affiliate for less than fair value.

As part of this process, secured creditors must address some thorny issues on an expedited basis. These issues include:

1. Whether the secured creditor should be the stalking horse bidder
2. How much the secured creditor should credit bid
3. The form of entity to take title to the property if the bid is successful
4. Due diligence relating to the property, including investigation of regulatory, environmental and tax issues, similar to any other merger and acquisition (M&A) transaction
5. Intercreditor issues (if a syndicate of lenders or a subordinated lien holder is involved).

We addressed all of these issues when our firm represented the secured creditors in the *Hereford Biofuels* case. *In re Hereford Biofuels LP*, No. 09-30453 (Bankr. N.D. Tex. 2009).

*Case Study: Hereford Biofuels*

Hereford Biofuels LP (Hereford), the owner of a biomass-fueled ethanol project in Hereford, Texas, filed for Chapter 11 protection when the project was approximately 95 percent complete and in need of about \$30 million in additional funding. The filing was necessitated by lack of liquidity, contract disputes, and defaults under Hereford's credit facilities. Although a majority of the lenders agreed to a waiver, holdout banks refused to fund. The senior bank group had provided \$120 million in construction financing, and a junior lender provided an additional \$43 million in second lien subordinated construction financing. Hereford's parent, Panda Ethanol Inc., invested approximately \$90 million in equity.

Hereford promptly filed a motion for approval of bidding procedures and a motion for authority to sell substantially all of its assets within sixty days.

The proposed stalking horse buyer was an affiliate of Hereford that made a \$10 million cash bid subject to a dollar-for-dollar reduction for cure costs on assumed contracts—the bid was projected to net approximately \$4 million on a plant that cost more than \$250 million to build. The potential buyer also requested a \$300,000 “breakup fee” and approval of reimbursement of costs of up to \$350,000. The senior lenders, the unsecured creditors’ committee (the “committee”), and other parties-in-interest objected to the breakup fee and cost reimbursement provisions. Not surprisingly, creditors holding secured claims had no intention of allowing an affiliate of the debtor to walk away with their collateral in return for a mere fraction of their claims.

Following testimony and extensive oral argument, the Bankruptcy Court disallowed the breakup fee, allowed the expense reimbursement, and extended the final hearing date to allow potential bidders more time for due diligence. The proposed stalking horse declined to continue under the revised terms, but an unrelated third party stepped into the stalking horse role with a \$15 million cash bid under the same terms previously approved by the court.

The committee, citing Sections 363(f)(4) and (k) of the Bankruptcy Code, objected to the secured lenders’ right to credit bid, arguing that it needed more time to determine whether the secured lenders’ claims should be allowed, whether the security interests were properly perfected, and whether the lenders’ interest in the property was subject to a bona fide dispute. The committee argued that “cause” existed for the court to deny the lenders the right to credit bid. In response, the court conditioned the lenders’ right to credit bid on the committee’s agreement or the passage of the committee’s time to object to the lenders’ liens without a successful objection. Although the final bidding procedures order allowed the lenders to credit bid as long as all issues with respect to their liens were resolved, the court directed the committee and the lenders to conduct expedited discovery and denied the committee’s request to extend the challenge deadline in light of the limited cash collateral available. The court also expressed reluctance to approve a credit bid that did not leave any cash or other assets behind for administrative and unsecured claims.

The administrative agent for the lenders and the committee conducted discovery and simultaneously negotiated a settlement with the committee that provided for a credit bid that would leave enough assets behind to fund the estate. In particular, the lenders agreed to leave some cash collateral behind for administrative expenses and split litigation recoveries, including avoidance action recoveries, with the unsecured creditors. As part of the settlement, the committee agreed to drop any challenge to the lenders' claims and liens and to support the lenders' credit bid at the auction.

The lenders' \$25 million credit bid won the auction, and the sale to the lenders was approved. The stalking horse's initial bid was the only other bid. The settlement between the lenders and the committee was also approved.

### **The Controversy Relating to a Secured Creditor's Right to Credit Bid for Assets Sold under a Chapter 11 Plan**

Section 1129(b) of the Bankruptcy Code sets forth the standards for confirming a plan of reorganization over the rejecting vote of a class of secured creditors. A plan may be confirmed notwithstanding the creditors' rejection if it is "fair and equitable" as to that class, a test that can be met by including in the plan one of the following treatments set forth in Subsections (i) through (iii) of Section 1129(b)(2)(A):

- (i) The creditor gets a new interest-bearing note, secured by its existing collateral, that provides for cash payments totaling the amount of the secured claim;
- (ii) The collateral is sold, subject to the creditors' right to credit bid under Section 363(k), with the lien transferred to the proceeds of the sale; or
- (iii) The creditor otherwise receives the indubitable equivalent of its secured claim.

11 U.S.C. § 1129(b)(2)(A). Until recently, most practitioners assumed that if assets were to be sold under a plan, only Section 1129(b)(2)(A)(ii), which includes the right to credit bid, would apply. The question raised by the *Philadelphia Newspapers*, *Pacific Lumber*, and *River Road* cases discussed below is whether a secured creditor can ever be deemed to have received the

“indubitable equivalent” of its collateral—satisfying Section 1129(b)(2)(A)(iii)—in a plan that provided for the sale of the collateral without allowing a credit bid.

*The Third Circuit’s Denial of a Secured Creditor’s Right to Credit Bid: The Philadelphia Newspapers Decision*

In *In re Philadelphia Newspapers LLC*, 599 F. 3d 298 (3d Cir. 2010), although plan confirmation was not yet before it, the Third Circuit decided that it is possible for a debtor to propose to sell property pursuant to a plan without allowing credit bidding, so long as the catchall indubitable equivalent standard of Section 1129(b)(2)(A)(iii) is satisfied. The court’s reasoning was, simply, that the three examples of fair and equitable treatment set forth in 1129(b)(2)(A) are stated in the disjunctive, so satisfying any one of them suffices to support plan confirmation.

In *Philadelphia Newspapers*, the secured creditors were owed more than \$300 million. *Id.* at 301. The debtor proposed a plan of reorganization providing for the sale of the business, for far less than the secured creditors were owed, to an entity controlled by current and former management and equity holders—a sale in which the secured lenders would not be permitted to credit bid. *Id.* at 301-302. The debtor sought approval of the bidding procedures for the sale it planned to conduct. *Id.* at 302. The secured lenders cried foul, citing their inability to credit bid as a violation of Section 1129(b)(2)(A)(ii). *Id.* at 304. Without that right, the secured creditors argued, their collateral would be sold out from under them at a bargain basement price, and they would be paid the proceeds in full satisfaction of their secured claims, with the buyers reaping the upside of future appreciation of the collateral and escaping paying the creditors in full.

The debtor argued that because the plan provided for the lenders to receive the cash proceeds of the sale, as well as title to the debtor’s headquarters building, the lenders were receiving the indubitable equivalent of their claim, as required by Section 1129(b)(2)(A)(iii), and therefore the plan was fair and equitable as to them because one of the three means of providing fair and equitable treatment had been employed.

The bankruptcy court and the district court agreed with the lenders, but ultimately, in a split decision, the Third Circuit Court of Appeals held that it was possible to propose a plan that called for a sale of collateral without allowing the secured creditors to bid, so long as the indubitable equivalent of the creditors' claim was otherwise provided. *Id.* at 317-318. Judge Ambro dissented, reasoning that the three alternatives set forth in 1129(b)(2)(A) are three different methods of protecting creditors from a fire sale of their collateral, to be employed as appropriate, depending on the plan's proposed treatment of the secured creditor. *Id.* at 325. Thus, if the debtor intends to retain ownership of the collateral, secured creditors keep their liens and receive payment over time—and may elect to be treated as fully secured.

According to Judge Ambro, if the debtor intends to sell the collateral, the creditors must be allowed to bid in their debt up to the full amount of their claim. *Id.* at 338. And if the debtor intends to do something different from the first two alternatives, it must provide the creditor with the indubitable equivalent of its claim—the creditor must retain the value of its bundle of rights—which includes the right to be treated as fully secured or to credit bid its full claim in a sale. *Id.*

#### *The Fifth Circuit's Decision in Pacific Lumber*

In *In re Pacific Lumber Co.*, 584 F. 3d 229 (5th Cir. 2009), the bankruptcy court confirmed a plan of reorganization that provided for the judicial valuation of collateral and payment of cash in the amount of that valuation to the secured creditors in full satisfaction of their secured claim. *Id.* at 238-239. Under the plan as confirmed, the collateral was transferred to a newly created entity whose equity was owned by the plan proponent, which funded the cash to pay the secured creditors. *Id.* at 237.

The secured creditors argued that the transfer of their collateral was actually a sale to the new entity and that they should be allowed to credit bid. *Id.* at 239. The bankruptcy judge found that the reorganization plan constituted a “transfer” rather than a “sale” of the collateral and that payment in cash of the amount of the creditors' secured claims, which was determined by expert testimony rather than exposure to the market, was the “indubitable equivalent” of the claims.

The secured creditors appealed confirmation and requested a stay. *Id.* at 239. A stay was denied by the bankruptcy court, the district court, and the Fifth Circuit, and the plan was consummated. *Id.* By the time the appeal was heard at the Fifth Circuit (on direct certification), it was largely moot. *Id.* at 240. Despite skepticism about the sale/transfer distinction expressed by one of the panel members at oral argument, the Fifth Circuit affirmed confirmation, noting that Section 1129(b)(2)(a) of the Bankruptcy Code states three alternatives in the disjunctive and that the “indubitable equivalent” standard of Section 1129(b)(2)(a)(iii) could provide a distinct basis for satisfying the cramdown standard. *Id.* at 246. Payment of the full amount of the judicially determined value of the collateral in cash, the Fifth Circuit held, did constitute the indubitable equivalent of the secured claim. *Id.*

*The Seventh Circuit Disagrees and Confirms a Secured Creditor’s Right to Credit Bid in River Road*

In June 2011, the Seventh Circuit in *River Road* departed from the holdings of *Pacific Lumber* and *Philadelphia Newspapers*, and instead relied on Judge Ambro’s dissenting opinion in *Philadelphia Newspapers*, holding that Section 1129(b)(2)(A)(iii) cannot be the basis for selling encumbered assets free and clear of liens without providing secured creditors the right to credit bid. *In re River Road Hotel Partners LLC*, 651 F. 3d 642, 2011 WL 2547615 (7th Cir. 2011).

River Road Hotel Partners LLC and its affiliates purchased and developed two properties using loan facilities of approximately \$155 million and \$142 million. *Id.* at \*1. Each of the loan facilities was provided by a syndicate of lenders and was secured by one of the two properties. *Id.* Lacking sufficient cash or financing to finish construction on the properties, the debtors filed for Chapter 11 relief in the Bankruptcy Court for the Northern District of Illinois. *Id.* On June 4, 2010, the debtors filed their Chapter 11 plans of reorganization, which sought to sell substantially all of their assets. *Id.* at \*2. The debtors also filed motions requesting approval of bidding procedures in connection with the asset sales. *Id.* The proposed bidding procedures provided for stalking horse bidders (with offers of \$42 million and \$47.5 million, respectively) and auction processes. *Id.* The plans and proposed procedures sought to deny the debtor’s secured lenders the ability to credit bid their debt as a matter of law under Section 1129(b)(2)(A)(iii) and for

cause under Section 363(k). *Id.* In support of their position, the debtors cited the plain language of Section 1129(b)(2)(A)(iii) and the Third Circuit's decision in *Philadelphia Newspapers, Id.* at \*6.

The Bankruptcy Court denied the debtors' bid procedures motion, holding that the plans of reorganization must comply with Section 1129(b)(2)(A)(ii) and permit credit bidding, unless the debtors could show "cause" under Section 363(k). *Id.* at \*2. The debtors appealed directly to the Seventh Circuit Court of Appeals.

On June 28, 2011, the Seventh Circuit affirmed the Bankruptcy Court's decision and held that a secured creditor has a statutory right to credit bid its debt, whether the sale is proposed under Section 363 or under a non-consensual plan of reorganization pursuant to Section 1129(b)(2)(A) of the Bankruptcy Code. *Id.* at \*7. The Seventh Circuit explained that the right to credit bid affords secured creditors the means to "protect themselves from the risk that the winning auction bid will not capture the asset's actual value" and that if the River Road auctions were permitted to go forward over the objection of the secured lenders, the winning bids may not provide the secured lenders with the current market value of their collateral. *Id.*

While the *River Road* decision is certainly positive news for secured creditors, it remains to be seen whether other courts will agree with the Seventh Circuit or follow the earlier contrary opinions of the Third and Fifth Circuits. Until there is a definitive ruling from the Supreme Court or an amendment to the Bankruptcy Code, secured creditors should take certain steps, as discussed below, to protect their right to credit bid under a Chapter 11 plan.

## **Issues that a Secured Creditor Should Be Prepared to Address**

### *Payment of the Administrative Expenses of the Chapter 11 Case*

As demonstrated by the *Hereford* case, an artificially low price is not the only risk secured creditors face. Courts are increasingly using their authority to limit or condition the right to credit bid to ensure that debtors do not face administrative insolvency following a sale in which a credit bid is successful. In the *National Envelope* Chapter 11 case (*In re NEC Holdings Corp.*, No. 10-

11890 (Bankr. D. Del. 2010)), the debtor sought a quick sale to a stalking horse bidder with whom it had negotiated a deal almost to completion before the case was filed. The first lien on most of the debtor's assets was held by the agent for a syndicate comprising traditional lenders, and the second lien was held by a smaller group of distressed investors. It became clear early in the case that there would be substantial claims asserted under Section 503(b)(9) of the Bankruptcy Code, which provides an administrative claim for the price of goods delivered to the debtor in the twenty days prior to the commencement of the case.

When the debtor sought approval of bidding procedures for an auction sale, the court advised the parties that it would not allow any bidder to submit a bid that did not include sufficient cash to pay the 503(b)(9) claims and all other administrative claims in full. This requirement served as a substantial disincentive to both groups of secured lenders as they considered making a credit bid, because any such credit bid would have required the secured creditors to put up cash to pay creditors lower in priority. In effect, the court's insistence that administrative claims be paid elevated those claims above the theoretically senior secured claims.

A similar issue may also arise if a sale is conducted under a Chapter 11 plan. In the *Philadelphia Newspapers* case, the plan of reorganization precluded the secured creditors from credit bidding, which forced them to participate in the auction with a cash bid. Some commentators have suggested that secured lenders should be indifferent as to whether they credit bid or pay cash and receive the cash back under a plan or after the consummation of a sale. However, this suggestion ignores the practical difficulty of getting one or more lenders (and sometimes a large group of diverse lenders with varying interests and potentially conflicting positions) to advance funds. In addition, as noted above, most courts will require creditors to fund administrative expenses of the debtor, and there is therefore no certainty that all of the funds advanced by a lender group will be returned without deduction. This is especially a risk where the funds are paid for assets under a Chapter 11 plan and there is no other source of cash to pay other amounts that are required to be paid on confirmation of the plan.

### *Challenge to a Secured Creditor's Claim*

A potential roadblock for a secured creditor intent on exercising its right to credit bid is an objection filed by the debtor, a creditors committee, or another party in interest to the allowability of the creditor's claim or the validity of the lien securing the claim. Under Section 363(k) the bankruptcy court can deny a creditor the right to credit bid "for cause." In addition, a secured creditor has the right to credit bid only if the validity or extent of its lien is not subject to a bona fide dispute. Although there are only a few reported cases in which a court has found cause to deny a creditor the right to credit bid, as illustrated in the *Hereford* case described above, challenges to a creditor's claim to extract consideration for unsecured creditors are common.

Accordingly, a secured creditor should be prepared to establish the validity of its claim and liens and to respond on an expedited basis to discovery requests. Although not binding on other parties in interest, the secured creditor should also attempt to obtain the debtor's acknowledgment of its claim and a general release from the debtor both pre-petition and, if possible, after a petition has been filed, for instance, as part of a cash collateral order.

### *Complications Caused by Junior Creditors*

A junior creditor with a lien on the same collateral as a senior creditor will have the right to object to a sale of the collateral on various grounds, based on its valuation of the collateral (with which others may not agree). The junior creditor may, for example, argue that its consent is required to any sale pursuant to Section 363(f)(3) or may object to proposed terms and conditions of the sale or the allowability of the senior creditor's claims or the validity of its liens.

The best way to avoid potential complications from junior creditors is to negotiate an intercreditor agreement at the time the debtor incurs the junior debt under which the junior creditor waives all rights related to the senior creditor's claim, any sale of the collateral (including a sale under Section 363 or a plan of reorganization), and other actions supported by the senior creditor in the debtor's bankruptcy proceeding. Such an agreement should be enforceable under Section 510(a) of the Bankruptcy Code, which provides that a "subordination agreement is enforceable in a case under this

title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.” 11 U.S.C.A. § 510(a). *See, e.g., In re Boston Generating LLC*, 440 B.R. 302, 318-19 (Bankr. S.D.N.Y. 2010).

### *Dissent among the Ranks: Issues Caused by a Non-Consenting Syndicate Member*

An agent for a group of lenders should also be prepared for one or more lenders disagreeing with the agent’s suggested approach and questioning the agent’s right to credit bid without each lender’s written consent. This is especially common where lenders have sold their debt for less than par and the current holders have different goals than the original lenders. Ultimately, whether the agent can act without unanimity is an issue of contract interpretation. The best way to preserve the agent’s ability to credit bid over the objection of one or more lenders is to have a loan or security agreement that gives the agent the unequivocal right to credit bid without the consent of all of the lenders.

However, even where the agreement is not crystal clear, recent court decisions on the issue have favored the agent on a “collective action” theory, concluding that an agent that has the exclusive right to exercise remedies can do so without the consent of all of the lenders. *See, e.g., In re Chrysler LLC*, 405 B.R. 84 (Bankr. S.D.N.Y. 2009), *aff’d* 576 F.3d 108 (2d Cir. 2009); *In re GWLS Holdings*, No. 08-12430, 2009 WL 453110 (Bankr. D. Del. 2009); *In re Foamex International*, No. 09-10560 (Bankr. D. Del. 2009); *In re Delphi Corp.*, No. 05-44481 (Bankr. S.D.N.Y. 2009) (Plan Confirmation); *In re Metaldyne Corp.*, No. 09-13412 (MG) (S.D.N.Y. 2009); *Beal Savings Bank v. Sommer*, 8 N.Y.3d 318 (N.Y. 2007).

### **Suggestions to Protect a Secured Lender’s Right to Credit Bid**

A secured creditor will generally have three opportunities prior to a sale of its collateral in bankruptcy to protect or preserve its right to credit bid. These opportunities should be available when the loan is first documented, during a workout or restructuring of the loan, and after the borrower files a bankruptcy petition, in connection with post-petition financing (either the use of cash collateral under Section 363(c)(2) of the Bankruptcy Code or debtor-in-possession financing under Section 364 of the Bankruptcy Code). The following are some suggestions to take advantage of each of these opportunities. Sample language is included in the Appendix.

*Original Loan Documentation*

1. The remedies Section of security documents should include an explicit right of the secured lender to credit bid in a sale of collateral under both Section 363 and a plan of reorganization and an agreement from the borrower not to challenge a lender's right to credit bid or to take any action to adversely affect such right, including, without limitation, providing for a sale under a plan of reorganization without giving the secured lender the right to credit bid. While such language may not be enforceable against a debtor in a bankruptcy case, a court will likely give weight to the language in determining the intent of the parties.
2. An intercreditor or subordination agreement with a junior creditor should include an express waiver by the junior creditor of any right to challenge the senior creditor's right to credit bid or to object to a sale of collateral under Section 363(f) or a plan of reorganization without the senior creditor's consent.
3. When representing an agent for a group of secured lenders, the loan agreement should clearly state that the agent has the right, without the consent of all of the lenders, to submit a credit bid at a sale of the collateral that will bind all of the lenders. The credit agreement should make clear that such a credit bid is part of the enforcement of rights (subject to required lenders, usually a simple majority) and not the release of liens on all or substantially all of the lenders' collateral (which usually requires unanimous consent). Conversely, when representing a participant in a syndicated loan, consideration should be given as to whether all lenders should be bound by the decision of the agent.

*Documentation During a Workout or Restructuring*

The secured creditor's right to credit bid and a waiver of the borrower's right to challenge such right or propose a plan of reorganization that deprives the secured creditor of such right should be reaffirmed in any amendment, waiver, standstill agreement, or forbearance agreement entered into with the borrower prior to a bankruptcy filing.

*Post-Petition Documentation*

1. Any agreement to provide debtor-in-possession financing or consent to the use of cash collateral should be conditioned on the unequivocal right to credit bid in any asset sales during the Chapter 11 process.
2. A secured creditor should bargain with the debtor and the creditors committee for the allowance of its claim as early in the Chapter 11 process as possible to avoid a challenge to the right to credit bid based on the validity of the creditor's claim. Generally, a debtor in possession will acknowledge a creditor's claim as part of a post-petition financing order, leaving any challenge to be undertaken by the creditors committee. Since no creditors committee will acknowledge the allowability of a claim immediately after the committee is appointed, the secured creditor should seek to include in the post-petition financing order a short deadline (e.g., sixty days) by which a committee must do its investigation and challenge or be deemed to have acknowledged the secured creditor's claim and the validity of the liens securing the claim.
3. A cash collateral or debtor-in-possession financing order should expressly state that the secured creditor will have no obligation to fund administrative expenses of the case, other than administrative expenses approved by the court under Section 506(c) of the Bankruptcy Code (which should be limited to "reasonable, necessary costs and expenses of preserving, or disposing of" the collateral), even if it acquires title to its collateral through a credit bid.
4. Before agreeing to pay cash for assets in lieu of a credit bid, a secured creditor should ensure that all of the cash will be returned and will not be either delayed or used to fund the debtor's administrative expenses.

## **Conclusion**

Section 363 of the Bankruptcy Code can be a cost-efficient and expeditious way for a debtor to sell or transfer its assets on a consensual basis to a third party or to its secured creditor. However, the Section can also be used by a debtor to put pressure on its secured creditor by proposing a sale to an insider or affiliate for less than full value and leaving it to the secured creditor to either object to the sale or credit bid its debt.

Attorneys representing secured creditors faced with a proposed sale of assets under Section 363 should prepare their clients to credit bid expeditiously and should advise their clients about how to deal with issues relating to the potential acquisition of their collateral, including valuation, environmental, regulatory, and tax issues. A secured creditor should also be prepared to object to a sale of its collateral, recognizing that if its objection is successful, it may have to face issues relating to the deterioration of its collateral, funding of the debtor's business, and preparing for an attempt by the debtor to sell the collateral under a cramdown plan of reorganization.

The Seventh Circuit's decision in *River Road* departs from the recent trend limiting a secured creditor's right to credit bid under a plan of reorganization. *River Road* is a positive development for secured creditors but does not fully close the door opened for debtors by courts in the Third and Fifth Circuits. Until the law is finally settled by the US Supreme Court or an amendment to the Bankruptcy Code, attorneys representing secured creditors should recognize that in some jurisdictions a debtor can successfully sell its assets under a plan that does not provide for a secured creditor's right to credit bid.

Secured creditors can thwart such attempts by requiring debtors to acknowledge their right to credit bid under a plan as part of any post-petition financing arrangement, or by bidding cash at the auction, on the condition that they be repaid with the proceeds of sale. Creditors who successfully acquire assets through a credit bid or for cash under a plan of reorganization, however, should be prepared for a bankruptcy court to require that they leave sufficient cash or other assets behind to pay administrative expenses in the bankruptcy proceeding.

### **Key Takeaways**

- The recent trend of using Chapter 11 to sell assets is unlikely to end anytime soon. Accordingly, a secured creditor of a debtor in Chapter 11 must be prepared to credit bid for its collateral on an expedited basis.
- Although the split in case law relating to a creditor's right to credit bid under a Chapter 11 plan raises an interesting academic issue of statutory construction, regardless of how the issue is ultimately

decided, a proactive, well-advised secured creditor should be able to protect its right to acquire its collateral in a bankruptcy sale.

- A secured creditor's attorney should use every available opportunity when documenting an initial transaction, a restructuring, waiver, or amendment, or a post-petition financing agreement to obtain a reaffirmation of the creditor's right to credit bid for its collateral.
- Bankruptcy courts are likely to continue to require that a secured creditor that acquires its collateral with a credit bid pay in cash, or leave behind assets, in an amount necessary to cover the administrative costs of the bankruptcy proceeding.

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**Acknowledgment:** We gratefully acknowledge the assistance of Nicholas Milburn, an associate at Hughes Hubbard & Reed LLP, in preparing this chapter.

## APPENDIX

### SAMPLE LOAN LANGUAGE

#### Lenders' Right to Credit Bid:

“The Lender shall have the right to submit a bid at any public or private sale in connection with the purchase of all or any portion of the Collateral, in which any of the Secured Obligations owing to the Lender under this Agreement is used and applied as a credit on account of the purchase price (“Credit Bid”), at (i) any public or private sale of all or any portion of the Collateral conducted under (A) the provisions of the Uniform Commercial Code (including, without limitation, pursuant to Sections 9-610 and 9-620 of the Uniform Commercial Code) or (B) the provisions of the Bankruptcy Code (including, without limitation, pursuant to Section 363 of the Bankruptcy Code or under a plan of reorganization), (ii) any foreclosure sale (whether by judicial action or otherwise) or (iii) any other similar disposition of all or any portion of the Collateral. The Borrower agrees that it will not contest, protest, object to or take any other action to adversely affect the Lender’s right to Credit Bid including, without limitation, providing for a sale of the Collateral under a plan of reorganization without giving the Lender the right to Credit Bid.”

#### Intercreditor Language:

“The Second Lien Claimholders will not, directly or indirectly, contest, protest, or object, and will be deemed to have consented pursuant to Section 363(f) of the Bankruptcy Code, to (i) a sale, lease, exchange, transfer or other disposition of Collateral (“Disposition”) free and clear of its liens or other interests under Section 363 of the Bankruptcy Code and all procedures and motions in connection with such Disposition, and (ii) [the First Lien Claimholders’][the First Lien Collateral Agent’s] right to Credit Bid in any such Disposition in accordance with Section 363(k) of the Bankruptcy Code.”

#### Agent’s Right to Credit Bid:

“The Administrative Agent, on behalf of itself and the Lenders, shall have the right to submit a bid at any public or private sale in connection with the

purchase of all or any portion of the Collateral, in which any of the Secured Obligations owing to the Administrative Agent, on behalf of itself and the Lenders, under this Agreement is used and applied as a credit on account of the purchase price (“Credit Bid”), at (i) any public or private sale of all or any portion of the Collateral conducted under (A) the provisions of the Uniform Commercial Code (including, without limitation, pursuant to Sections 9-610 and 9-620 of the Uniform Commercial Code) or (B) the provisions of the Bankruptcy Code (including, without limitation, pursuant to Section 363 of the Bankruptcy Code or under a plan of reorganization), (ii) any foreclosure sale (whether by judicial action or otherwise) or (iii) any other similar disposition of all or any portion of the Collateral. Each Lender agrees that, except as otherwise provided in any Loan Document or with the written consent of the Administrative Agent, it will not take any enforcement action, accelerate obligations under any Loan Document or exercise any right that it might otherwise have under applicable law to Credit Bid.”

Reaffirmation of Right to Credit Bid:

“The Borrower hereby reaffirms its obligations and liabilities under the Security Agreement and the other Loan Documents in all respects, including, without limitation, (i) the [Lender’s][Administrative Agent’s] right to Credit Bid and (ii) the Borrower’s agreement that it will not contest, protest, object to or take any other action to adversely affect the [Lender’s][Administrative Agent’s] right to Credit Bid including, without limitation, providing for a sale of the Collateral under a plan of reorganization without giving the [Lender][Administrative Agent] the right to Credit Bid.”

Post-petition Reaffirmation of Right to Credit Bid:

“The Pre-Petition Agent shall have the unqualified right to credit bid up to the full amount of any Allowed Bank Claim in any sale of the Pre-Petition Collateral, under or pursuant to (i) Section 363 of the Bankruptcy Code, (ii) a plan of reorganization or plan of liquidation under Section 1129 of the Bankruptcy Code, or (iii) a sale or disposition by a Chapter 7 trustee for the Debtor under Section 725 of the Bankruptcy Code. The Debtor, on behalf of itself and its estate, stipulates and agrees that any sale of all or part of the

Collateral that does not include an unqualified right to credit bid up to the full amount of the Allowed Bank Claim would mean that the Pre-Petition Agent and the Pre-Petition Lenders will not receive the indubitable equivalent of their claims.”

Agreement that Secured Lender Not Responsible for Administrative Expenses:

“If any Pre-Petition Lender obtains title to any portion of the Pre-Petition Collateral pursuant to a credit bid in any sale of the Pre-Petition Collateral under or pursuant to (i) Section 363 of the Bankruptcy Code, (ii) a plan of reorganization or plan of liquidation under Section 1129 of the Bankruptcy Code, or (iii) a sale or disposition by a Chapter 7 trustee for the Debtor under Section 725 of the Bankruptcy Code, such Pre-Petition Lender shall have no obligation to (a) fund the operations of the Debtor’s businesses or (b) pay transaction fees and expenses or other costs and expenses of administration of the bankruptcy case, including, without limitation, the direct payment or reimbursement of any (I) unpaid fees or expenses of retained professionals of the Debtor or (II) unpaid fees or expenses of professionals retained by any statutory committee of unsecured creditors appointed by the Court incurred in this case or any successor case.”



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