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CREDIT BIDDING: BACK TO BASICS

In this article, the authors offer a compact treatise on a secured lender's right to credit bid obligations owed to it in a sale of a borrower's assets. The topics covered include: the right to credit bid; the reasons to credit bid; limitations to credit bidding; the effect of loan documents; and the importance of diligence and strategy when preparing a credit bid.

By Brian J. Lohan and Maja Zerjal Fink *

As we entered 2022, defaults and bankruptcies were at historic lows. Since then, however, inflation, rising rates, and supply chain issues (among other things) have increased the possibility of an uptick in distress activity. Regardless of whether we see continued growth and prosperity, or the pendulum swings the other way, understanding, and if applicable, properly negotiating and/or exercising, your rights and remedies as a lender (or potential lender) is an important tool to prepare for whatever is to come.

This article focuses on a secured lender's right to credit bid obligations owed to it in a sale of a borrower's assets. Specifically, we discuss legal considerations of credit bidding under the Bankruptcy Code, as well as practical considerations under a lender's loan documents.[1] While this article discusses credit bidding in the context of a secured lending relationship, the concept of credit bidding equally applies to secured creditors generally.

[1] While addressing credit bidding generally, the article does not address credit bidding in out-of-court situations such as Article 9 Sales and foreclosures.

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WHAT RIGHTS DOES A SECURED LENDER HAVE TO CREDIT BID UNDER THE BANKRUPTCY CODE?

With limited exceptions, the Bankruptcy Code permits a debtor to sell its assets free and clear of a secured lender's liens if certain conditions are met.[2] In connection with such a sale, however, a secured lender can generally "credit bid" its claim — i.e., offset its claim against the purchase price for the assets that are subject to such secured lender's lien.[3]

[2] 11 U.S.C. § 363(f) (estate's property can be sold free and clear of a third-party's interest in such assets if, among other things: (a) applicable nonbankruptcy law allows the sale free and clear of such interest, (b) the third-party consents to the sale, (c) the interest is a lien and the sale price is greater than the value of all liens, (d) the interest is in *bona fide* dispute, or (e) the entity could be compelled to accept money in satisfaction of its interest).

[3] Specifically, section 363(k) of the Bankruptcy Code provides that "[a]t a sale under [section 363(b)] 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,

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The right to credit bid is specifically addressed in sections 363(k) and 1129(b)(2)(A)(ii) of the Bankruptcy Code. Section 363 of the Bankruptcy Code generally provides a debtor with the ability to sell its assets (including outside of the ordinary course, which requires court approval), and section 1129 of the Bankruptcy Code addresses confirmation of a chapter 11 plan (including a plan which contemplates the sale of a debtor's assets).

Sales of estate assets can be pursued at any time during a chapter 11 case, including through a chapter 11 plan. Section 1129(b)(2)(A)(ii) requires that a cramdown plan provide "for the sale, *subject to section 363(k)* of this title [i.e., the secured lender's right to credit bid], of any property that is subject to the liens securing such claims, free and clear of such liens . . . . "[4] Until the Supreme Court's *RadLAX* decision (discussed below), certain courts held that a chapter 11 plan could be confirmed even if the secured lender was denied the right to credit bid under subsection (ii), so long as the plan offered the secured creditor the "indubitable equivalent" of its claims, as required by subsection (iii) of section 1129(b)(2)(A). In 2012, the Supreme Court, in *RadLAX Gateway Hotel LLC, et al. v. Amalgamated Bank*, 132 S.Ct. 2065 (2012), held that when a chapter 11 plan contemplates a sale free and clear of a secured creditor's lien, the plan has to satisfy subsection (ii) of section 1129(b)(2)(A), which preserves the secured creditor's right to credit bid.[5]

Accordingly, if a debtor contemplates a sale of its assets during a chapter 11 case (either in a section 363 sale or a sale pursuant to a chapter 11 plan), a secured lender can credit bid under section 363(k) of the Bankruptcy Code. In either scenario, however, the right to credit bid is not unfettered. Specifically, section 363(k) provides that a court could deny, limit or condition a lender's right to credit bid "for cause" (as further discussed below). As 1129(b)(2)(A)(ii) provides that any sale of assets is subject to section 363(k), the same limitation applies in a sale pursuant to a chapter 11 plan. In addition, a secured lender's right pursuant to 1129(b)(2)(A)(ii) only arises if a plan is being "crammed down" on the secured lender class. In other words, if the class of secured claims accepts the plan, section 1129(b)(2)(A)(ii) need not be satisfied with respect to any secured lender in such class for a debtor to confirm its plan.

WHY SHOULD A LENDER CONSIDER CREDIT BIDDING?

There are a multitude of reasons a secured lender may consider a credit bid, and a credit bid can be part of an offensive or defensive strategy. First, existing secured lenders to a distressed borrower may believe a turnaround story exists for the borrower and want to capture the upside of such turnaround. In addition, investors may acquire secured claims against a borrower (often at a discount) for the purpose of credit bidding such claims in a sale of the borrower's assets.[6] In these scenarios, the secured lender credit bids for, and becomes the subsequent owner of, the borrower's assets.

Conversely, a secured lender can also credit bid in a defensive manner. For example, a secured lender can submit a credit bid to set a floor for the purchase price of its collateral in the hope for higher bids. In this scenario, the credit bid may be for less than the full value of the secured lender's claim, especially if the secured lender does not believe any third party is likely to pay a price that would match or exceed the amount of its secured claim. Such bid may signal to the market that the

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and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property."

[4] 11 U.S.C. § 1129(b)(2)(A)(ii) (emphasis added).

[5] The Supreme Court rejected Fifth Circuit and Third Circuit decisions holding that a debtor can confirm a "cramdown" plan without giving a secured creditor the right to credit bid because a secured creditor can supposedly always be offered the "indubitable equivalent" of its claim in lieu of a credit bid under subsection (iii) of section 1129(b)(2)(A). *Pacific Lumber Co., et al. v. Official Unsecured Creditors' Committee*, 584 F.3d 229 (5th Cir. 2009); *In re Philadelphia Newspapers LLC, et al*., 599 F.3d 298 (3d Cir. 2010).

[6] Competitors and certain lenders that the borrower may deem aggressive are often placed on the loan agreement's "disqualified lenders" list, which prevents such entities from acquiring the borrower's loans.

secured lenders have a "release" price that is less that the full amount of their claim--in essence, a thawing bid.

Conversely, a secured lender may credit bid to prevent a sale of its collateral at a price it believes undervalues the assets. If third parties are not offering enough value at the time of the auction, a secured lender may want to submit a topping credit bid, and own the assets or sell them when market conditions present an opportunity to obtain greater value.[7]

As a general matter, a secured lender can credit bid the face value of its secured claim, regardless of the price at which such lender acquired the secured claim. However, the manner in which the lender acquires its claim (including the price) may be a consideration in whether there is "cause" to deny, limit, or condition a secured creditor's right to credit bid.

Whether using a credit bid as an offensive or defensive strategy, lenders can be proactive and seek to act as the "stalking horse bidder," i.e., the bidder that sets the floor for the price and the required sale conditions in exchange for certain benefits, which can include the reimbursement of certain expenses and, under certain circumstances, a break-up fee.

LIMITATIONS TO CREDIT BIDDING

A secured lender can only credit bid for assets that are subject to its lien. To the extent the secured lender seeks to acquire assets of a borrower that are not subject to the lender's lien the lender will be required to offer consideration, other than its secured claims. Collateral packages securing credit facilities often exclude certain assets (usually where perfection would be costly or impractical), so in a sale of all assets, additional consideration will be likely.[8] Moreover, in the event the assets are subject to more than one lien, secured creditors holding junior liens can be allowed to credit bid, subject to any contractual limitations set forth in any intercreditor agreement, but generally must pay lenders holding senior liens in cash in full.

A secured lender's claim must also be allowed. Because of the Bankruptcy Code's adequate protection requirements for use of collateral,[9] secured creditors (and especially, secured lenders) are typically in a unique position to have a debtor stipulate to the amount and validity of the creditors' claim at the outset of a bankruptcy case (sometimes in the context of a cash collateral order, or, if such lender is providing debtor in possession ("DIP") financing, a DIP order).[10] Such stipulations are typically subject to a "challenge period" for other parties in interest (e.g., a creditors' committee) to challenge a secured creditor's claims or liens. To the extent, however, the priority and validity of a secured creditor's claims are not stipulated by a debtor or not included in a debtor's schedules, a secured creditor should file a proof of claim.[11] If an objection or challenge creates a *bona fide* dispute as to the validity, extent, or priority of a secured creditor's lien or the amount of its allowed claim, the bankruptcy court may condition a secured creditor's ability to credit bid, including on such creditor's agreement to pay the purchase price in cash if the claim is ultimately disallowed (it may also require depositing such amount in escrow, or providing a letter of credit or other security, for example).

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[7] In considering strategies, however, lenders must be careful not to engage in collusion. While collaboration among bidders (including credit bidders) is allowed, section 363(n) of the Bankruptcy Code gives the debtor the right to avoid a sale or recover damages "if the sale price was controlled by an agreement among potential bidders at such sale." Generally, disclosing any existing or likely agreements with third parties can shield a credit bidder from section 363(n) issues. *See, e.g., In re Waypoint Leasing Holdings, Ltd.*, 607 B.R. 143 (Bankr. S.D.N.Y. 2019) (section 363(n) challenge was unsuccessful where secured lender's credit bid was the winning bid and the lender was in discussions with a strategic buyer for a subsequent transaction when such discussions with the strategic buyer were disclosed).

[8] Such additional consideration is sometimes also required if the estate would be left without cash to wind down or become

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administratively insolvent if the credit bid is the winning bid and substantially all assets are sold. In addition, this article does not discuss the implications and strategies for "roll-up" DIP financing, as well as credit bidding adequate protection or DIP claims.

[9] Practically, a debtor will need to provide adequate protection for, at a minimum, use of the secured lenders' collateral during a case. *See, e.g.*, 11 U.S.C. § 363(e) ("Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.").

[10] This article does not discuss the implications and strategies for "roll-up" DIP financing, as well as credit bidding adequate protection or DIP claims.

[11] Section 502(a) of the Bankruptcy Code provides that when a proof of claim is filed, the underlying claim is considered allowed until a party in interest objects.

Further, as noted above, section 363(k) provides for a secured lender's right to credit bid "unless the court for cause orders otherwise." "Cause" is not defined in the Bankruptcy Code and is left for courts to determine on a case-by-case basis. Generally, bases for limiting credit bidding rights include challenges to the lender's lien or claim and a lender's inequitable conduct.[12] Certain courts have considered the effect a credit bid would have on the auction process, and in at least one instance determined that "freezing" an auction process, in and of itself, could constitute "cause" to deny or limit the right to credit bid. For example, in *Fisker*,[13] the court concluded that freezing the bidding could in and of itself be sufficient "cause" to disallow or limit credit bidding. As a result, the court limited the secured lender's credit bid to what it paid for the claim as opposed to the face value of the claim based on its conclusion that, among other things, (i) if the credit bid were not limited, the auction process would not occur at all and (ii) the claim was disputed. In *In re Aeropostale, Inc*.,[14] however, the court differentiated "freezing" bidding in *Fisker* from "chilling" bidding, and found that "chilling" bidding alone does not constitute "cause" under section 363(k). In such case, other factors, such as inequitable conduct, would also have to be present to establish "cause" under 363(k).[15]

Conversely, the debtor and third parties can use these limitations strategically or defensively to try to limit or disallow a secured lender's credit bit.

[12] *See, e.g.*, *In re Figueroa Mt. Brewing, LLC*, No. 9:20-bk-11208-MB, 2021 Bankr. LEXIS 1775, *22, 24 (Bankr. C.D. Cal. July 2, 2021) (noting that courts have found cause under section 363(k) when a creditor's lien is questioned or otherwise in dispute and denying the creditor's credit bid where there was "a sufficient dispute regarding [the creditor's] claim).

[13] 510 B.R. 55 (Bankr. D. Del. 2014).

[14] 555 B.R. 369 (Bankr. S.D.N.Y. 2016).

[15] *See also In re Tempnology, LLC*, 542 B.R. 50, 69 (Bankr. D.N.H. 2015) (denying a challenge to a secured creditor's right to credit bid its claim in the absence of any evidence of inequitable conduct or that the secured claim was subject to *bona fide* dispute), *aff'd*, 558 B.R. 500 (B.A.P. 1st Cir. 2016), *aff'd*, 879 F.3d 376 (1st Cir. 2018); *In re Charles Street African Methodist Episcopal Church of Boston*, 510 B.R. 453 (Bankr. D. Mass. 2014) (denying in part a motion to limit a credit bid where the debtor's counterclaims did not relate to the validity of the secured creditor's claims or liens, but requiring the secured creditor to include in its bid cash in an amount equal to a breakup fee payable to the stalking horse bidder).

WHAT DOES A LENDER NEED TO CONSIDER UNDER THE LOAN DOCUMENTS WHEN CONSIDERING A CREDIT BID?

Although the Bankruptcy Code provides a secured lender with the right to credit bid, how that right is exercised is, in part, informed by the loan documents. In the case of a single lender to a borrower, the right is generally controlled and/or exercised by the lender at its discretion (subject to the limitations described above).

Where there is more than one lender to a borrower, however, credit bidding is not as straightforward. For example, while loan documents governing secured lenders' claims generally provide a mechanism to exercise a credit bid, questions that should be considered include:

- Who "controls" the right to credit bid (agent, lenders)?
- What is the threshold for directing the party that has the right to credit bid (simple majority, super majority, other)?
- What indemnities need to be provided, and to whom?
- What triggers a right to credit bid under the loan documents?
- What notice is required?
- What rights, if any, do individual lenders have with respect to a credit bid?
- Can you "drag" dissenting lenders?
- Are there other secured creditors that have rights in the same collateral?
    - What is their priority?
    - Is there an intercreditor agreement?
    - Can they be "dragged"?

In light of all these considerations, a secured lender in a facility with more than one lender should understand, and to the extent possible, protect its rights with respect to credit bidding — ideally when the applicable documents are drafted.

THE IMPORTANCE OF DILIGENCE AND STRATEGY WHEN PREPARING A CREDIT BIT

Diligence plays an important role in determining whether, and to what extent, a lender should credit bid. Two threshold questions, among others, must be considered in the diligence phase: (i) do the governing loan documents impose any requirements or restrictions on a lender's right to credit bid and (ii) which assets being sold are subject to a secured lender's lien?

After doing its diligence, a secured lender should determine whether it (i) wants to, or can (there may be regulatory or other restrictions), own and operate the assets or (ii) is willing to allow a third party to purchase the assets. If a lender concludes the latter, a corollary question arises of what price a secured lender is willing to accept for its collateral (its "release" price). Further, a secured lender must be informed as to the potential market for the borrower's assets. A robust market, itself, may create a competitive environment, and a secured lender must consider whether its credit bid will encourage or "chill" bidding.

Moreover, if a lender intends on credit bidding as a means to own the debtor's assets, other issues need to be considered. For example, some diligence items include:

- **Employee matters**. What incentive or bonus plans does the borrower maintain for is employees? To the extent there are any equity-based incentive plans, what will need to be done to retain key employees? Would a sale trigger change-of-control severance obligations?

- **Pension Benefit Guaranty Corporation/Control Group Pension Plan Liabilities**. Does the borrower maintain a pension plan? If so, how many active employees participate in the plan, what is its funded status, as well as what is the composition of its assets? The potential bidder will have to decide whether to assume such plans and what liability is associated with them. If a borrower's pension plan is terminated in connection with a credit bid, is the potential bidder acquiring the equity of a non-debtor subsidiary or affiliate that could be liable for pension plan obligations as a member of a "control group"?[16]

- **Environmental Issues**. Does the borrower have ongoing remediation obligations that cannot be released? Are there owner or operator liability concerns?

- **Senior Liens**. Are there liens senior to the secured lenders' liens that may (or may not) be permitted under the loan documents (for example, statutory real property tax liens)? Creditors holding such liens may have to be paid in cash or their liens may have to be preserved.

- **Non-Debtor Subsidiaries**. If a lender is acquiring the equity of a subsidiary that is not a debtor in bankruptcy, diligence should be done on the claims at the non-debtor subsidiary (and whether a change of control triggers any additional claims).

- **Intellectual Property Issues**. What intellectual property rights are key to operating the borrower's business? Where do those rights come from? Are those intellectual property rights part of the secured lender's collateral? To the extent a borrower is a licensor of intellectual property, what rights does the licensee have under section 363(n) of the Bankruptcy Code to the continued use of the intellectual property (even if such license is rejected)? What consents may be required to transfer rights under licenses?

- **Regulatory Approvals**. What local, state, and/or federal regulatory approvals are required to operate the business (e.g., are there gaming, liquor, or other similar licenses)? What is the process for obtaining such approval or transferring existing certificates?

- **Transition/Shared Services**. Is the secured lender getting everything it needs to operate the business on day one? Is there a need for a period of transition? Are there any pending approvals? Is the cash management system in place? Are customer receivables being purchased? How do customers pay their bills? Do they pay to a lock box of the seller?

- **Executory Contracts/Leases**. Are there contracts or leases that are needed to operate the business that should be assumed? Conversely, are there contracts or leases that are burdensome that should be rejected? For contracts or leases that are to be assumed, what are the cure costs associated with assumption? What is required to demonstrate adequate assurance of performance in the future?

[16] If there is a defined benefit pension plan, the debtor and its controlled group members could become liable for the pension plan termination liabilities.

The diligence of these and other aspects of the assets should inform a secured lender's view of the value of its collateral (e.g., it may be more attractive if there is a robust market for such assets or if a secured lender can create additional value by owning such asset through synergies, for example). If a secured lender intends to operate the assets, it should ensure that it can actually use and operate the assets once purchased. For example, if the collateral package excludes important intellectual property rights, a secured lender should understand whether the assets are still valuable without such right, and if not, how, and at what price, those rights can be acquired. Also, while assets are sold free and clear of claims and interests, a lender should understand what assets it is actually purchasing. For example, purchasing equity interests in a non-debtor subsidiary transfers the equity interests free and clear of claims and interests against the equity itself — claims against the non-debtor subsidiary are not impaired.

Additionally, a secured lender will have to consider the acquisition mechanics. Usually, a bidding vehicle is set up to purchase the assets, with secured lenders holding equity or debt interests in such vehicle (if the vehicle were to assume all or part of the seller's debt, for example). Where more than one lender is credit bidding, it is important to define the respective rights and obligations with respect to the bidding vehicle.

CONCLUSION

Credit bidding is an important right of a secured creditor. Exercising such right, however, requires certain consideration and advanced planning. If you are a secured lender to a distressed borrower, it is never too early to review (i) loan documents for any conditions or restrictions on credit bidding (especially vis-a-vis other secured lenders) and (ii) the assets comprising your collateral, the perfection thereof, and the assets necessary to operate the borrower's business. ■