Exploring the Outer Limits of Credit Bidding
When the Asset Sale Package Includes Assets Not Subject to the Bidder’s Liens

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(TMA International Headquarters) There has been a proliferation of recent Chapter 11 filings in which anemic valuations in a global recessionary economy have left little room for unsecured creditors or equity holders. These debtors have also faced enormous liquidity constraints that resulted from, among other things, both the disappearance of traditional debtor-in-possession (DIP) financing sources and the unforgiving pressures on liquidity caused by many of the amendments to the U.S. Bankruptcy Code contained in the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA).[1]

At the same time, capital markets outside of Chapter 11 reorganization have become much more robust, permitting many challenged business enterprises to “amend and extend” their capital structures while avoiding operational restructurings in the short term. The net result of these collective events has been that an unusually high percentage of Chapter 11 business reorganization cases filed in 2009 and 2010 (and expected to be filed in 2011) were either prenegotiated Chapter 11 cases or immediate asset sales (or both).

As debtors have looked to Section 363 of the Bankruptcy Code to sell substantially all of their assets, various issues related to credit bidding have taken center stage. For
example, courts have been required to determine the amount that a secured creditor is able to credit bid and to resolve certain credit bidding issues related to syndicated lending groups. One issue that has not received much attention is the contours of a secured creditor’s ability to credit bid when its collateral is being sold in a single packaged transaction with assets that are either encumbered by liens belonging to unrelated creditors or are unencumbered altogether and therefore otherwise available for potential distributions to administrative, priority, and unsecured claimants.

Section 363(k) of the Bankruptcy Code authorizes secured creditors to credit bid when their collateral is sold via a sale conducted pursuant to Section 363.[2] Credit bidding refers to the process in which a secured creditor can bid its outstanding debt in a sale of the collateral that secures that debt. To illustrate, assume a bank (B) lends a company (C) $100 to purchase a truck. Assume further that B perfects a security interest in the truck. Now assume that C files a petition under the Bankruptcy Code and seeks to sell the truck in a 363 sale. If C still owes B $75 on account of the truck, then (in almost all instances) B may credit bid up to $75 in a sale for the truck. That is, B may bid up to $75—without putting up any new cash—simply by agreeing to forgive the secured debt by an amount equal to the amount of its bid. If B credit bids $75, then (in almost all circumstances) that bid will prevail over a competing $70 all-cash bid.

As previously noted, courts have grappled with myriad credit bidding issues. An instructive credit bidding decision is Cohen v. KB Mezzanine Fund II LP (In re SubMicron Sys. Corp.), 432 F.3d 448 (3d Cir. 2006), in which the 3d Circuit analyzed whether a secured creditor could credit bid the full face value of its claim or whether its credit bid was limited to the economic value of its claims. The court held that Section 363(k) “empowers creditors to bid the total face value of their claims—it does not limit bids to claims’ economic value . . . .” SubMicron, 432 F.3d at 459. Whether other judicial circuits will follow the 3d Circuit in its various credit bidding rulings remains to be seen.

Another credit bidding issue that courts have confronted concerns the ability of a syndicate of secured lenders to credit bid even if there is not unanimity among the members of the lending group. This actually entails two issues: (i) whether an agent
may credit bid despite a lack of unanimity among the constituent lenders and (ii) what
treatment non-participating lenders should receive if the agent’s credit bid prevails.

Whether an agent may credit bid despite the objection of members of the lending
syndicate depends, in the first instance, on the language in the credit
documents. Having said that, courts have consistently approved credit bids over the
objection of dissenting lenders. See, e.g., In re Chrysler, LLC, 576 F.3d 108, 119 (2d Cir.
2009) (agreeing with the bankruptcy court’s ruling that “although the [objecting
parties] did not themselves consent to the release, consent was validly provided by the
collateral trustee, who had authority to act on behalf of all first lien credit holders”);
agreements prohibits the Agent from exercising rights that are consistent with
[Section] 363(k) of the Bankruptcy Code.”), aff’d, 421 B.R. 620 (S.D.N.Y. 2009);
In re GWLS Holdings, Inc., No. 08-12430, 2009 WL 453110, at *6 (Bankr. D. Del. Feb. 23,
2009).

As for the treatment that objecting lenders receive when an agent credit bids, some
successful bidders agree to “cash out” dissenting lenders—that is, the successful bidder
provides a cash payment to other lenders in an amount equal to the amount of recovery
they would have received had the credit bid been a cash bid. In other instances,
however, a successful bidder places the newly acquired collateral into a new entity and
distributes equity in that entity to all of the members of the lending syndicate based on
their pro rata interests in the underlying loan.

Some dissenting lenders have objected to the treatment they receive from the successful
bidder, but bankruptcy courts have generally labeled these as “intercreditor” matters
and declined to address them in the context of the bankruptcy case. See, e.g., In re
Metaldyne Corp., 409 B.R. at 679-80 (finding that disputes over the consideration
minority lenders were to receive “raise issues concerning an intercreditor dispute or a
dispute between [minority lender] and the Agent, neither of which is properly before
this Court at this time, if they ever could properly be brought before this Court.”); In re
GWLS Holdings, Inc., 2009 WL 453110, at *5-6 (declining to determine whether
minority lien holder had causes of action against majority lien holders or agent on
account of distribution of proceeds from sale).
Rights in Collateral, Other Assets

A relatively new debate in the credit bidding arena is whether and how lienholders can credit bid when there is one sale at which the assets being sold consist of both (i) the secured lender’s collateral and (ii) other assets that are encumbered by the liens of unrelated creditors or are completely unencumbered. To continue with the trucking illustration discussed earlier, assume that in addition to borrowing $100 from B to purchase a truck, C also borrows $100 from a different bank (D) to purchase a trailer for the truck. Unlike B, however, D does not perfect a security interest in the trailer. Now assume that C files a petition under the Bankruptcy Code and seeks to sell both the truck and the trailer in one 363 sale. An issue arises if B seeks to bid on both of C’s assets in a 363 sale and if B wishes to credit bid the debt on the truck in the sale.

The issue in such a circumstance stems from two coexisting axioms. First, a party may not credit bid on assets upon which it does not have a lien. And second, a secured party may not (in most circumstances) be denied the right to credit bid on its collateral when that collateral is sold in a 363 sale.[3]

A party should not be permitted to use credit bid dollars to acquire unencumbered assets because to do so would deprive unsecured creditors of the recoveries to which they are rightfully entitled on account of the sale of the unsecured assets. For instance, it would be unfair to D if B were permitted to purchases both C’s truck and its trailer solely with a credit bid. D is entitled to some portion of the value that C receives on account of the sale of the trailer. If B purchases the trailer with credit bid dollars, however, there will be no cash to distribute to D on account of its unsecured claim (if C has other cash available to pay claims, then B’s credit bid does benefit D, at least indirectly, by reducing the amount of C’s indebtedness).

The other axiom is also true: the right to credit bid is generally available (at least under Section 363) to secured creditors (especially undersecured creditors) when their properly liened collateral is sold in a sale conducted pursuant to Section 363 of the Bankruptcy Code. Assume B is owed $75 on the truck, but the truck would only yield $50 in a sale. The Bankruptcy Code protects B, a secured creditor, by permitting B to credit bid on the truck (i.e., its collateral) if the truck is sold in a 363 sale. See In re
Philadelphia Newspapers, LLC, 418 B.R. 548, 563 (E.D. Pa. 2009) (citing H & M Parmley Farms v. Farmers Home Admin., 127 B.R. 644, 648 (D.S.D. 1990)) (“The ability to credit bid provides a weapon for a secured creditor who is dissatisfied with a potential sales price to increase the bid to what it deems to be fair market value, thereby protecting the benefit of its bargain.”). The right to credit bid protects B because it enables B to choose to take the collateral rather than accept an amount that is less than what it is owed.

Because secured creditors have rights vis-à-vis their collateral, and because unsecured creditors have rights in connection with assets of the estate that are unencumbered, additional sales procedures are needed when a secured creditor seeks to credit bid at a sale in which its collateral is being sold alongside other assets that are unencumbered. These additional procedures should ensure both that (i) the secured lender is permitted to credit bid for its collateral and (ii) no credit bid dollars are allowed to be used to acquire unencumbered assets.

One option would be for C to conduct two consecutive sales. This is a solution (albeit a simplistic one) because it isolates B’s collateral (the truck), enables B to credit bid on that collateral, and eliminates any risk that credit bid dollars would be used to acquire unencumbered assets. But this may not be a realistic alternative. Moreover, C may be able to enhance overall value of the collateral by conducting one joint sale.

When collateral and unencumbered assets are being sold together—and when a secured lender seeks to submit a “hybrid bid,” one that contains both cash and credit bid components—the seller should determine a minimum amount of cash—for purposes of this article, the minimum cash component—that must be included in any bid and allocated to the unencumbered assets. A seller should value the credit bid component of a hybrid bid on a dollar-for-dollar basis, so long as the hybrid bid also contains the minimum cash component.

Determining an appropriate allocation of value for the differing components of the sale package is the key task in a mixed asset situation.[4] Whether the seller makes such allocations on a consensual basis, or whether the bankruptcy court makes such allocation in a contested situation, the ultimate allocation should be reflected in the sale
order. This promotes clarity, protects the sellers by recording the allocation determination in an official court order, and ensures that all parties are on notice as to the value allocation.

**Setting the Minimum Cash Component**

If C sells the truck and the trailer in one 363 sale, and B seeks to purchase both assets via a hybrid bid, then C must devise a process that both (i) ensures B’s right to credit bid and (ii) protects the recovery for D. One approach would be to require B’s hybrid bid to contain a minimum cash component that is at least equal to the trailer’s net forced liquidation value.[5] As the purchaser, this is the approach that B would favor because it provides B with maximum flexibility in terms of using cash or credit bid dollars to acquire the assets. Another option would be to set the minimum cash component as the book value of the trailer. As an unsecured creditor, this is the approach that D would favor because, in theory, it would increase the amount allocated to the unencumbered assets. This, in turn, would increase the amount that D would expect to receive on account of its unsecured claim. Finally, a third option would be to use the estimated market value of the trailer to establish the minimum cash component.

B would argue that the credit bid component of its hybrid bid should be valued on a dollar-for-dollar basis, so long as its hybrid bid allocates an amount in cash at least equal to the net forced liquidation value of the trailer. Often, B would be acting as the stalking horse bidder and, as such, would seek to bid as little as possible. From C’s perspective, the alternative to a successful 363 sale will often be a prompt forced liquidation. Therefore, C may be willing to accommodate B (by using B’s preferred minimum cash component) to ensure the 363 process moves forward.

Moreover, C recognizes that setting the minimum cash component as the net forced liquidation value does not prejudice D in the stalking horse (pre-auction) process because D would only receive net forced liquidation value if the 363 process failed. B would further insist that the lower minimum cash component is fair because even after C sets the minimum cash component, B’s hybrid bid still must provide the most overall value to the estate in order to prevail.[6] Therefore, B would argue that it is in the best interest of the estate, overall, to ensure that B has a full and fair opportunity to credit
bid. B would contend that setting the minimum cash component at the trailer’s net forced liquidation value benefits the estate and is the only way to truly preserve B’s credit bidding rights.

D might argue that the credit bid component of B’s hybrid bid should only be valued on a dollar-for-dollar basis if the minimum cash component equals the trailer’s book value. D would likely assert that (i) value is added by the fact that the truck and the trailer are being sold together (as a “going concern”); (ii) unsecured creditors (like D) should be entitled to enjoy the benefits of this enhanced value; and (iii) allowing B to acquire the trailer with a cash component below book value deprives D of this benefit to which it should be entitled.

A third approach would use the trailer’s market value to determine the appropriate minimum cash component. If the trailer would only yield net forced liquidation value if sold on its own (i.e., if the trailer’s net forced liquidation value and its market value are the same), then it is arguably equitable to establish the minimum cash component by using net forced liquidation value. As noted earlier, B’s bid would still have to provide the most overall value to the estate in order to prevail (the credit bid component of B’s hybrid bid provides value to the estate by reducing, on a dollar-for-dollar basis, the estate’s secured indebtedness).

If the trailer would generate more than its net forced liquidation value if sold on its own, however, then C (and a judge overseeing the 363 sale of C’s assets) may seek to use the trailer’s market value to set the minimum cash component.[7] It may be difficult, from a valuation perspective, to calculate the trailer’s market value if it were sold on its own. However, to the extent this can be calculated, C and the judge may argue that that amount should be used to establish the minimum cash component because it ensures that D gets at least some benefits of a going concern sale.

Often the market value will be lower than the book value (thus at least partially frustrating the unsecured creditors). But the market value may be higher than net forced liquidation value. Therefore, using market value to set the minimum cash component may provide unsecured creditors with a greater recovery than they would receive under the approach the secured creditors prefer.
Protecting All Parties

In sum, when a company sells its assets pursuant to Section 363 of the Bankruptcy Code, and when certain of the assets being sold are encumbered and others are unencumbered, interested parties in the case should insist that the bankruptcy court adopt additional sales procedures to protect the rights of all parties. A seller should set a minimum cash component allocable to the unencumbered assets and then only value the credit bid component of a hybrid bid on a dollar-for-dollar basis if the hybrid bid contains at least the minimum cash component. The difficulty will lie in determining the minimum cash component. Nevertheless, this process is essential to (i) protecting unsecured creditors; (ii) safeguarding secured creditors’ right to credit bid in a 363 sale; and (iii) maximizing value of the estate.

[1] See the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), P.L. 109-8. Several provisions of BAPCPA increased pressure on debtors’ liquidity. For example, after BAPCPA, claims for goods received by a debtor in the ordinary course of business within 20 days before commencement of the case are entitled to administrative expense priority status, and the reclamation period is extended to 45 days. 11 U.S.C. Sections 503(b)(9), 546(c). Utility providers are entitled to more robust deposits because BAPCPA modified the requirements of “adequate assurance.” 11 U.S.C. Section 366. Also, a reorganizing company that may be relying on a tax refund as an important source of cash may be prevented from receiving the cash until audits of all prior years have been completed because governmental entities are authorized to withhold money owed from refunds notwithstanding the automatic stay. 11 U.S.C. Section 362(b). BAPCPA’s provisions related to labor issues can further strain a debtor’s liquidity: BAPCPA increased wage priority caps for wages earned 180 days before filing; allowed retiree benefits modified within 180 days of bankruptcy to be reinstated; and permitted back pay awarded postpetition to be granted administrative priority, even for prepetition conduct. 11 U.S.C. Sections 503(b)(1)(A)(ii), 507(a)(4); 1114(l). Furthermore, BAPCPA limited extensions to the time the debtor has to propose
a plan and reject leases of real property, both of which constrain a debtor's flexibility and may limit access to postpetition financing. 11 U.S.C. Sections 365(d)(4), 1121(d).

[2] Some courts have recently questioned whether secured creditors have an absolute right to credit bid when their collateral is sold at a sale conducted in connection with a plan of reorganization. See, e.g., In re Philadelphia Newspapers, LLC, 599 F.3d 298 (3d Cir. 2010); Scotia Pacific Co., LLC v. Official Unsecured Creditors’ Committee (In re Pacific Lumber Co.), 584 F.3d 229 (5th Cir. 2009); but see In re River Road Hotel Partners, LLC, No. 09-30029 (Bankr. N.D. Ill. Oct. 5, 2010) (Docket No. 462) (denying a debtor's bid procedures motion because, even though the sale was being conducted pursuant to a plan, there was no cause shown to deny credit bidding). Whether credit bidding should be available as a matter of right in connection with sales transactions that are part of a plan of reorganization remains an open question that is outside the scope of this article.

[3] Section 363(k) does enable a court to deny a creditor the right to credit bid “for cause.” However, “cause” to prevent a creditor from exercising its right to credit bid is generally limited to situations where (i) there has been collusion between the debtor and the secured creditors in an effort to prevent certain other creditors from collecting on their claims, see In re Theroux, 169 B.R. 498, 499 (Bankr. D.R.I. 1994); (ii) claims of senior creditors would not be satisfied, see In re Valley Bldg. Supply, Inc., 39 B.R. 131, 133 (Bankr. D. Vt. 1984); or (iii) there has been a failure to comply with the bid procedures, see In re Diebart Bancroft, Nos. 92-3744, 92-3745, 1993 WL 21423, at *5 (E.D. La. Jan. 26, 1993).

[4] Even if a debtor sells secured and unencumbered assets together to an all cash bidder, the debtor still must decide how much of the purchase price to allocate to secured assets and how much to allocate to the unencumbered assets (this is necessary in order to properly distribute the proceeds of the sale).

[5] Net forced liquidation value refers to the estimated value of the assets if they are liquidated as quickly as possible and on their own (i.e., not as part of a “going concern”), less expenses incurred on account of such liquidation.
[6] This does not factor in other criteria that a seller may use in determining what is the highest or otherwise best bid and simply focuses on comparing consideration on an “apples-to-apples” basis.

[7] The market value of the trailer might be higher if sold together with the truck than it would be if the trailer were sold on its own. D may argue—since the truck and the trailer are, in fact, being sold together—that C should use the market value of the trailer if sold together with the truck to establish the minimum cash component. B would argue that the lower figure should be used, again, because B still must have the highest overall bid to win. In theory, there could be four separate valuations for unencumbered assets—(i) net forced liquidation value; (ii) market value if the unencumbered assets were all sold together, but separate from the secured assets; (iii) market value of the unencumbered assets if all the assets (secured and unsecured) were sold together; and (iv) book value. In many cases, however, (i) and (ii) will be the same. Further, it may be difficult to differentiate as between (ii) and (iii). If the sale price for the truck and trailer sold together would, in fact, be higher than the sum of the sale prices of the two items sold separately, it is difficult to determine how to allocate the extra value as between the truck and the trailer for purposes of establishing a minimum cash component.

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