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Resolved: Loan-to-Own DIP Lenders Should Not Be Allowed to Credit Bid

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PRO: LOAN-TO-OWN DIP LENDERS SHOULD NOT BE ALLOWED TO CREDIT BID

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<u>**INTRODUCTION**</u>[1]

With the emergence of non-traditional lenders, hedge funds and private equity groups, the “loan-to-own” phenomenon has become prevalent. The “loan-to-own” investment is one where a lender’s investment is turned into a controlling equity position in the reorganized debtor. John J. Rapisardi, *Bankruptcy Practice: Problems in Distressed Loan-to-Own Investments*, 237 N.Y.L.J. 3rd (col. 1). The existence of these non-traditional lenders in many recent Chapter 11 cases places the efficacy of Section 363(k) of the Bankruptcy Code into question. The ability of a secured creditor to credit bid its debt in the sale of its collateral has for many years been permitted as an accepted mechanism for a secured creditor to protect its collateral. However, the credit bid has turned from a shield to a sword. Credit bids today are used by non-traditional lenders as part of a loan-to-own strategy to gain leverage over the 363 sale process and purchase a debtor’s assets free and clear of liens and encumbrances – gaining all the benefits of chapter 11, but leaving unsecured creditors with little or no recovery. This development may warp the fundamental purpose of Chapter 11 and should be questioned.

Loan-to-own lenders are typically prepetition lenders or equity holders who provide debtor-in-possession (“DIP”) financing in connection with a stalking horse asset purchase agreement to purchase substantially all of the debtor’s assets. These transactions take the reorganization out of the hands of the debtor and its creditors using certain common terms, including by providing that: the DIP financing is contingent upon the sale, the sale will take place in a shortened time frame, the lender has the ability to credit bid its debt (both prepetition

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[1] The views expressed in this article do not represent the views of Foley & Lardner LLP, but are presented solely for the purpose of a scholarly debate on the topic to be presented at the ABI’s 25th Annual Spring Meeting.

and DIP financing), the lender will receive a break-up or termination fee that may also be credit bid, creditors have a very limited time to challenge the amount of the lender's claim, and creditors have limited funds for any investigation.

Bankruptcy Courts should question whether the Chapter 11 process is being abused for the benefit of the loan-to-own lenders. While none of the provisions of a loan-to-own transaction are illegal, the sum of the parts may violate the fundamental purpose of Chapter 11. In order to prevent this apparent inequity, Bankruptcy Courts should consider exercise their discretion to disallow credit bidding by loan-to-own lenders.

Credit Bidding By Loan to Own DIP Lenders Contravenes the Fundamental Purpose of Chapter 11

The fundamental purpose of chapter 11 is to rehabilitate the debtor for the benefit of all its creditors, and provide the debtor with a "fresh start". See, e.g., Pioneer Investment Services Company v. Brunswick Associates Limited Partnership, 507 U.S. 380, 389 (1993) ("Whereas the aim of a Chapter 7 liquidation is the prompt closure and distribution of the debtor's estate, Chapter 11 provides for reorganization with the aim of rehabilitating the debtor and avoiding forfeitures by creditors."); Local Loan Company v. Hunt, 292 U.S. 234, 244 (1934) (quoting Williams v. U.S. Fidelity & Guaranty Company, 236 U.S. 549, 554-55 (1915)) ("One of the primary purposes of the Bankruptcy Act is to 'relieve the honest debtor from the weight of oppressive indebtedness, and permit him a start afresh free from the obligations and responsibilities consequent upon business misfortunes.'").

Chapter 11 was further intended to govern situations where the potential for a meaningful recovery exists for unsecured creditors. This is clear from the Bankruptcy Code's provision for the mandatory appointment of an unsecured creditors' committee in chapter 11 cases other than small business cases. See 11 U.S.C. § 1102(a)(1) (" . . . as soon as practicable after the order for relief under chapter 11 of this title, the United States trustee *shall* appoint a committee of creditors holding unsecured claims . . ."). The legislative history of the Bankruptcy Code makes it clear that the unsecured creditors' committee was intended to play a key role in chapter 11 plan formulation. Specifically, with respect to section 1102, Congress noted:

> This section provides for the appointment of creditors' and equity security holders' committees, which will be the primary negotiating bodies for the formulation of the plan of reorganization. They will represent the various classes of creditors and equity security holders from which they are selected. They will also provide supervision of the debtor in possession and of the trustee, and will protect their constituents' interests.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 235 (1978), 401, reprinted in 1978 U.S.C.C.A.N. 5963, 6357.

When a loan-to-own lender is permitted to credit bid its debt, Chapter 11 becomes a tool for the purchase of the Debtor's property free and clear of the claims against the Debtor. No longer does the case involve a negotiation between the debtor and the creditors' committee over the best way to recover assets for unsecured creditors. Instead, the bankruptcy is usually filed for the purpose of fulfilling a sale to the DIP lender and the procedures provide little opportunity for competition or review. Due to the advantage the DIP lender has in the process, rarely does it result in any benefit to other creditors. As a result, such circumstances appear contrary to the fundamental purpose of Chapter 11 and should be questioned.

<u>A DIP Lender's Credit Bid Chills The Bidding Process and Gives the DIP Lender an Unfair Advantage</u>

The loan-to-own transaction including ability to credit bid its debt, provides the lender with an unfair advantage in the bidding process. The overwhelming trend among the non-traditional lenders is to structure a transaction with a troubled company as a sale under Section 363 of the Bankruptcy Code with DIP financing. Providing for DIP financing allows the lender to exert substantial control over the reorganization. This control is first found in the documents governing the sale and financing.

The DIP financing and sale documents are drafted in such a way as to make a sale to the DIP lender a *fait accompli*. Essentially, no other result is allowed. The documents will generally provide that DIP financing is contingent upon the sale proceeding at a certain rate and certain benchmarks are established. Anything that frustrates the sale to the DIP lender, including entry into an alternative transaction or the court's failure to approve the sale to the DIP lender, or that delays the sale process, will cause the DIP financing to terminate. Accordingly, if the Debtor is in need of DIP financing to continue its operations, as most are, creditors and the court are forced to move the sale along quickly in order to preserve the value of the assets, despite the effect such a rushed transaction may have on the auction process. The purchase agreement is likewise dependent upon the DIP financing. If the DIP financing is not approved, the asset purchase agreement is terminated. Accordingly, the process is designed from the outset to produce a sale to the DIP Lender.

As a DIP lender and the stalking horse purchaser, the loan-to-own lender has the ability to also dictate how the sale will proceed, including bidding procedures, timing of the sale, break-up fees and expense reimbursements, and the parameters for any challenge to its lien position or claim (as discussed further herein).

The loan-to-own lender's control over the process and its ability to credit bid its claim, discourage other bidders from becoming involved in the process. According to the Third Circuit Court of Appeals in the case of <u>Cohen v. KB Mezzanine Fund II, (In re SubMicron Systems Corp.)</u>, 432 F.3d 448, 459 (3rd Cir. 2006), lenders are permitted to credit bid the face amount of their proof of claim and not just the secured amount. The rationale for such decision is that the lender's secured claim is based on the fair market value, which is never more accurately determined than by what a willing buyer would pay at an auction. Id. at 460. According to the SubMicron decision, this process works because a secured creditor will never bid more than it thinks it can recover from the asset Id. While this rationale makes sense with a traditional secured lender, it does not apply in the case of a loan-to-own lender whose goal is to purchase the assets of the company. In the loan-to-own scenario, there is little incentive for the lender not to bid the full amount of its claim, regardless of the value of the property. There is no downside to the secured lender bidding the full amount of its claim because the unsecured portion of its claim is unlikely to result in a recovery in any event. Why not bid the entire amount? Allowing the lender to credit bid its claim in these situation merely insures that no competitive bidding will occur and that the lender will obtain the Debtor's property for the price of its loan, as planned.

The result is that loan-to-own lenders bid the full amount of their claim, even if it is greater than the value of the assets, usurping the value of the property. One Bankruptcy Court described the situation accordingly:

> [I]f an undersecured creditor was allowed to credit-bid, this "bidding in" could give rise to "roundhousing" whereby an undersecured creditor can bid in excess of its secured claim, up to and including the total amount of both its secured and unsecured claims, confident in the knowledge that substantially all, if not all, of the funds paid for the reorganized debtor would be returned in partial or total satisfaction of its claims. By doing so, such a creditor could appropriate all going-concern value in the debtor to itself and share no infusion of value through the bid price with other creditors.

In re Moonrake Associates, Ltd., 200 B.R. 950 (Bankr. N.D. Ga. 1996), citations omitted.

With a credit bid greater than the value of the assets, other potential bidders are unlikely to even investigate a potential transaction. The chilling effect of such a credit bid is heightened further when a topping fee or break-up fee is considered – also typical terms in these transactions. For example, in the SubMicron case, secured creditors worked together to create a pre-packaged chapter 11 to purchase the debtor's assets. Their bid consisted of a credit bid of their claims plus just enough cash to pay off a superior lienholder and administrative expense claims. Id. at 454. No other bidders participated in the auction and unsecured creditors were left with no assets for recovery. Id.

In this loan-to-own transaction, the lender eats up the value of the property while unsecured creditors are left with little or no recovery. Bankruptcy Courts should question whether such a practice violated the fundamental purpose of Chapter 11 and should be reformed.

The DIP Lender's Credit Bid Prevents a Meaningful Challenge to its Claim

The limited ability of creditors to challenge the credit bid before the auction also weighs against allowing DIP lenders to credit bid their liens. Lenders who make loans to troubled companies with the hope or plan that such a loan will result in the acquisition of a controlling equity interest naturally consider their own interests in dealing with the troubled company. The lender has an interest in the company entering bankruptcy with no unencumbered assets and in some cases, the lender's actions open the door for an attack by creditors. In fact, generally speaking, with a loan-to-own lender, this is a creditor's only source of leverage or recovery. Creditors' committees may challenge the lender's claim under theories of fraudulent transfer, recharacterization of debt as equity, marshalling and equitable subordination.

In recent years, however, the loan-to-own lender has used its position to limit a creditors' ability to challenge their debt. According to the terms of section 363(k), only holders of an "allowed claim" may credit bid. Consequently, the holder of a lien that has not been determined to be valid may not bid its lien. See National Bank of Commerce of El Dorado v.

McMullan (In re McMullan), 196 BAR. 818, 835 (Bankr. WAD. Ark. 1996); L. King, Collier on Bankruptcy, at ¶ 363.09 n.1 (15th ed. Rev. 2006). See also In re Medical Software Solutions, 286 B.R. 431 (Banker. D. Utah 2002) (holding that section 363(k) only permits creditors with a valid secured claim to credit bid); John Hancock Mutual Life Ins. Co. v. California Hancock, Inc. (In re California Hancock, Inc.), 88 B.R. 226, 230 (9th Cir. B.A.P. 1988) (creditor may only bid amount of allowed claim under section 363(k)).

To assure their ability to credit bid, loan-to-own lenders provide for their credit bid in the bidding procedures and then require the Debtor to admit the amount of its claim in the DIP loan documents. These are documents that are approved, at least on an interim basis, within days after filing a case and usually before a creditors' committee is appointed. These procedures usually only allow a creditors' committee a short period of time in order to investigate and bring any objections or claims against the lender. Realistically, in any event, in order to have any impact on the sale, any challenge must be brought and decided before the auction even takes place. Ideally, any challenges should be decided before the auction procedures are even published to the world. If the goal is to bring in as many bidders as possible, and allowing a lender a large credit bid deters the participation of other bidders, the right to challenge such credit bid can only truly be effective if it is resolved in time to be known by the public and by the world of potential bidders. Yet, the fast-track nature of these loan-to-own sales and the procedures dictated by the lenders prevent any timely resolution. Usually, the creditors' committee is also saddled with a small carve-out for its fees to perform such investigation. The result is, either the claim is never challenged prior to a sale or a challenge is put together in short period of time with little resources.

The lack of sufficient time and funding prevents a meaningful challenge to the lender's claim. In recent cases, creditors' committee's attempts to challenge these credit bids have fallen terribly short. Look for example at the recent decisions in <u>SubMicron Corp.</u> and the oft discussed <u>Radnor Holdings</u> decision. 353 B.R. 820 (Bankr. D. Del. 2006) Non-traditional lenders have lauded these decisions for curtailing creditor challenges, but they are prime examples of how the loan-to-own trend has caused movement away from the fundamental purpose of Chapter 11. <u>Radnor</u> was a typical loan-to-own transaction, but creditors in that case, likely saddled with few resources and very little time to investigate the lender's claim, were unsuccessful in their challenge and the lender purchased the debtor's assets using its credit bid. <u>Radnor</u> is an example of how the process hinders a creditors' committee's ability to negotiate a recovery for its creditors.

In <u>Radnor</u>, the loan-to-own lender and minority investor ("TCP") made three tranches of loans to debtors totaling $128 million. The first two tranches were extended on the same day that it purchased $25 million of Series A Preferred Stock. As part of the transaction, TCP and the debtors entered into an Investor Rights Agreement which gave TCP the right to name one member and one observer on the board of directors, to increase its representation on the board of directors if the debtors fail to meet certain EBITDA standards and the right to veto certain employment agreements and transactions with affiliates. The court noted that TCP never exercised these last two rights. In connection with all three tranches, TCP performed its due diligence and received solvency certificates from the debtors. The debtors projected to post $48 million in EBITDA for 2005.

The debtors failed miserably on their projections posting a negative $20 million EBITDA for 2005. As a result, TCP launched investigations into the debtors' operations and the reasons for the loss. The debtors, on the other hand, requested an additional advance from TCP claiming that this advance would meet its short-term liquidity needs and that the company still expected to exceed $60 million in EBITDA in 2006. On April 4, 2006, TCP agreed to advance the debtors an additional $23.5 million as tranche c. The debtors had requested an equity investment as opposed to a loan, but TCP was steadfast that it would only make an additional debt investment. Again, the debtors certified that they were solvent. As part of this new advance, TCP received additional rights and made certain demands. TCP was granted the right to name a Chief Operating Officer, but, according to the court, TCP apparently did not exercise this right when it agreed to the appointment of a turnaround management consultant to the position.

The holders of unsecured notes had the right to stop the tranche C loan because it exceeded the maximum indebtedness, but instead 95% of the noteholders consented. In fact, the debtors paid the noteholders $675,000 – half of a consent fee – for its consent. The debtors again fell short of their projections and within approximately three weeks of the tranche C loan, the debtors' banks recalculated its borrowing base information and determined that their revolving facilities were over-advanced. In June 2006 the lenders threatened to cut off funding under its working capital facility.

The debtors filed for bankruptcy on August 21, 2006 and TCP was the stalking horse bidder and DIP lender. In order to keep the sale on track and pursuant to the bidding procedures, the parties went to trial on TCP's claim only 103 days later.

The court rejected each of the committee's challenges. Focusing on the intent of the parties, as dictated by the Third Circuit in SubMicron, and applying a "common sense" approach to the facts, the court ruled that the loans could not be recharacterized as equity.

According to the court's findings, the parties at all times treated the loans as loans and nothing else. The court held that it was legitimate for an existing lender to extend additional credit to a distressed borrower as a means to protect its existing loan. "TCP's knowledge that the Debtors' were experiencing a liquidity crisis when the Tranche C Loans were made is insufficient to support recharacterization." Radnor, 353 B.R. at 839. The court found no wrongdoing by TCP. It also found that TCP did not have control over the debtors' day-to-day operations.

The Radnor decision is troubling for creditors. While the facts of the case were not ideal (noteholders consented to the tranche C loan), it creates a precedent that will be felt throughout the bankruptcy world. Additionally, the court placed little weight on facts which appeared to question the propriety of the credit bid. Using a "common sense" approach, the court states that TCP would not have made the loans to the debtors if it knew that the debtors were in such a financial crisis because it would not have taken the risk. Yet, the debtors in 2005 missed their EBITDA projections by $68 million. Could TCP really believe that after suffering a negative $20 million EBITDA that the company was still solvent and that it would meet its projected $45 million EBITDA for 2006? Was TCP truly unaware of the situation or was this precisely the reason TCP structured its transactions as debt rather than equity?

In Radnor, the committee presented expert testimony that because the debtors continued to operate after October 2005, taking on more debt to obtain working capital, the debtors' assets were reduced by $158 million that could have been available for unsecured creditors. If true, this is a disturbing result which highlights the issues presented in loan-to-own transactions.

Credit Bids Should Not Be Permitted In Loan-to-Own Transactions

In order to restore a process that gives all creditors a role in the reorganization, creditors must be provided a full and fair opportunity to investigate and have the court determine the allowed amount of the lender's claim in time to make an impact on the sale. Otherwise, Bankruptcy Courts should consider whether credit bids should not be permitted at all. While each of the provisions implemented by the loan-to-own lenders is technically permitted under the Bankruptcy Code, Bankruptcy Courts also have the ability to deny such lenders the ability to credit bid their claim.

Secured creditors do not have an absolute entitlement to credit bid under Section 363(k) of the Bankruptcy Code, and may be prevented from credit bidding "for cause." See, e.g., In re Theroux, 169 B.R. 498, 499 n.3 (Bankr. D.R.I. 1994) (noting that "there is no absolute entitlement to credit bid"). See also In re Takeout Taxi Holdings, Inc., 307 B.R. 525, 536 (Bankr. E.D. Va. 2004) (credit bid may be denied for cause); In re Diebart Bancroft, 1993 WL 21423 (E.D. La. 1993) (district court upheld bankruptcy court decision to deny credit bid for cause because cash needed to resolve lien dispute). "The term 'cause' is not defined in Section 363 of the Bankruptcy Code, but it is intended to be a flexible concept enabling a court to fashion an appropriate remedy on a case-by-case basis. Further, the language of §363(k) does not prohibit a bankruptcy court from placing conditions upon a secured creditor's ability to credit bid." In re NJ Affordable Homes Corporation, 2006 WL 2128624, *16 (Bankr. D.N.J. 2006).

Here, cause may exist as detailed above in that the credit bid chills bidding, inhibits competitive bidding and prejudices creditors who are unable to challenge the lender's claims in time to make an impact on the sale. Cause may further exist in that allowing the lender to credit bid frustrates the purpose of the sale.

Further, Bankruptcy Courts should consider whether the loan-to-own transactions violate the prohibition against sub rosa plans. The provisions of Section 1129 are sufficiently important that courts have refused to approve certain sales of an estate's assets if approval would have the effect of short-circuiting a formal plan of reorganization. See In re White Motor Credit Corp., 14 B.R. 584 (Bankr. N.D. Ohio 1981) (all asset sale under 363(b) conflicts with reorganization provisions of chapter 11); (footnote omitted); Pension Benefit Guarantee Corp. v. Braniff Airways, Inc. (In re Braniff Airways Inc.), 700 F.2d 935 (5th Cir. 1983) (refusing to permit 363 sale where financial provisions of the contemplated transaction were such that they had "the practical effect of dictating some of the terms of any future reorganization plan."); Committee of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983) (to approve a sale under section 363(b), a court must find a sound business reason to grant such an application.")

In Lionel the court cautioned that sales of substantially all of a debtors' assets outside of a plan of reorganization should only be permitted after stringent analysis of evidence to determine if there is a good business reason for the sale:

> In fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most vocal special interest groups; rather, he should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike. He might, for example, look to such relevant factors as the proportionate value of the asset to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-à-vis any appraisals of the property, which of the alternatives of use, sale or lease the proposal envisions and, most importantly perhaps, whether the asset is increasing or decreasing in value. This list is not intended to be exclusive, but merely to provide guidance to the bankruptcy judge.

Id.

Lionel's ruling is applicable in the loan-to-own context. Credit bidding in the situations described above makes it highly unlikely that any other potential bidder could bring a successful overbid and instead the estate is administered via the sale – a process over which creditors have very little influence. Such a process appears at odds with the fundamental purpose of Chapter 11.

In Loan-to-Own Transactions, Lenders Should be Required to Bid With Cash.

In order to restore the balance to the Chapter 11 process and to ensure that it is not used as a tool for hedge funds and private equity groups to purchase the assets of a troubled company, loan-to-own lenders should no longer be automatically permitted to credit bid their claims. As demonstrated above, the process currently in use assures a sale to the lender and prevents meaningful participation by unsecured creditors. Instead, creditors must sit back and hope for competing bidders which usually do not appear. In these cases, lenders should instead be required to bid cash for the debtor's assets. Cash only bidding will ensure that competing bidders are on even footing with the lender and will encourage truly competitive bidding to garner the highest and best price for the assets. Further, creditors will then have the time and opportunity to challenge the lender's claim without impacting the sale. Cash bidding gives creditors a meaningful challenge to the lender's claim and ensures that the auction process is a competitive one.

Lenders cannot be prejudiced by this process. If the lender is truly interested in purchasing the assets, it will bid in cash. To the extent the lender is determined to have an allowed secured claim, the lender's liens will attach to the sale proceeds and the lender will be paid in accordance with the Bankruptcy Code. The result is no different than in most other traditional asset sales. How can the lender object to such a process? Its lien position is never at risk and it maintains all the same rights it is provided under the Bankruptcy Code.

CONCLUSION

The loan-to-own phenomenon is changing the look of Chapter 11 for creditors. Instead of being a process geared toward the recovery for all creditors, the loan-to-own phenomenon appears to have converted Chapter 11 into a tool to ensure that the lender obtains the Debtor's assets free and clear of claims at the lowest possible price. In this context, credit bidding is no longer a shield, but it is a weapon used to ensure such a sale. As such, the bankruptcy courts should not be so quick to allow credit bidding, but should instead err on the side of requiring cash bids to even out the process and to provide the best recovery for all involved. It is true that the Bankruptcy Code does not prohibit the use of each of the terms utilized by loan-to-own lenders to gain control over the process. However, Bankruptcy Courts need to remember that they have the power to deny credit bidding for cause and consider whether preserving the Chapter 11 process and encouraging competitive bidding is sufficient cause under the circumstances.