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Two New Cases Cast A Shadow Over **Credit Bidding**

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Two recent bankruptcy court decisions have increased uncertainty over the right of secured creditors to credit bid in sales of debtors' assets. Relying on and expanding a rarely used "for cause" limitation on a secured creditor's right to credit bid under §363(k) of the Bankruptcy Code, these decisions may ultimately affect credit bidding rights in a broad swath of cases.

Whereas courts have historically found "cause" to limit credit bidding in the limited circumstances where there is a bona fide dispute regarding the extent or validity of a secured claim or egregious conduct on the part of a secured creditor, recent decisions in *Fisker Automotive Holdings*[1] and *Free Lance-Star Publishing*[2] have suggested that merely the furtherance of general bankruptcy goals, such as the desire to foster a competitive bidding environment, might constitute "cause" sufficient to limit credit bidding rights.

It remains to be seen whether these cases will be followed or narrowly interpreted. But by increasing uncertainty with respect to the rights of secured creditors in bankruptcy sales, these decisions have the potential to have a dramatic and deleterious impact on the market for secured claims.

The Right to Credit Bid

Section 363(k) of the Bankruptcy Code provides secured creditors the right to "credit bid" the value of their debt in certain auctions or sales of their collateral—effectively exchanging all or a portion of the secured creditors' debt for the assets securing it.[3] Credit bidding provides protection to a secured creditor against the sale of the creditor's collateral at a depressed price without the need to commit additional cash.[4] Importantly, regardless of the value of the collateral, a secured creditor is empowered "to bid the total face amount of [its] claim."[5]

Section 363(k) includes a safety valve, whereby a court may limit or disallow credit bids "for cause." This exception has only been discussed in a handful of reported decisions, and in previous cases sufficient cause was usually limited to a bona fide dispute over the validity of the relevant claim or lien[6] or misconduct by the secured creditor.[7] Otherwise, courts have described the right to credit bid as "fundamental"[8] and, while not absolute, near absolute.[9]

Expanding the 'For Cause' Limitation

On Nov. 13, 2013, Fisker Automotive filed for Chapter 11 protection in the U.S. Bankruptcy Court for the District of Delaware. Prior to the bankruptcy filing, Hybrid Tech Holdings had purchased a $168.5 million senior secured claim against Fisker from the U.S. Department of Energy for $25 million. Hybrid then negotiated with Fisker to buy substantially all of its assets in a bankruptcy sale for a $75 million credit bid. The official committee of unsecured creditors (the Creditors' Committee) appointed in Fisker's case objected to the sale, arguing that Hybrid's credit bid should be capped at the $25 million Hybrid paid for the claim.[10]

The Creditors' Committee's argument hinged on the appearance of a competing potential purchaser, Wanxiang America Corporation, which would participate in an auction for Fisker's assets only if Hybrid's credit bid were limited. Importantly, Fisker and the Creditors' Committee stipulated that if Hybrid's credit bid were capped at $25 million, "there [would be] a strong likelihood that there would be an auction that has a material chance of creating material value for the estate over and above the present Hybrid bid" and that if Hybrid's credit bid were not capped, "there [would be] no realistic possibility of an auction."[11]

Relying largely on this stipulation, the bankruptcy court held that a "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*."[12]

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Finding that permitting Hybrid to credit bid $75 million would not just chill bidding, but "freeze bidding," the court capped Hybrid's credit bid at $25 million. Wanxiang ended up as the successful bidder at the auction for Fisker's assets with a $149.2 million cash bid.[13]

It is worth noting that the court seems to have been at least partly motivated by the more traditional factors used to limit credit bidding for cause. The court wrote that Hybrid had "insisted on an unfair [sale] process, i.e., a hurried process," and that "the validity of its secured status had not been determined."[14] However, the thrust of the court's ruling emphasized the effects of an uncapped credit bid on the auction process—a rationale that, standing alone, had not been used before by a court to restrict a credit bid.

Recently, a second bankruptcy court adopted in part *Fisker*'s rationale in limiting a credit bid. On Jan. 23, 2014, Free Lance-Star Publishing Company filed for Chapter 11 protection with the intent of selling substantially all of its assets in a §363 sale. Free Lance-Star argued that its secured creditor, DSP Acquisition, should have its credit bidding rights restricted for three reasons: (1) DSP did not have a valid lien on all of the property being sold, (2) DSP had engaged in inequitable conduct that had "damped interest in the auction" and (3) restricting DSP's credit bid would "restore enthusiasm for the sale and foster a robust bidding process."[15] Free Lance-Star's first two rationales are in line with the historic standards for limiting a credit bid, but the third rationale follows Fisker's expansion of those standards.

The bankruptcy court relied upon all three rationales to limit DSP's credit bid, finding a "perfect storm, requiring the curtailment of DSP's credit bidding rights."[16] According to the court, DSP pressured the debtor for a "speedy bankruptcy filing," objected to the debtor's hiring of a financial advisor to market the assets, and insisted that any marketing materials contain "on the front page, in bold font, a statement that DSP had a right to a $39 million credit bid."[17] Moreover, the court found that DSP had secretly recorded financing statements with respect to assets over which DSP knew it did not have liens.[18]

After an evidentiary hearing, the court concluded that DSP's credit bid should be capped at a total of $13.9 million. It is not clear from the ruling or the record of the hearing (which was partially conducted under seal) how the cap was determined. The court noted merely that it relied on Free Lance-Star's financial advisor, which "eliminated the unencumbered assets … and applied a market analysis to develop an appropriate case for a credit bid that would foster a competitive auction process."[19] DSP ended up as the winning bidder for Free Lance-Star's assets, but instead of a $39 million credit bid, it paid $16.3 million in cash on top of its $13.9 million credit bid.[20]

Takeaways

It is too early to tell if other courts will adopt *Fisker*'s expanded rationale for restricting credit bidding, but secured creditors of distressed companies have reason to be concerned. Viewed most expansively, *Fisker* stands for the proposition that a credit bid can be restricted absent any indication of misconduct or challenges to the creditor's liens or claims.

Importantly, the facts of both *Fisker* and *Free Lance-Star* may have exhibited the historic bases for finding cause to limit a credit bid. The court in *Fisker* found that the sale process Hybrid imposed was "inconsistent with the notions of fairness in the bankruptcy process" and amounted to an attempt to "short-circuit the bankruptcy process."[21] The court in *Fisker* also questioned the allowed value of Hybrid's secured claims.[22]

Likewise, the court in *Free Lance-Star* discussed at length what it viewed to be "inequitable" conduct by DSP.[23] The court's reliance on that conduct, and the fact that DSP's claim was not secured by all of the assets being sold, aligns closely with pre-*Fisker* precedent.

Neither court was faced with a secured creditor with unimpeachably clean hands and unchallenged liens. Moreover, the next reported decision limiting a credit bid post-*Free Lance-Star* had "no occasion to address *Fisker*'s rationale" because the debtor "expressly disavow[ed] any reliance" on that decision.[24] In that case, the court held that potential challenges to the secured creditor's liens did not warrant a limitation on credit bidding, but the court did limit the credit bid to the extent necessary to pay a cash break-up fee to the "stalking-horse" bidder.[25]

However, there are important takeaways from both decisions in any event. First, both *Fisker* and *Free Lance-Star* can be viewed as reactions by bankruptcy courts to what they viewed as "loan-to-own" investors seeking to exert excessive control over debtors and the bankruptcy process.[26] Secured creditors are well advised to be sensitive to how they may be viewed by courts when negotiating with distressed companies and seeking to craft and implement sales on a tight timeline. These negotiations could ultimately be subject to scrutiny by a court and a potentially hostile official committee of unsecured creditors.

Second, bad facts make bad law, and these decisions will certainly be relied upon in future bankruptcy cases by debtors, committees and other parties that are seeking to limit secured creditors' rights to credit bid. *Fisker* and *Free Lance-Star* provide these parties with additional leverage to negotiate concessions from secured creditors. In this regard, the uncertainty engendered by both decisions is likely to live long past their facts.

Third, while there is no indication that either court viewed the distressed purchase price of the secured debt as particularly relevant to its analysis, the court in *Fisker* did cap Hybrid's credit bid at the $25 million Hybrid paid for the secured debt. This fact will undoubtedly be raised in future bankruptcy cases as an argument for limiting credit bids based on claims purchased at a discount. Ultimately, however, the amount of the credit bidding cap in *Fisker* appears to have been happenstance: The court relied upon a stipulation between Fisker and the Creditors' Committee that $25 million was the limit that would permit a robust auction process.[27]

Whether or not the *Fisker* and *Free Lance-Star* expansion of the "for cause" limitation is ultimately adopted by other courts, in the near term, the increased uncertainty and additional lines of attack regarding credit bidding rights will likely negatively impact the market for secured claims of distressed companies.

1. No. 14-CV-99 (GMS), 2014 WL 210593 (Bankr. D. Del. Jan. 17, 2014).
2. Case No. 14-30315-KRH, 2014 Bankr. LEXIS 1611 (Bankr. E.D. Va. April 14, 2014).
3. 11 U.S.C. §363(k).
4. See *RadLAX Gateway Hotel v. Amalgamated Bank*, 182 L. Ed. 2d 967, 973 n.2 (2012).
5. *In re Submicron Systems*, 432 F.3d 448, 459 (3d Cir. 2006).
6. See, e.g., *In re L.L. Murphrey*, No. 12-03837-8-JRL, 2013 WL 2451368 (Bankr. E.D.N.C. June 6, 2013) (restricting a credit bid due to issues regarding the validity of the relevant liens); *Morgan Stanley Dean Witter Mortg. Capital v. Alon USA LP (In re Akard Street Fuels, L.P.)*, Civ. A. No. 3:01-CV-1927-D, 2001 U.S. Dist. LEXIS 21644 (N.D. Tex. Dec. 4, 2001) (same).
7. See, e.g., *In re Aloha Airlines*, Case No. 08-00337, 2009 Bankr. LEXIS 4588 (Bankr. D. Haw. May 14, 2009) (denying a secured creditor the right to credit bid due to misconduct, including creating side deals with a competitor regarding the sale of confidential information).
8. *Paul T. v. Fifth Third Mortg. Co. (In re J & M Salupo Dev. Co.)*, 388 B.R. 795, 803 n.2 (B.A.P. 6th Cir. 2008).
9. *In re Phila. Newspapers*, 599 F.3d 298, 315-16 (3d Cir. Pa. 2010) (collecting cases showing the right to credit bid is not absolute because the court may deny a credit bid for cause).
10. *Fisker*, No. 14-CV-99 (GMS), 2014 WL 210593, at *4 n.2.
11. Id. at *2.
12. Id. at *4-5 (emphasis added) (quoting *Phila. Newspapers*, 599 F.3d at 315-16).
13. See Tom Hals, "Court clears sale of hybrid car maker Fisker to China's Wanxiang," REUTERS (Feb. 18, 2014, 12:32 PM), http://www.reuters.com/article/2014/02/18/us-fisker-wanxiang-sale-idUSBREA1H1LM20140218.
14. *Fisker*, No. 14-CV-99 (GMS), 2014 WL 210593, at *6.
15. *Free Lance-Star*, 2014 Bankr. LEXIS 1611, at *19.
16. Id. at *25.
17. Id. at *11-13.
18. Id. at *14-15 (the court noted that DSP attempted to obtain liens on those assets as part of an adequate protection package in the bankruptcy proceeding, indicating that DSP understood it did not previously have liens on those assets).
19. Id. at *24-25.
20. See Maria Chutchian, "Free Lance-Star Newspaper Co. Gets Go-Ahead For $30M Sale," LAW360 (May 28, 2014, 6:26 PM), http://www.law360.com/private-equity/articles/542270?nl_pk=b91a5140-350f-4c60-b97d-24cb9a2c6f03&utm_source=newsletter&utm_medium=email&utm_campaign=private equity.
21. See *Fisker*, No. 14-CV-99 (GMS), 2014 WL 210593, at *5.
22. Id. at *5.
23. *Free Lance-Star*, 2014 Bankr. LEXIS 1611, at *22.
24. *In re Charles St. African Methodist Episcopal Church*, Case No. 12-12292-FJB, 2014 Bankr. LEXIS 2264 at *9 (Bankr. D. Mass. May 14, 2014).
25. Id. at *16.
26. See *Free Lance-Star*, 2014 Bankr. LEXIS 1611, at *22, 25; *Fisker*, 2014 WL 210593, at *5.
27. *Fisker*, 2014 WL 210593, at *6.