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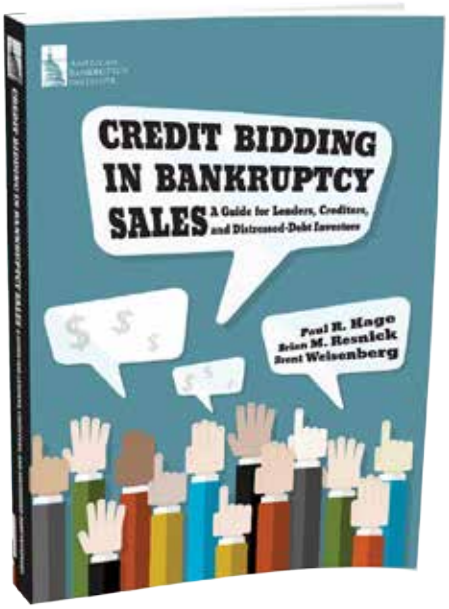

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CREDIT BIDDING – REVISITING AN OLD BATTLEGROUND IN ASSET SALES

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CREDIT BIDDING – REVISITING AN OLD BATTLEGROUND IN ASSET SALES[1]

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> While the Bankruptcy Code quite reasonably and appropriately recognizes a right to credit bid pursuant to [section] 363(k), such fact cannot alter the economic realities that an auction sale in which one bidder is an existing lender who does not have to put up new money, but can rely on money previously advanced and which the lender has no other actual way to recover, is not a sale in which the bidders are on a level playing field.[2]

I. INTRODUCTION

On its face, the ability of a secured creditor to credit bid the amount of its debt at a sale of its collateral is a straightforward concept. Since the enactment of section 363(k) of the Bankruptcy Code, secured creditors have primarily used credit bidding to protect against what they perceive to be undervalued sales.[3] Courts have, for the most part, been fairly consistent in their interpretations of credit bidding in asset sales.

In the last fifteen years, the context in which secured creditors have sought to credit bid the amount of their claims has changed. Various distressed investment vehicles, sometimes characterized as hedge funds or private equity firms (but often a hybrid of the two), have become extremely active in the distressed debt market both prior and subsequent to the filing of a bankruptcy. These distressed investment vehicles frequently seek to loan funds to a debtor or purchase a pre-existing secured loan, whether on a pre or post-petition basis, in order to facilitate a "loan to own" strategy through credit bidding. Thus, as credit bidding and orderly liquidations

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[1] These materials were initially published in the Norton Annual Survey of Bankruptcy Law. *See* John T. Gregg, *A Review of Credit Bidding Under 11 U.S.C. § 363(k)*, 2008 Norton Ann. Surv. Bankr. L 17 (2008). These materials have been updated and reprinted with permission for use in connection with the 22nd Annual Central States Bankruptcy Workshop sponsored by the American Bankruptcy Institute on June 11-15, 2015.

[2] *In re Antaeus Technical Services, Inc.*, 345 B.R. 556, 564 (Bankr. W.D. Va. 2005).

[3] Lenders are not the only parties entitled to credit bid. Rather, any secured creditor, including construction lien holders, mechanics' lien holders and attorneys holding charging liens, are authorized to credit bid. *See*, *e.g.*, *In re Joseph*, 330 B.R. 87 (Bankr. D. Conn. 2005) (holding attorney has right to credit bid up to the amount of his charging lien).

continue to be the preferred means by which to "reorganize," it is important to understand the parameters of credit bidding in all contexts. [4]

Existing case law counsels that when the potential for a secured creditor to credit bid exists, it is imperative that parties closely examine, among other things, (i) any order establishing bidding procedures, (ii) the allowed nature of a secured creditor's claim, (iii) a secured creditor's alleged misconduct and (iv) the effect that credit bidding will have on professional fees. This article explores the credit bid process in general, discusses the contexts within which the process has come into question, examines recent decisions in which the opportunity of a secured creditor to credit bid has been challenged, and finally, considers the potential limitations to compensation imposed by credit bidding.

II. STATUTORY OVERVIEW

The Bankruptcy Code expressly allows a secured creditor to bid the amount of its "allowed claim," subject to "cause" as ordered by the court. Specifically, section 363(k) of the Bankruptcy Code provides that:

> [a]t a sale under subsection (b) of this section 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, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.[5]

While a secured creditor may setoff its allowed secured claims against the purchase price of property of the estate to be sold and subject to its lien, no comparable authority exists in the Bankruptcy Code that permits unsecured creditors to setoff their claims.[6]

The legislative history of section 363(k) is consistent with the plain meaning of the statute itself and the interpretations of the courts to date. Importantly, the legislative history makes clear that a valuation previously performed under section 506(a) or attempted to be

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[4] For additional secondary sources, *see* Michael P. Richman and Lori V. Vaughn, Pro: Loan-To-Own DIP Lenders Should Not Be Allowed to Credit Bid, American Bankruptcy Institute 25th Annual Spring Meeting (April 12-15, 2007); Mary Joanne Dowd and Jeffrey N. Rothleder, Recent Developments in Credit Bidding, American Bankruptcy Institute Views from the Bench (2007). This article does not address the nexus between sections 363(k) and 1111 of the Bankruptcy Code. For such a discussion, *see*, *e.g.*, 5 Norton Bankr. L. and Prac. 3d § 102:1, *et seq*. (West 2008); Michael E. Rubinger and Gary W. Marsh, "Sale of Collateral" Plans Which Deny a Nonrecourse Undersecured Creditor the Right to Credit Bid: *Pine Gate* Revisited, 10 Bankr. Dev. J. 265 (1994). This article is also limited to credit bidding in the context of straight assets sales and does not discuss the right to credit bid under a proposed plan. *See RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, --- U.S. ---, 132 S.Ct. 2065 (2012). For such a discussion, *see*, *e.g.*, Mark S. Melickian and Jack O'Connor, Lenders Given Cause to Relax, 31 AUG Am. Bankr. Inst. J. 20 (Aug. 2012).

[5] 11 U.S.C. § 363(k).

[6] *See*, *e.g.*, *In re Moritz*, 162 B.R. 618 (Bankr. M.D. Fla. 1994).

retroactively applied to a credit bid is not permissible.[7] Rather, according to the legislative history, a bid as part of the sale process itself is determinative as to the value of the assets sold.[8]

The legislative history and the courts' interpretation of section 363(k) are potentially at odds in at least one crucial respect, though. Earlier legislative history seems to suggest that at an asset sale, the holder of an interest that is the high bidder is allowed to offset the *value* of his interest against the purchase price of the property.[9] However, the legislative history subsequently indicates, and later reinforces, that the value of the property is not the amount to be offset.[10] Instead, the holder of a lien on property being sold may bid at the sale and, if successful, offset the amount owed to him that is secured by the lien on the property against the purchase price while remaining liable for the balance of the sale price in excess of the secured creditor's secured claim.[11] As discussed below, the overwhelming majority of courts have interpreted section 363(k) to mean that the credit bidder is allowed to offset the total amount of its secured claim from the sale price, not simply the value of the property sold.[12]

III. CAUSE TO DENY THE ABILITY TO CREDIT BID

While section 363(k) clearly permits a secured creditor to credit bid at an asset sale, courts are given discretion to deny that opportunity. Although the statute itself is silent as to what constitutes "cause" to deny the opportunity to credit bid, several decisions have established factors to consider, including (i) the chilling effect on the sale process, (ii) the conduct of the party seeking to credit bid, (iii) the ability of the credit bidder to provide a deposit or other form of protection to the estate in case the credit bidder's lien is subsequently successfully challenged, (iv) the adequacy of the purchase price, and (v) the benefit to the debtor's estate.

A recent decision by the Bankruptcy Court for the District of Delaware recently gained a great deal of attention due to the restrictions it placed on credit bidding.[13] It has since been frequently cited as alleged paramount authority to deny or limit the right to credit bid when the sale process would suffer and the interest of other bidders chilled. In *In re Fisker Automotive Holdings, Inc.*, the court limited the ability of a secured creditor to credit bid for substantially all of the debtors' assets because (i) the credit bid would chill, or even freeze, the bidding process, (ii) the proposed expedited private sale pursuant to a credit bid would be inconsistent with

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7 Senate Report No. 95-989, 95th Cong., 2d Sess. 55 (1978).

8 *Id*.

9 House Report No. 95-595, 95th Cong., 1st Sess. 345 (1977); *see* Senate Report No. 95-989, 95th Cong., 2d Sess. 56 (1978).

10 *Id.*; 124 Cong. Rec. H 11, 093 (Sept. 28, 1978); S. 17409 (Oct. 6, 1978).

11 House Report No. 95-595, 95th Cong., 1st Sess. 345 (1977); *see* Senate Report No. 95-989, 95th Cong., 2d Sess. 56 (1978).

12 *See*, *e.g.*, *In re Submicron Systems Corp*., 432 F.3d 448, 459 (3d Cir. 2006); *In re Morgan House Gen. P'ship*, 1997 WL 50419 (E.D. Pa. Feb. 7, 1997); *In re Sun Cruz Casinos, LLC*, 298 B.R. 833, 839 (Bankr. S.D. Fla. 2003); *In re Realty Invs. Ltd. V*, 72 B.R. 143, 146 (Bankr. C.D. Cal. 1997); *In re Midway Invs., Ltd*., 187 B.R. 382, 391 n. 12 (Bankr. S.D. Fla. 1995).

13 *In re Fisker Automotive Holdings, Inc.*, 510 B.R 55 (Bankr. D. Del. 2014), *leave to appeal denied by*, 2014 WL 546036 (D. Del. Feb. 7, 2014), *leave to appeal denied by*, 2014 WL 576370 (D. Del. Feb. 12, 2014). A similar discussion regarding the *Fisker* decision appears in the Collier Guide to Chapter 11, Key Topics and Selected Industries ¶ 23.06[6][c] (2014).

notions of fairness in the bankruptcy process, and (iii) the amount of the secured claim was uncertain.

Prior to their bankruptcy filing, the debtors were original equipment manufacturers of plug-in hybrid electric vehicles.[14] The United States Department of Energy had provided a secured loan to the debtors in the approximate principal amount of $168 million.[15] After the debtors began suffering financial distress for various reasons, the DOE terminated the debtor's lending facility and sold its position as senior secured lender to Hybrid Tech Holdings, LLC.[16] Hybrid and the debtors thereafter began discussing Hybrid's potential purchase of the debtors' assets through a credit bid of all or part of the senior secured loan.[17] Eventually, the debtors and Hybrid agreed that the debtors would sell substantially all of their assets to Hybrid for $75 million in the form of a credit bid.[18] Importantly, the debtors determined that the proposed sale to Hybrid should be private, as a sale to a third party was allegedly not likely to generate more than the sale to Hybrid.[19]

After filing voluntary petitions for relief under Chapter 11, the debtors requested that the bankruptcy court expedite the sale process so as to allow immediate consummation of the proposed sale to Hybrid.[20] The official committee of unsecured creditors filed an objection to the proposed sale, disputed Hybrid's ability to credit bid, and requested that the bankruptcy court order that the debtors conduct an auction for their assets.[21] Moreover, the committee identified a competing bidder which expressed interest in participating in an auction, but only if Hybrid's ability to credit bid was limited.[22]

At a hearing on the motion to approve the sale of assets to Hybrid, the debtors and the committee narrowed the issues pursuant to the following stipulations which were critical to the court's decision: (i) if Hybrid's ability to credit bid was capped at $25 million (the amount for which it purchased the secured claim), a strong likelihood existed that an auction would create material benefit to the estate, (ii) if Hybrid's credit bid was not capped, no auction would occur, (iii) limiting Hybrid's ability to credit bid would facilitate competitive bidding, and (iv) certain assets of the debtors were subject to Hybrid's security interests, other assets of the debtors were not subject to Hybrid's security interests, and a dispute existed as to whether Hybrid had a properly perfected security interest in still other assets of the debtors.[23] The committee thus argued that credit bidding should not be permitted because a material portion of the assets were either not subject to a properly perfected security interest or the existence of such a security interest was in dispute.[24] In addition, the committee contended that "cause" existed to deny

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14 *Id*. at 56-57.
15 *Id*.
16 *Id*. at 57.
17 *Id*.
18 *Id*.
19 *Id*.
20 *Id*. at 60.
21 *Id*. at 57-59.
22 *Id*. at 58.
23 *Id*. at 57-59.
24 *Id*.

credit bidding because limitation of the credit bid would facilitate a cash auction for all of the debtors' assets.[25]

In deciding whether to limit or cap the amount of Hybrid's credit bid, the bankruptcy court, citing *RadLAX* and *Philadelphia Newspapers*, among other decisions, first noted that pursuant to section 363(k) of the Bankruptcy Code, a secured creditor is generally entitled to credit bid its allowed secured claim.[26] However, the court observed the general rule that a court may modify or even deny credit bidding "for cause."[27] After identifying various decisions by other courts where credit bidding was limited or denied for, among other things, inequitable conduct and to foster competitive bidding environments, the court emphasized that absent a limitation on credit bidding, no auction would occur in the *Fisker* case.[28] The court based its determination on the fact that the third party purchaser identified by the committee had previously stated that it would not participate in any auction where Hybrid was allowed to credit bid the face amount of the claim.[29] As such, the court found that allowing Hybrid to credit bid more than $25 million would not only chill bidding; rather, it would freeze the bidding.[30]

The court also questioned the timing of the proposed sale and referred to the aggressive timetable as "troublesome" given the fact that the debtors were no longer operating.[31] The debtors filed their petitions on November 22, 2013, but "insisted" that the hearing on the motion to sell be scheduled by no later than January 3, 2014.[32] Therefore, the court noted, creditors and other parties in interest were given at most twenty-four business days to object to the sale motion.[33] According to the court, such timetable was inconsistent with fairness in the bankruptcy process.[34]

Finally, the court found cause to limit the amount of the credit bid because, as set forth in the stipulated agreements, Hybrid's claim was partially secured, partially unsecured and disputed as to the remainder.[35] The court distinguished Third Circuit precedent where the issue was simply the value of the collateral, not the extent of the secured claim.[36] In *Fisker*, however, the issue was how much of the claim would constitute an allowed secured claim.[37] Because it was uncertain as to how much of Hybrid's claim was secured, the court found it appropriate to cap the credit bid at $25 million.[38]

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25 *Id*.
26 *Id*. at 59.
27 *Id*. at 59-60.
28 *Id*. at 60.
29 *Id*.
30 *Id*. at 60-61.
31 *Id*. at 60.
32 *Id*.
33 *Id*.
34 *Id*. at 61.
35 *Id*. at 61. The stipulated agreements between the debtors and the committee were extremely relevant to the court's decision, as it was clear that material assets were unencumbered or the validity of Hybrid's security interest was subject to a bona fide dispute.
36 *Id*. (citing *In re Submicron Systems Corp*., 432 F.3d 448 (3d Cir. 2006)).
37 *Id*.
38 *Id*.

The decision in *Fisker* is arguably not groundbreaking by any means, as Hybrid was not precluded from participating in the auction or credit bidding in part. Instead, based on the facts and circumstances before it and similar to decisions from other courts, the *Fisker* court limited Hybrid's ability to credit bid the face amount of its alleged secured claim. *Fisker* does, however, provide some support to committees and other parties in interest objecting to fast-track sales, especially where a debtor is no longer operating.

Shortly after *Fisker*, the Bankruptcy Court for the Eastern District of Virginia similarly considered whether cause existed to limit credit bidding based on the alleged prepetition misconduct of the secured creditor.[39] The facts at issue were quite different though. In *Free Lance Star*, the debtors borrowed approximately $50 million from a traditional lender.[40] As security for the loan, the debtors granted deeds of trust on, and security interests in, certain real and personal property of the debtors.[41] Absent from the lender's collateral package were parcels of real estate, personal property and fixtures referred to as tower assets.[42] After the lender sold its loan, the new secured creditor advised the debtors that they should file for bankruptcy and sell substantially all of their assets, ideally to the secured creditor as part of a loan-to-own strategy.[43]

As part of this loan-to-own strategy, the secured creditor requested that the debtors execute deeds of trust to encumber the parcels of real estate related to the tower assets and prepare for a bankruptcy filing a short time later.[44] Around the same time and unbeknownst to the debtors, the secured creditor filed financing statements purporting to perfect security interests in the personal property related to the tower assets.[45] Thereafter, the secured creditor undertook, in hindsight, several other unadvisable actions, including: (i) requesting a forbearance agreement with a blanket release, (ii) advising the debtors that the prepetition grant of encumbrances on the tower assets was unnecessary because it would obtain them through post-petition financing, (iii) renewing pressure on the debtors to file for bankruptcy, but only ninety days after the secured creditor filed its financing statements related to the tower assets, (iv) informing the debtors that they should not market their assets in connection with any bankruptcy sale, and (v) insisting that if the assets were marketed, it occur for only a six week time frame with a bold statement that the secured creditor had the right to credit bid.[46] Finally, when the debtors informed the secured creditor that it was unlikely any post-petition financing would be needed, the secured creditor challenged the debtors' projections and insisted that it act as DIP lender to ensure that it could encumber the parcels related to the tower assets.[47] The debtors declined, and negotiations ceased.[48] Shortly thereafter, the secured creditor informed the debtor that it would no longer

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39 *In re The Free Lance-Star Publishing Co. of Fredericksburg, VA*, 512 B.R. 798 (Bankr. E.D. Va. 2014).

40 *Id*. at 802.

41 *Id*.

42 *Id*.

43 *Id*.

44 *Id*. at 802-03.

45 *Id*. at 803.

46 *Id*. at 803.

47 *Id*.

48 *Id*.

support the bankruptcy.[49] More alarmingly, the secured creditor filed additional financing statements without the consent of, or even notice to, the debtors.[50]

The debtors eventually filed for Chapter 11 and sought the use of cash collateral, which was opposed by the secured creditor and culminated in a contested hearing at which the secured creditor requested liens on the tower assets as adequate protection.[51] The secured creditor did not, however, advise the court or the debtors that it had already filed financing statements against the tower assets.[52] After the hearing, the court denied the secured creditor's request for liens on the tower assets.[53] The debtors eventually filed their motion to sell substantially all of their assets. In connection with that motion, the court considered whether the secured creditor could credit bid.[54]

The debtors argued that cause existed to deny the secured creditor the right to credit bid because (i) the secured creditor did not have a lien on all assets of the debtors, so it could not credit bid for those assets, (ii) the secured creditor's conduct was inequitable, thereby depressing the potential purchase price, and (iii) the interest of third parties and enthusiasm for the sale would be restored if credit bidding were denied.[55] The court first noted that it had held, as part of an adversary proceeding commenced by the secured creditor against the debtors, that the secured creditor did not hold a security interest in, or deed of trust on, the tower assets, as well as certain other personal property.[56] Second, the court characterized the secured creditor's intention as a "classic loan-to-own scenario" from the moment it purchased the loan.[57] The court stressed the secured creditor's inequitable conduct, as exemplified by its unilateral expansion of the scope of its security interest, its attempts to shorten the marketing period, and the language in the marketing materials regarding the secured creditor's right to credit bid.[58] The court offered the following thoughts:

> The credit bid mechanism that normally works to protect secured lenders against the undervaluation of collateral sold at a bankruptcy sale . . . does not always function properly when a party has bought the secured debt in a loan-to-own strategy in order to acquire the target company. In such a situation, the secured party may attempt to depress rather than to enhance market value. Credit bidding can be employed to chill bidding prior to or during an auction, or to keep prospective bidders from participating in the sales process. [The secured creditor's] motivation to own the [debtors'] business rather than to have the Loan repaid has interfered with the sales process. [The secured creditor] has tried to depress the sales price of the [debtors'] assets, not to maximize the value of those assets. A depressed

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49 *Id*. at 804.
50 *Id*.
51 *Id*.
52 *Id*.
53 *Id*.
54 *Id*. at 800.
55 *Id*. at 805.
56 *Id*. at 805-06.
57 *Id*. at 806.
58 *Id*.

> value would benefit only [the secured creditor], and it would do so at the expense of the estate's other creditors. The deployment of [the secured creditor's] loan-to-own strategy has depressed enthusiasm for the bankruptcy sale in the marketplace.[59]

After considering expert testimony from the debtors' investment banker regarding the likely confusion and chilling of the sale process, the court ultimately decided to limit, not deny, the secured creditor's right to credit bid.[60]

Other courts have, like the court in *Fisker*, expressed concern that credit bidding will result in an abuse of the bankruptcy process because other creditors will receive no benefit from the sale.[61] For example, in *In re Theroux*, a Chapter 7 trustee requested that the bankruptcy court approve a notice of intent to sell a liquor license to the debtor's secured creditor free and clear of all liens.[62] The local taxing authorities objected to the sale, contending that the sale price was unreasonably low and that the intent of the sale was to benefit the secured creditor to the detriment of the taxing authorities.[63] The taxing authorities argued that the correct procedure would be for the secured creditor to move for relief from the automatic stay and conduct a foreclosure sale which, in the view of the taxing authorities, would produce a sale price more accurately reflecting the fair market value of the liquor license.[64]

The court sustained the objection of the taxing authorities to the proposed sale, which the court found specifically designed to wipe out the interests of the taxing authorities while providing a windfall to the secured creditor.[65] The court underscored its decision by emphasizing that it found the trustee's motivation questionable, considering that the sale would only benefit the secured creditor while inflicting substantial harm on the taxing authorities.[66] The court noted that the trustee should have abandoned the estate's interest due to the estate's lack of any equity in the license.[67] Moreover, the court presumed that a conflict of interest existed due to the likelihood that the secured creditor had agreed to compensate the trustee for the sale.[68] Therefore, the court held that where the intended selling price is only a fraction of fair market value, a sale should not be approved.[69] The court emphasized that despite the potential for the secured creditor to make a substantial credit bid, section 363(k) allows the court to deny the credit bid for cause, which the court found because the sale price was so inadequate and the motive of the trustee suspicious.[70]

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59 *Id*. at 807 (citing *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 315-16 (3d Cir. 2010)).

60 *Id*. at 808. The written decision does not state the means by which the court determined the cap on the amount of the credit bid, perhaps because the court conducted a portion of the hearing under seal. *Id*. at 807.

61 *In re Theroux*, 169 B.R. 498 (Bankr. D.R.I. 1994); *see In re Feinstein Family P'ship*, 247 B.R. 502 (Bankr. M.D. Fla. 2000).

62 *Id*. at 498.

63 *Id*. at 498-99.

64 *Id*.

65 *Id*. at 499.

66 *Id*.

67 *Id*.

68 *Id*.

69 *Id*.

70 *Id*.

In a similar decision by the Bankruptcy Court for the Middle District of Florida, the court considered whether a sale to a credit bidder should be approved despite the fact that the estate possessed no equity in the assets subject to the sale. In *In re Feinstein Family Partnership*, the Chapter 7 trustee proposed a sale of substantially all of the debtor's assets, with the sale price comprised solely of a credit bid by the secured lender.[71] As noted by the court, the proposed sale would produce no funds because the lender claimed a right to bid not only actual cash proceeds from a post-petition financing arrangement in the debtor's Chapter 11 case prior to conversion, but rather, the full amount authorized plus costs and attorney's fees.[72] Moreover, the post-petition financing order provided an option to certain junior lienors to pay a percentage of the total debt owed to the lender in exchange for a release of the lender's superpriority lien.[73] As proposed, the sale would have deprived the junior lienors of the ability to exercise such option.[74]

In its decision, the court provided some practical commentary on the role of Chapter 7 trustees where the lender is fully secured:

> [i]t is not rare that trustees of Chapter 7 estates are approached by secured creditors who seek the trustee's help to liquidate fully encumbered collateral. They realize that before the trustee is willing to go along with the proposition the secured creditor must put a little sweetener in the deal by agreeing to pay other costs of administration. The more sophisticated trustee may demand that the secured creditor throw in a pittance to pay a meaningless dividend to unsecured creditors, making the arrangement more palatable to the Court. The proposition is very attractive from the secured creditor's point of view and economically sound because it may stave off a possible attempt by the Trustee to seek to surcharge the collateral and, most importantly, save the potentially expensive cost of a foreclosure suit. The offered deal is attractive to the trustee because it assures that he or she will earn a commission in an otherwise no asset case and may seek a commission based on the gross sales price and not on the net distributed to parties in interest. While some courts may find this calculation of the trustee's commission acceptable, there is well reasoned authority to the contrary.[75]

The court continued by stating that the interest of a secured creditor is by nature adverse to the interest of general unsecured creditors.[76] As such, the court emphasized that the Bankruptcy Code does not contemplate the Chapter 7 trustee acting as the liquidator for secured creditors who should, in the court's view, liquidate their own collateral.[77] In the instant case, the

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71 *In re Feinstein Family P'ship*, 247 B.R. 502 (Bankr. M.D. Fla. 2000).
72 *Id*. at 507.
73 *Id*. at 506.
74 *Id*. at 504.
75 *Id*. at 507.
76 *Id.*
77 *Id.*

court found that the property at issue had no cognizable value beyond the total debts secured by the lender's valid liens.[78]

Moreover, the court noted, the lender had previously requested, and been granted, relief from the automatic stay in order to foreclose on the property in state court.[79] However, when it became apparent that junior lienors and potentially the Chapter 7 trustee would challenge the validity of its lien in the state court, the lenders decided to return to the Bankruptcy Court in order to resolve the issues with the trustee by providing a "sweetener" for administrative costs and a "pittance" to unsecured creditors.[80]

Based on these policy considerations and the requirements imposed by the Bankruptcy Code, the court denied the trustee's attempt to sell the property and allow a credit bid from the lender.[81] Because the lender had already selected the state court as its forum when it requested relief from the automatic stay and no equity remained in the property for the estate, the court held that the lender should proceed with foreclosure in the state court, and should not be allowed to benefit from a foreclosure disguised as a section 363 asset sale in the bankruptcy court.[82]

Cause to deny a secured creditor the ability to credit bid has also been found to exist where the secured creditor is unable to provide security to the estate to protect against loss in the event the secured creditor's liens are later avoided or otherwise declared invalid.[83] In *In re Diebart Bancroft*, the trustee sought to sell certain of the debtor's assets which were subject to a leasehold collateral mortgage.[84] At the sale hearing, the mortgagee objected to the purchase price and proposed that the assets be deeded to the secured creditor for the balance due and owing on the promissory note and a cash payment.[85] Alternatively, the mortgagee requested that it be granted relief from the automatic stay to allow it to foreclose.[86] The Internal Revenue Service also objected to the purchase price and claimed that it had a first lien on the property because the mortgagee's lien had previously been extinguished.[87]

The bankruptcy court, noting that a priority dispute existed, allowed the mortgagee to credit bid so long as it deposited cash sufficient to payoff the IRS in the event its lien had priority over the mortgagee's lien.[88] When the mortgagee was declared the winning bidder, the bankruptcy court ordered it to deposit ten percent of its bid by the close of the next business day, with the remaining amount of the IRS claim due in cash shortly thereafter.[89] After the mortgagee could not produce the remaining funds for deposit, the court refused to approve the sale to the

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78 *Id.* at 507-508.
79 *Id*. at 508.
80 *Id*. at 509.
81 *Id*.
82 *Id*.
83 *In re Diebart Bancroft*, 1993 WL 21423 (E.D. La. Jan. 26, 1993); *but see*, *e.g.*, *In re Octagon Roofing*, 123 B.R. 583 (Bankr. N.D. Ill. 1991) (credit bid allowed where protection provided by credit bidder in form of letter of credit).
84 *Id*. at 1.
85 *Id*. at 2.
86 *Id*.
87 *Id*.
88 *Id*.
89 *Id*.

mortgagee and authorized the trustee to sell the assets to the next highest bidder.[90] The mortgagee then appealed the bankruptcy court's decision to the District Court for the Eastern District of Louisiana, claiming it was denied the opportunity to credit bid without cause.[91]

On appeal the District Court for the Eastern District of Louisiana found that the bankruptcy court properly denied the right to purchase the assets because of the lien dispute.[92] The district court noted that in the event that the mortgagee was later found not to be the senior secured creditor, it would have needed to pay cash for the assets in order to satisfy the lien of the IRS.[93] Therefore, the court held that the bankruptcy court properly required the mortgagee to escrow the amount of the IRS's lien pending determination of the priority of the liens of the IRS and mortgagee.[94]

At least one court has held that cause exists to deny credit bidding where the liens of other secured creditors are *pari passu* with the liens of the secured creditor attempting to credit bid.[95] In *In re Takeout Taxi Holdings, Inc.*, substantially all of the debtor's assets were subject to a first priority security interest of a financing agent and a second position lien securing the indebtedness owed to five individuals, all of whom were deemed of equal priority.[96] The financing agent's lien was subordinate to the lien of the credit bidder, who was also one of the second position lienholders.[97]

After the Chapter 7 trustee filed a motion seeking to sell the assets to franchisees of the debtor pursuant to a private sale and the credit bidder expressed an interest, the court conducted a hearing on the credit bidder's secured status, finding that the credit bidder held a valid lien.[98] The credit bidder eventually consented to the sale of the debtor's property free and clear, reserving his right to credit bid at the sale.[99]

However, at the sale hearing, the court noted that the four other secured creditors of equal priority with the credit bidder had not been properly served with the motion.[100] Moreover, the credit bidder and the four other secured creditors were secured by the same security agreement and financing statement, which the court found troublesome.[101] The court noted that although section 363(k) authorizes credit bids in general, they can be denied for cause.[102] According to the court, cause existed to deny credit bidding because the other four creditors of equal priority were denied the opportunity to object to the credit bid.[103] The court found the potential for objection likely, especially in light of the fact that the proposed sale would not yield any cash

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90 *Id*.
91 *Id*.
92 *Id*.
93 *Id*.
94 *Id*.
95 *In re Takeout Taxi Holdings, Inc.*, 307 B.R. 525 (Bankr. E.D. Va. 2004).
96 *Id*. at 528.
97 *Id*. at 535.
98 *Id*. at 528.
99 *Id*. at 535.
100 *Id*. at 535.
101 *Id*.
102 *Id*.
103 *Id*.

proceeds for distribution to the other four secured parties.[104] Thus, the court found the sale prejudicial to parties that were potentially of equal priority and denied the trustee's motion to sell the debtor's assets due to insufficient notice.[105]

The decision in *Takeout Taxi* is, in some respects, a precursor to a more large scale issue – that in which a participant in a syndicated loan disagrees with the decision by the agent to credit bid. In these situations, the courts have relied heavily on the intercreditor agreements governing the parties' relationships.

In *In re Metaldyne Corp*., the debtors filed a motion seeking to sell substantially all of their assets pursuant to a bid submitted by the collateral agent for participating secured lenders. In total, the secured lenders were owed approximately $425 million.[106] A participating lender holding only $3.5 million of that debt objected to the sale, arguing that the lenders' agent could not properly credit bid all of the prepetition debt, even though 97% of the participants directed the agent to credit bid.[107] The objecting participant also argued that under the credit agreement, the agent could not release the participant's liens on the debtors' collateral without the participant's consent.[108]

Turning to the specific provisions in the credit agreement and interpreting them in accordance with New York law, the court determined that a sale through a credit bid does not require modification or amendment of the loan documents, as the dissenting participant contended.[109] Rather, the agent was granted the authority under the loan documents themselves to undertake actions on behalf of the dissenting participant.[110] The court also noted that in reality, the dissenting participant had a fundamental dispute with the agent and other lenders, not with the credit bid itself.[111]

In reaching its conclusion, the *Metaldyne* court relied, in part, upon a recent decision from the Bankruptcy Court for the District of Delaware with nearly identical issues.[112] In *GWL*, the debtor sought to sell substantially all of its assets to first lien lenders through a credit bid.[113] Similar to the facts in *Metaldyne*, all but one of the lenders consented to the sale by arguing that unanimous consent was required for modification of the credit agreement.[114] The court rejected the rogue lender's argument, holding that only a modification of the loan documents required unanimous consent.[115] The *GWL* court found credit bidding by the agent to be consistent with the loan documents in existence at that time and that the lender had delegated the authority to

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104 *Id*.

105 *Id*.

106 409 B.R. 671, 672 (Bankr. S.D.N.Y. 2009).

107 *Id*.

108 *Id*. at 675.

109 *Id*. at 677-78 (citing *In re Chrysler LLC*, 576 F.3d 108, 119-20 (2d Cir. 2009)).

110 *Id*.

111 *Id*. at 675 n.7; *see In re Lehigh Coal and Navigation Co*., 429 B.R. 833, 835 (Bankr. M.D. Pa. 2010) (allowing credit bid where no confusion would result and noting argument against credit bid was dispute with fellow noteholders pursuant to investment agreement).

112 *In re GWLS Holdings, Inc*., 2009 WL 453110 (Bankr. D.Del. Feb. 23, 2009).

113 *Id*. at *5.

114 *Id*.

115 *Id*.

credit bid to the agent.[116] However, as noted by the *Metaldyne* court, in *GWL* the court ultimately approved the sale subject to a lien in the amount of the objecting lender's claim because the court had been provided with the loan documents for the first time at the sale hearing.[117] The court therefore granted a temporary lien subject to further briefing on the issue.[118]

IV. THE NEXUS BETWEEN BIDDING PROCEDURES AND CREDIT BIDDING

Recent case law indicates that courts will require strict compliance with bidding procedures that address credit bidding.[119] It is therefore imperative that challenges to a secured creditor's right to credit bid be made in accordance with established bidding procedures or even prior to the approval of any formal bidding procedures. The court's decision in *In re Antaeus Technical Services, Inc.* provides some insight in this regard.

In *Antaeus*, the Chapter 7 trustee and the debtor's secured creditor entered into a settlement agreement to resolve the trustee's adversary proceeding to subordinate the secured creditor's claims and disallow its proofs of claim.[120] As part of the settlement agreement, the secured creditor was entitled to credit bid up to a certain amount in the event that the assets were sold prior to a certain date.[121] However, in the event the assets were not sold prior to that date, the secured creditor was granted the option to purchase the assets for a cash payment above the full value of its claim by a certain date or be deemed to have released its liens on the assets.[122]

Before the deadline to credit bid had expired, the Chapter 7 trustee suffered a heart attack and, as a result, was unavailable until after the deadlines established by the court's approval of the settlement agreement.[123] After the deadline for the secured creditor to make the cash payment had expired, the secured creditor asserted that it was nonetheless entitled to make the credit bid due to an oral modification of the settlement agreement with representatives of the trustee. The trustee, however, denied this.[124]

The bankruptcy court held that the deadlines had not been extended by the trustee's health issues or the alleged oral modification.[125] Rather, according to the court, the parties were not entitled to modify or amend the settlement agreement in any way without first obtaining approval and providing notice to all parties in interest.[126] The court acknowledged the secured creditor's failure to act was due to its own fault and questioned whether such failure was perhaps an attempt to increase the value of its lien.[127] Ultimately, the court ruled that the secured

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116 *Id*.

117 *Id*. at *3.

118 *Id*.

119 Courts have adopted local rules that require motions seeking authority to sell assets to highlight any provision by which the debtor seeks to allow credit bidding. *See*, *e.g.*, LBR 6004-1(b)(iv)(N) (Bankr. D. Del.).

120 *In re Antaeus Technical Services, Inc.*, 345 B.R. 556 (Bankr. W.D. Va. 2005).

121 *Id*. at 558

122 *Id*. at 558-59.

123 *Id*. at 563.

124 *Id*.

125 *Id*.

126 *Id*. at 563-64.

127 *Id*. at 564.

creditor's failure to act resulted in the secured creditor's abandonment of both the settlement agreement and its right to credit bid for the assets.[128]

In *Greenblatt v. Steinberg*, a decision similar to *Antaeus*, requiring strict adherence to bidding procedures, the Chapter 7 trustee sought and obtained a bid procedures order from the bankruptcy court. The bid procedures required, among other things, that potential bidders submit bids of no less than a threshold amount. They also allowed secured creditors with first priority liens to credit bid for certain equipment owned by the debtor.[129] In the bid procedures order, the court recognized the alleged first priority lien of the secured creditor and established a deadline for any parties in interest to challenge such lien.[130] In the event that a party challenged the lien by filing a written objection in compliance with the bid procedures order, the challenging party was required to appear at a hearing "to determine the nature, extent or validity of the secured creditor's liens."[131] Rather than filing an objection as the bid procedures order required, two junior lienholders commenced an adversary proceeding alleging breach of contract by the secured creditor.[132] Moreover, the challenging parties served discovery on the secured creditor and requested expedited responses prior to the hearing addressing the validity of the secured creditor's liens.[133] Finally, the challenging parties filed a motion to delay the auction pending determination of the adversary proceeding.[134]

At the hearing to address challenges to the secured creditor's liens, the court denied the challenging parties' request to delay the auction.[135] Four days later, when the challenging parties attempted to credit bid at the auction for the debtor's assets (presumably because they were also secured creditors), the court disallowed their credit bid because the challenging parties had failed to comply with the bid procedures order by contesting the validity and priority of the secured creditor's lien and introducing any evidence in support of their challenge.[136] The court therefore authorized the trustee to sell the assets to the secured creditor, who had credit bid the amount of its claim.[137]

On appeal the district court upheld the bankruptcy court's ruling by noting that even if the adversary proceeding could be construed as a challenge to the secured creditor's liens, the challenging creditors had not contested such liens at the appropriate hearing pursuant to the bid

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128 *Id*. at 565.

129 *Greenblatt v. Steinberg*, 339 B.R. 458, 460 (N.D. Ill. 2006); *see In re Howard*, 2012 WL 314074 (Bankr. E.D. Tenn. Feb. 1, 2012) (secured creditor must credit bid in accordance with agreed order establishing means by which to formulate credit bid).

130 *Id*.

131 *Id.*

132 *Id.*

133 *Id.*

134 *Id.*

135 *Id.*

136 *Id*. at 461.

137 *Id*. at 461-62.

procedures order.[138] Therefore, the district court affirmed the bankruptcy court's decision to disallow the attempts of the challenging creditors to credit bid at the auction.[139]

Another recent decision counsels that the party seeking to credit bid must actually be the secured party, and not simply an affiliate of the secured party.[140] In *In re Netfax, Inc.*, a Chapter 7 trustee proposed to sell the debtor's intellectual property free and clear of all post-petition secured claims, but subject to prepetition secured claims, to a third party, who was owned by the same individual that owned the secured creditor.[141] Another party subsequently submitted a competing bid, which the trustee deemed to be a better offer.[142] The original bidder objected to the proposed sale, after which the bankruptcy court conducted six days of hearings.[143] During the course of the sale hearing, the two bidders significantly revised their bids, with the court approving the sale to the second bidder, as the court was satisfied that it was sufficient to satisfy all liens.[144]

On appeal to the district court, the original bidder and the secured creditor argued that the purchase price failed to satisfy the requirement under section 363(f) that the purchase price exceed the aggregate value of all liens on the property.[145] Moreover, the original bidder argued that it had submitted a valid credit bid under section 363(k) which the bankruptcy court erroneously refused to consider.[146] In response, the winning bidder asserted that no credit bid was asserted and, even if it had been, such credit bid was inappropriate.[147]

After first determining that the bankruptcy court properly allowed payment from the winning bidder in a contingent revenue stream because nothing in section 363(f)(3) precludes such a transaction, the court addressed the credit bid argument.[148] The court noted that the record from the court below established that a credit bid was never made.[149] Rather, according to the record, the original bidder indicated at the hearing that in the event that the bankruptcy court overruled the original bidder's section 363(f)(3) objection, the secured creditor would be substituted for the original bidder and seek to credit bid.[150] The winning bidder objected to the credit bid, and the court decided that the ability of the secured creditor to credit bid would be determined at the end of the hearing and after presentation of all evidence.[151]

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138 *Id*. at 463; *see In re Daufuskie Island Properties, LLC*, 441 B.R. 60 (Bankr. D. S.C. 2010) (alleged secured creditor denied right to credit bid because bidding procedures order identified only certain secured creditors as having right to credit bid).

139 *Id*.

140 *In re Netfax, Inc.,* 335 B.R. 85 (D. Md. 2005).

141 *Id.* at 87.

142 *Id*. at 87-88.

143 *Id*. at 88.

144 *Id*.

145 *Id*. at 91.

146 *Id*.

147 *Id*.

148 *Id*. at 93.

149 *Id*. at 94.

150 *Id*.

151 *Id*.

On the final day of the hearing, the trustee informed the court that the secured creditor had not been substituted for the original bidder and that the original bidder was still partaking in the sale motion.[152] According to the district court, the bankruptcy court properly determined that no substitution had occurred, and, therefore, a credit bid could not be made because the original bidder had no secured claim with which to base its credit bid.[153] While not directly addressing procedures, *Netfax* suggests that a secured creditor should request that procedures be established to permit substitution of affiliates for credit bidding purposes in the event of certain contingencies.

V. CREDIT BIDDING PENDING DETERMINATION OF ALLOWED CLAIM

Frequently, the status of a secured creditor seeking to credit bid will be subject to an objection or an adversary proceeding to determine the validity, extent or priority of the secured creditor's liens. In most situations, courts have been willing to fashion a remedy that permits the secured creditor to credit bid, so long as payment in cash is assured in the event the liens are subsequently successfully challenged. In *In re St. Croix Hotel Corporation*, the Bankruptcy Court for the District of the Virgin Islands considered whether the debtor's prepetition secured lender should be required to post cash for its purchase of the debtor's assets in connection with a sale of assets under section 363(b) of the Bankruptcy Code.[154] When the debtor filed for bankruptcy, the secured lender held mortgages on various assets of the debtor, including the major piece of realty the debtor sought to sell, and filed a proof of claim asserting its status as a secured creditor.[155] The debtor objected to the proof of claim and commenced an adversary proceeding to determine the secured lender's interest in the assets, if any.[156]

At the auction, which required a minimum bid of $1 million, the secured lender was the only bidder and credit bid the minimum amount.[157] However, when the trustee required that ten percent of the bid be posted in cash, the secured lender objected.[158] In addition, the debtor and other parties in interest objected to the sale, alleging that the sale price was insufficient and that the secured lender should not have been allowed to credit bid.[159] The bankruptcy court subsequently approved the sale and directed the secured lender to pay the sale price without offset for its credit bid.[160]

On appeal by the secured lender, the district court considered (i) whether the sale should have occurred in the first place, and (ii) whether the bank should have been permitted to offset the purchase price against its secured claim.[161] After determining that the bankruptcy court

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152 *Id*.

153 *Id*. at 94-95.

154 *In re St. Croix Hotel Corp.*, 44 B.R. 277, 278 (D. V.I. 1984); *see In re RML Dev., Inc.*, --- B.R. ---, 2014 WL 3378578 (Bankr. W.D. Tenn. July 10, 2014) (dispute regarding secured creditor's claim constituted cause to limit credit bid to amount estimated pursuant to section 502(c)); *In re NJ Affordable Homes Corp.*, 2006 WL 2128624 (Bankr. D.N.J. June 29, 2006) (credit bidding permitted, so long as commission paid to service provider).

155 *Id*.

156 *Id.*

157 *Id.*

158 *Id.*

159 *Id.*

160 *Id.*

161 *Id.*

properly permitted the sale because objections were filed only after the sale had occurred, the court examined whether the secured lender was the holder of an "allowed claim."[162] The court first noted that an objection to the claim had been filed and, therefore, the secured lender did not technically have an "allowed" claim under section 502(a) and (b).[163] However, the court emphasized that "this ignores the fact that the bank continues to this day to assert a secured claim and, without the fault of the bank, that issue has not yet been resolved."[164]

The court expressed concern that if the secured lender was required to pay the sale price in cash, the possibility of depletion of the sale proceeds would exist to the prejudice of the secured lender due to administrative and other expenses.[165] As such, the court fashioned a remedy that it believed would be fair and equitable to all parties.[166] The court permitted the secured lender to credit bid pending a determination as to whether it held an allowed claim. According to the court, if the claim was allowed as a secured claim, the issue would be moot and the secured lender would be entitled to credit bid.[167]

However, the court also considered the possibility that the secured lender would not prevail.[168] In such instance, the secured lender would be required to immediately pay cash to the debtor's estate, with interest compounded at the same rate paid to customers for certificates of deposit.[169] The court explained that "[b]y requiring interest to be paid at the same rate the bank offers for million dollar certificates of deposit on a thirty day basis, we assure that the bank does not gain any benefit from the use of the money that it does not pay for, and that the debtor and its creditors will have a fair return on the purchase price during the period that the funds are tied up pending final resolution of the issue of the bank's claim."[170] The court therefore affirmed the sale of the hotel to the secured lender.[171]

In *In re Miami General Hospital, Inc.*, a decision with facts analogous to *St. Croix Hotel*, an unsuccessful bidder appealed the bankruptcy court's order approving a sale of the debtor's assets to the mortgagee.[172] Prior to the sale, the bankruptcy court approved bidding procedures, which, among other things, permitted the mortgagee to credit bid for the assets.[173] Moreover, the

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162 *Id.* at 278-79.

163 *Id.* at 279.

164 *Id.*; *see also In re Olde Prairie Block Owner, LLC*, 464 B.R. 337, 347-48 (Bankr. N.D. Ill. 2011) (spurious and disruptive objections did not constitute cause to deny credit bid); *but see In re Daufuskie Island Properties, LLC*, 441 B.R. 60, 63-64 (Bankr. D. S.C. 2010) (secured creditor not allowed to bid where validity of lien unresolved); *In re L.D. McMullan,* 196 B.R. 818, 835 (Bankr. W.D. Ark. 1996) (same); *In re L.L. Murphrey Co.*,
2013 WL 2451368 (Bankr. E.D. N.C. June 6, 2013) (credit bidding denied where bona fide dispute under section 363(f)(4) exists).

165 *Id.* The court did not explain why the proceeds of the sale could not simply be held in escrow pending a determination as to the validity of the secured lender's claim.

166 *Id.* 279; *see In re Octagon Roofing,* 123 B.R. 583, 592 (Bankr. N.D. Ill. 1991) (letter of credit guaranteed payment from credit bidder in event liens later declared invalid).

167 *Id.*

168 *Id.*

169 *Id.*

170 *Id.* at 279-80.

171 *Id.* at 280.

172 *In re Miami General Hospital, Inc.*, 81 B.R. 682, 683 (Bankr. S.D. Fla. 1988).

173 *Id.* at 685.

bidding procedures ratified a stipulation between the Chapter 11 trustee and the mortgagee, whereby the right of the mortgagee to credit bid was without prejudice to the trustee to later challenge the validity, priority or extent of the mortgagee's liens.[174] According to the stipulation, in the event that the trustee successfully challenged the liens of the mortgagee, the mortgagee would be required to pay the trustee the amount of the mortgagee's credit bid in cash.[175] The mortgagee complied with the terms of the bidding procedures and the stipulation by timely filing its secured proof of claim.[176] At the auction, the mortgagee and another party engaged in competitive bidding, with the mortgagee eventually submitting what the trustee deemed to be the highest and best offer.[177]

On appeal, the second highest bidder argued that the mortgagee should not have been allowed to credit bid because the bankruptcy court had not adjudicated the validity of the mortgagee's liens.[178] Recognizing the facts of *St. Croix Hotel* were similar, the court noted that in *St. Croix Hotel* the court had permitted the secured party to credit bid and fashioned a remedy to protect the estate by holding the secured party liable in the event that the secured party's liens were later avoided or declared invalid.[179] In affirming the bankruptcy court's decision to allow the mortgagee to credit bid, the court emphasized that a remedy similar to *St. Croix Hotel* was already in place by virtue of the stipulation between the trustee and the mortgagee.[180]

The court further observed that, ideally, the validity of the mortgagee's liens would have been adjudicated prior to the sale.[181] However, because the debtor was hemorrhaging funds and was in jeopardy of losing a significant asset unless a sale was immediately consummated, the court found that the bankruptcy court's decision was appropriate as an emergency remedy.[182] The court noted that in the event that the sale had not been consummated, the debtor would have ceased operating as a going concern, which would be to the detriment of all creditors.[183] Therefore, the court upheld the bankruptcy court's decision to allow the mortgagee to credit bid, subject to the trustee's right to subsequently contest the validity of the mortgagee's lien.[184]

In *In re Medical Software Solutions, Inc.*, a Chapter 11 debtor proposed to sell substantially all of its assets to an insider separate and apart from any plan of reorganization or

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174 *Id.*

175 *Id.*

176 *Id.*

177 *Id.*

178 *Id.* at 687.

179 *Id.* at 687-88; *see In re RML Dev., Inc.*, --- B.R. ---, 2014 WL 3378578 (Bankr. W.D. Tenn. July 10, 2014) (if dispute regarding claim not resolved, secured creditor required to provide letter of credit, surety bond or like instrument in amount of credit bid).

180 *Id.* Notably, the second highest bidder argued that the trustee's remedy under the stipulation would be inadequate because the bankruptcy court would not retain jurisdiction to entertain an action to collect from the mortgagee in the even the liens were avoided or otherwise declared invalid. The court disagreed noting that, assuming the bankruptcy court lacked jurisdiction, the trustee could nonetheless commence an action in another forum to recover the purchase price. *Id*. at 688.

181 *Id.*

182 *Id.*

183 *Id.*

184 *Id.*

liquidation.[185] Prior to the petition date, the debtor funded its cash flow requirements, in part, by selling software products to its customers.[186] However, certain cash flow needs were also funded by a group of lenders, which was essentially a stock for cash transaction, resulting in a majority ownership of the debtor by the lenders.[187] When the debtor's financial condition worsened, the lenders provided an additional capital infusion and, in exchange, received a security interest in substantially all of the debtor's assets.[188] Subsequent attempts to market and sell the business failed, leading to the debtor's decision to file for bankruptcy.[189]

After the prepetition lenders provided post-petition financing to the debtor, the debtor proposed to sell substantially all of its assets to the lenders, as the debtor believed a sale its only option due to continuing post-petition losses.[190] The post-petition financing arrangement approved by the court required a sale by a certain date.[191] The lenders emerged as the stalking horse bidder and proposed, pursuant to the purchase agreement, to (i) cancel the lenders' secured prepetition indebtedness, (ii) cancel the lenders' post-petition indebtedness, and (iii) provide a lump sum payment for the benefit of unsecured creditors, among other things.[192] Because of the inside nature of the proposed transaction, the court requested that a previously appointed examiner investigate the sale and certain bad faith allegations.[193] The examiner ultimately determined that the sale should proceed, as the lenders' offer was the highest and best bid.[194]

The debtor's former chief executive officer, whose new employer had submitted a bid for the assets, and certain shareholders of the debtor objected to the sale because, among other things, they believed that the debt bid by the creditor should be recharacterized as equity or, alternatively, the debt should be equitably subordinated.[195] The objectors further asserted that the secured claims were improperly filed and, therefore, the credit bid was illusory.[196]

The court disagreed with the objecting parties' allegation that the lenders' secured claim was improperly filed by noting the debtor had not scheduled the claim as contingent, unliquidated or disputed.[197] Moreover, no party had objected to the lenders' secured claim.[198]

The court also considered the argument that the credit bid should not be allowed under section 363(k) because a "third party" was not involved and because the purchase agreement provided for the release of both unsecured and secured claims.[199] The debtor argued that the unsecured creditors would be in a better position without characterizing the purchase price as a

185 *In re Medical Software Solutions, Inc.*, 286 B.R. 431 (Bankr. D. Utah 2002).
186 *Id.*
187 *Id.* at 435-36.
188 *Id.* at 436.
189 *Id.* at 437.
190 *Id.*
191 *Id.*
192 *Id.* at 437-38.
193 *Id.* at 438.
194 *Id.* at 439.
195 *Id.*
196 *Id.*
197 *Id.* at 442.
198 *Id.*
199 *Id.* at 442-43.

credit bid because, by characterizing it as a credit bid, the assets were deemed to be worth less than the credit bid and the lenders would retain a general unsecured claim for the deficiency.[200] The court noted that although it has discretion under section 363(k) to disallow a credit bid for cause, it could find no reason to do so.[201] After overruling the objecting parties' arguments that the debt should be recharacterized or the lenders' claims should be equitably subordinated, the court authorized the lenders' proposed credit bid and found the purchase price to be fair and reasonable.[202]

In *In re LWD, Inc.*, the debtors sought to sell substantially all of their assets at a public auction.[203] Prior to the auction, the debtors and their secured creditor, who had purchased outstanding secured debt owed by the debtors to its prepetition secured lender, negotiated the terms of the auction, including a term sheet.[204] The term sheet allowed the secured creditor's secured claim and authorized the secured creditor to credit bid.[205] At the auction, the secured creditor was the successful bidder and applied its credit bid to the purchase price.[206] The bankruptcy court entered a final order approving the sale to the secured creditor and authorizing the second highest bidder to acquire the assets in the event that the secured creditor was unable to close the sale.

Thereafter, the bankruptcy court entered an order requiring the secured creditor to submit an accounting of funds paid to it by any of the debtors.[207] After reviewing the accounting, the creditors committee filed a motion which alleged that the secured creditor had received the cash assets prior to the sale as improper post-petition transfers, which precluded the sale of such cash assets and chilled bidding by other parties at the auction.[208] In addition, the committee alleged that the secured creditor failed to disclose the existence of an insurance policy from which the secured creditor or any other party would derive substantial benefit as the purchaser of the debtors' assets.[209] The secured creditor defended the receipt of the cash assets by arguing that most of the payments were authorized by the cash collateral order and were made for equipment leased by the secured creditor to the debtors.[210] After the bankruptcy court ruled that the secured creditor's receipt of the cash assets were unauthorized post-petition transfers, the secured creditor appealed.[211]

On appeal the secured creditor argued that the bankruptcy court erred when it held the cash assets were unauthorized adequate protection payments because the term sheet unambiguously terminated the secured creditor's right to adequate protection payments.[212] The

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200 *Id.* at 443.

201 *Id*. The court's reasoning is somewhat confusing due to a reference to the value of the assets potentially being worth less than the credit bid.

202 *Id.* at 447.

203 *In re LWD, Inc.,* 340 B.R. 363, 365 (W.D. Ky. 2006).

204 *Id.*

205 *Id.*

206 *Id.*

207 *Id.*

208 *Id.*

209 *Id.*

210 *Id.*

211 *Id.* at 365-66.

212 *Id.* at 367.

District Court for the Western District of Kentucky affirmed the bankruptcy court, noting that the term sheet settled all of the claims of the secured creditor and therefore superseded and replaced the cash collateral order.[213]

The district court also agreed with the bankruptcy court that the debtor and the secured creditor had failed to disclose the insurance policy such that potential bidders were denied an opportunity to value the assets properly so as to be placed on equal footing to that of the secured creditor.[214] Therefore, according to the district court, the bankruptcy court correctly ruled in favor of the committee when it set aside the sale of the assets by credit bid to the secured creditor.[215]

Finally, in *In re Radnor Holdings Corporation*, the court overruled an objection of the creditors committee to the proposed bidding and sale procedures that authorized the secured creditor to credit bid at an auction of substantially all of the debtors' assets.[216] Soon after the bidding and sale procedures were filed, the committee filed its objection and also commenced an adversary proceeding seeking to, among other things, equitably subordinate and recharacterize the secured creditor's claim, in addition to disallowing the proofs of claim previously filed by the secured creditor.[217] As part of the objection, the committee asserted that the secured creditor was precluded from credit bidding because the claims of the secured creditor were not "allowed claims."[218]

In order to resolve the issue prior to the auction and circumvent any prejudice to the secured creditor, the court conducted an expedited hearing to determine whether the secured creditor's claims were actually allowed claims.[219] The court reviewed whether, at the time the initial loans had been extended, the secured creditor had an expectation of repayment and whether it had entered into the financing arrangements merely as part of a loan-to-own strategy.[220] After a lengthy analysis and discussion, the court allowed the secured creditor's proofs of claim because the prepetition loans were in the nature of a loan and not a capital infusion in exchange for equity, as alleged by the committee.[221]

VI. VALUE OF CLAIMS AS OPPOSED TO THE VALUE OF COLLATERAL

Upon review of the statute itself, the legislative history, and recent case law, it is now clear that a secured creditor is permitted to bid the entire amount of its claim, not just the value of the collateral.[222] For example, in a case pre-dating the oft-cited *Philadelphia Newspapers* and

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213 *Id.*

214 *Id.* at 368.

215 *Id.*

216 *In re Radnor Holdings, Corp*., 353 B.R. 820, 827 (Bankr. D. Del. 2006); *see In re The Merit Group, Inc.*, 464 B.R. 240 (Bankr. D. S.C. 2011) (conditionally overruling committee's request to deny credit bidding due to alleged basis for recharacterization of claim).

217 *Id*.

218 *Id*. at 845-46.

219 *Id*. at 826.

220 *Id*. at 826-38.

221 *Id*. at 846.

222 *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, --- U.S. ---, 132 S.Ct. 2065 (2012); *In re Philadelphia Newspaper, LLC*, 599 F.3d 298 (3d Cir. 2010); *see Spillman Inv. Group, Ltd. v. American Bank of*

RadLAX, the court considered whether a plan proposed by the debtors improperly purported to limit the secured lenders' ability to credit bid the entire amount of their claims.[223] After the secured lenders objected to the plan, the court considered the plain meaning of section 363(k) as well as the legislative history and reasoned that section 363(k) permits a credit bid equal to the entire claim, including any unsecured deficiency portion of the claim.[224] In addition, the court found persuasive a decision from the Bankruptcy Court for the Central District of California and quoted the following:

> An argument might be made that the "allowed claim" referred to in the Congressional Record is only the secured portion of KK's claim. But this is an argument of form and not of substance.
>
> Until KK is paid in full, any bid received is subject to overbid by KK. If ARC's bid were valued at $3,300,000.00, KK could overbid it, and KK's bid would then become, by definition, the "allowed" claim. Because KK is a non-recourse creditor, it is practical that KK will bid in its entire obligation and therefore that is its "allowed" claim. Because no one could buy the property without KK's consent, unless KK is paid in full, the "allowed claim" of KK must (for purposes of credit bidding), be its total claim without reference to the "value" of the property.[225]

The court therefore concluded that it was improper for the plan to limit the ability of the secured lender to credit bid an amount less than the face amount of its claim.[226]

Two decisions from the Third Circuit Court of Appeals and the Bankruptcy Court for the District of Delaware have suggested parameters in the loan-to-own context that are consistent. In *In re Submicron Systems Corporation*, the Third Circuit Court of Appeals addressed whether junior lienholders should be permitted to credit bid under section 363(k).[227] The junior lienholders, in executing what was arguably a loan-to-own strategy, sought to credit bid the face value of their claims, despite the fact that the collateral securing their claims had no economic value.[228] The Third Circuit held that under section 363(k), the junior lienholders were entitled to bid the full face amount of their claims, subject to satisfaction of the senior secured creditors in

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Texas (In re Spillman Dev. Group, Ltd.), 401 B.R. 240 (Bankr. W.D. Tex. 2009), *aff'd*, 710 F.3d 299 (5th Cir. 2013) (credit bid of full amount of indebtedness eliminated right to pursue guarantors).

223 *In re Sun Cruz Casinos, LLC,* 298 B.R. 833, 836 (Bankr. S.D. Fla. 2003); *see also In re NNN 3500 Maple 26, LLC*, 2014 WL 1407320 (Bankr. N.D. Tex. April 10, 2014) (transfer of equity through plan, not sale of assets, thus precluding credit bid).

224 *Id*. at 838-39 (citing 124 Cong. Rec. H 11093 (Daily Ed. Sept. 28, 1978)).

225 *Id*. at 839 (citing *In re Realty Invs., Ltd*., 72 B.R. 142, 146 (Bankr. C.D. Cal. 1987)); *see In re Midway Invs., Ltd*., 187 B.R. 382, 391 (Bankr. S.D. Fla. 1995) (credit bid allowed in full amount of claim).

226 *Id.* at 839.

227 *In re Submicron Systems Corp.,* 432 F.3d 448 (3d Cir. 2006). For a discussion of the other issues in *Submicron, see* Jo Ann J. Brighton, Submicron Developments in Recharacterization: Certainty and Finality, or Further Confusion, 25 APR Am. Bankr. Inst. J. 28 (April, 2006).

228 *Id*. at 459 (citing *In re Sun Cruz Casinos, LLC*, 298 B.R. 833, 839 (Bankr. S.D. Fla. 2003); *In re Morgan House Gen. P'ship*, 1997 WL 50419 at *1 (E.D. Pa. Feb. 7, 1997); *In re Midway Invs., Ltd.*, 187 B.R. 382, 391 n. 12 (Bankr. S.D. Fla. 1995); *In re Realty Invs., Ltd. V*, 72 B.R. 143, 146 (Bankr. C.D. Cal. 1987)).

cash.[229] According to the Third Circuit, the plain language of section 363(k) dictates that the junior lienholders' bid should not be limited by the value of their collateral.[230] Moreover, the Third Circuit interpreted section 363(k) as a recognition by Congress of a free market sale process, representing an alternative to reliance on the inefficient and unpredictable process of collateral valuation.[231]

VII. FEES OF INVESTMENT BANKERS

Depending on specific facts and circumstances, some courts have surcharged a secured creditor's collateral, even when the secured creditor purchased assets through a credit bid. Investment bankers are particularly at risk where substantially all of a debtor's assets are sold pursuant to a credit bid. In *In re HNRC Dissolution Company*, for example, the debtor retained an investment banker to market and sell its assets.[232] As part of the retention, the debtor agreed to pay the investment banker a transaction fee equal to a percentage of the sale price for the assets.[233] At the auction, the secured creditor submitted a credit bid for approximately half of the sale price, with the remainder of the bid in cash.[234] The investment banker subsequently sought compensation based on a percentage of the total sale price, which included the credit bid.[235] The debtor objected to any payment to the investment banker that was calculated based on the credit bid.[236]

After the bankruptcy court awarded the investment banker its fee based on the sale price, including the credit bid, the debtor appealed.[237] The district court noted that the parties had contemplated a fee structure based on "aggregate consideration,"[238] and thus interpreted the credit bid as nothing more than a method of payment. The court noted that if the secured creditor had paid cash, it would have been entitled to recoup such cash payment in satisfaction of the secured debt owed by the debtor to the secured creditor.[239] The court therefore included the amount of the credit bid when determining the investment banker's fee.

Confronted with a similar issue, the Bankruptcy Court for the District of Kansas relied on surcharge to compensate a professional notwithstanding a credit bid by the secured creditor.[240] In *A-1 Plank*, the court held that the secured creditor who credit bid the full purchase was

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229 *Submicron*, 432 F.3d at 459; *see In re Finova Capital Corp*., 356 B.R. 609, 625-26 (Bankr. D. Del. 2006); *Altus Bank v. State Farm Fire and Casualty Co.*, 1992 WL 341321 (9th Cir. Nov. 19, 1992).

230 *Id*.

231 *Id*. at 461.

232 *In re HNRC Dissolution Co.,* 340 B.R. 818, 821 (E.D. Ky. 2006).

233 *Id.*

234 *Id.*

235 *Id.* at 822.

236 *Id.*

237 *Id.* at 823.

238 *Id.* at 824.

239 *Id.*; *see In re Daufuskie Island Properties, LLC*, 441 B.R. 60, 65-66 (Bankr. D. S.C. 2010) (bidding procedures approved by court construed to require payment of auction fee by credit bidder).

240 *See In re A-1 Plank & Scaffold Mfg., Inc.*, 437 B.R. 689 (Bankr. D. Kan. 2010).

nonetheless subject to a surcharge of its collateral for the fee of the real estate broker.[241] The Chapter 11 debtors had proposed to sell all property subject to the secured creditor's security interest and mortgage.[242] The secured creditor was significantly undersecured and at all times had resisted any notion that its collateral might be surcharged.[243] Shortly after the debtors filed for bankruptcy, however, the debtors and their real estate broker entered an agreement whereby the broker would market the debtors' real estate.[244] The bankruptcy court eventually entered an order approving the retention application of the broker which included a commission of six percent on the gross sale price of the real estate.[245] Over a six month period, the broker exposed the real estate to several prospective buyers, including a third party who eventually came forward with a cash bid of $800,000.[246] In their sale motion, the debtors proposed to pay the realtor's commission based on the cash bid for the property.[247] Thereafter, the secured creditor credit bid the full purchase price and objected to the payment of any commission.[248]

In considering whether to surcharge the secured creditor's collateral, the court turned to both the Bankruptcy Code and applicable Kansas state law.[249] Kansas law provides that a real estate broker that produces a buyer that is ready willing and able to close, and those efforts cause the transaction, the broker is entitled to a commission.[250] Such commission is due even if the transaction does not close, so long as the failure to close results from actions or "interference not caused by" the broker.[251] The court noted that the retention agreement entitled the broker to the commission because it procured the cash bidder, even though the cash bidder was not the winning bidder.[252] When the secured creditor made its credit bid, that was sufficient to be characterized as interference beyond the control of the broker.[253] According to the court, if a secured creditor could always credit bid and thus deny a broker its commission, brokers would be disincentivized from participating in a bankruptcy sale.[254]

The court next considered whether surcharge was appropriate. The court found that the secured creditor benefitted from the broker's efforts because a purchaser was actually procured.[255] It was inconsequential that the secured creditor ultimately bid twice as much as the prospective cash purchaser.[256] The court found persuasive the fact that the broker marketed the property without any notice that the secured creditor might credit bid.[257] In addition, the court

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241 *Id*. at 691; *contra In re TIC Memphis RI 13, LLC*, 498 B.R. 831 (Bankr. W.D. Tenn. 2013) (debtor's professionals assumed the risk of insufficient proceeds used from non-credit bid sale to satisfy secured creditor who contested every aspect of bankruptcy).

242 *Id*. at 691.

243 *Id*.

244 *Id*. at 691-92.

245 *Id*. at 691.

246 *Id*. at 692.

247 *Id*.

248 *Id*. at 693.

249 *Id*. at 693-94.

250 *Id*. at 693.

251 *Id*. at 694.

252 *Id*.

253 *Id*.

254 *Id*.

255 *Id*.

256 *Id*.

257 *Id*.

emphasized that the broker's efforts enabled the secured creditor to leverage its credit bid.[258] Although the secured creditor prevailed at the auction through its credit bid, it later sold the real estate to the cash bidder that the broker had first identified.[259] The court viewed the broker's efforts as facilitating the secured creditor's negotiations with, and eventual sale to, the cash bidder which occurred as a separate transaction outside of bankruptcy.[260]

Finally, the court noted that the secured creditor never objected to the commission proposed as part of the retention application, which was approved by the court without objection of the secured creditor.[261] The court thus found the secured creditor's silence in this regard to weigh in favor of awarding the broker its commission (even though the commission was to be based on a cash sale).[262]

In another decision considering the nexus between credit bidding and professional fees, an investment banker was retained by the debtor to market and sell the debtor's assets over the secured creditor's objection.[263] The order approving the investment banker's retention included a provision stating that in the event that one of the debtor's secured creditors successfully credit bid, the investment banker reserved the right to request a fee in connection with its sales and marketing efforts.[264] The order also provided that any commission, fee and/or reimbursement of the investment banker "is reserved for later argument under applicable law, including 11 U.S.C. § 506(c). . ."[265]

Through its investment banker, the debtor subsequently marketed, and conducted an auction for, substantially all of its assets which served as collateral for the secured creditor.[266] At the auction, the secured creditor was the highest bidder by virtue of its credit bid.[267] Thereafter, the debtor proposed to pay the investment banker's fees and expenses incurred in connection with the marketing and sale of the debtor's assets.[268]

On appeal the district court affirmed the bankruptcy court's ruling that the secured creditor was required to pay the investment banker's fees and expenses pursuant to its retention order and section 506(c).[269] The district court held that the debtor was permitted to recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent that the secured creditor benefited from the efforts expended by the debtor's investment banker.[270]

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258 *Id*.
259 *Id*. at 695.
260 *Id*.
261 *Id*.
262 *Id*.
263 *Borrego Springs Bank, N.A. v. Skuna River Lumber, LLC (In re Skuna River Lumber, LLC)*, 381 B.R. 211, 213 (N.D. Miss. 2008); *see also In re Skuna River Lumber, LLC*, 352 B.R. 788 (Bankr. N.D. Miss. 2006).
264 *Skuna River*, 381 B.R. at 213.
265 *Skuna River*, 352 B.R. at 790.
266 *Id*. at 791-92.
267 *Id.* at 792.
268 *Id*.
269 *Skuna River*, 381 B.R. at 215-16.
270 *Id*. at 216.

According to the district court, the bankruptcy court properly surcharged the assets after they had been sold to the secured creditor.[271] The secured creditor argued that the surcharge was inappropriate because it had credit bid for the assets and, therefore, the efforts of the investment banker did not confer any benefit to the secured creditor.[272] The district court rejected such argument noting that the marketing, sale and auction process had established a market value for the assets.[273] Similar to the view of the *A-1 Plank* court, the district court explained that, as a policy consideration, unless a secured creditor submitting a credit bid could be surcharged, professionals would be discouraged from providing any services to debtors or trustees if a credit bidder could circumvent payment of fees and expenses.[274]

Undeterred, the secured creditor appealed to the Fifth Circuit Court of Appeals, which reversed.[275] According to the Fifth Circuit, at the time the collateral was surcharged under section 506(c), the bankruptcy court had already approved a sale.[276] It is unclear if the sale had actually been consummated, or only approved, when the bankruptcy court entered the surcharge order. Because a surcharge is limited to property of the bankruptcy estate, the Fifth Circuit held the bankruptcy court was without jurisdiction over the property when it granted the motion to surcharge.[277] The Fifth Circuit commented that if the bankruptcy court wished to retain jurisdiction over the property, it should have withheld approval of the sale pending payment by the secured creditor of the investment banker's fees.[278] Instead, the court's sale order effectively stripped the bankruptcy court of jurisdiction over the property and limited jurisdiction to the proceeds, of which there were none due to the credit bid.[279]

VIII. TRUSTEE COMPENSATION AND QUARTERLY FEES

Investment bankers are not the only professionals whose compensation is at risk due to credit bidding. Courts have uniformly denied compensation under section 326(a) to trustees as a result of their efforts to market and sell property that was eventually purchased by a credit bidder.[280] In *In re Pink Cadillac Associates*, a Chapter 11 trustee sold certain real estate encumbered by a mortgage.[281] At the sale hearing, the sole bid was tendered by the mortgagee in the form of a credit bid.[282] After the court approved the sale to the mortgagee, the trustee sought compensation pursuant to sections 326(a), 330 and 506(c).[283]

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271 *Id*.

272 *Id.*

273 *Id.*

274 *Id.*

275 *Borrego Springs Bank, N.A. v. Skuna River Lumber, LLC (In re Skuna River Lumber, LLC)*, 564 F.3d 353 (5th Cir. 2009).

276 *Id*. at 355.

277 *Id*.

278 *Id*. at 356.

279 *Id*.

280 *In re Lan Assocs., XI, L.P.*, 192 F.3d 109 (3d Cir. 1999); *In re Pink Cadillac Assocs.,* 1997 WL 164282 (S.D.N.Y. April 8, 1997).

281 *Pink Cadillac*, 1997 WL 164282 at *1 (S.D.N.Y. April 8, 1997).

282 *Id.*

283 *Id.* at *2.

Because the compensation sought by the trustee exceeded the maximum allowed under section 326(a), the United State Trustee objected to the compensation request.[284] The Chapter 11 trustee argued that the compensation sought was significantly less than the threshold amount allowed under section 326(a) if the calculation included the amount of the credit bid, and should therefore be allowed.[285] After the bankruptcy court approved the compensation request, the United States Trustee appealed.[286]

The District Court for the Southern District of New York reversed the bankruptcy court, concluding that the amount of the credit bid did not constitute "monies disbursed" under section 326(a).[287] In addition, the district court rejected the Chapter 11 trustee's argument that it was entitled to surcharge. The district court held that section 506(c) does not provide the trustee with the authority to seek compensation directly from the mortgagee.[288]

The Third Circuit Court of Appeals has adopted a position similar to that expressed in *Pink Cadillac*.[289] In *In re Lan Assocs.*, a Chapter 11 trustee was appointed in order to administer the debtor's principle assets, a parcel of real property subject to a mortgage of the debtor's prepetition lender.[290]After the case converted to Chapter 7, the trustee was reappointed.[291] Although the trustee was prepared to abandon the property due to a lack of equity, the secured lender offered to purchase the property by credit bidding at an asset sale.[292] The secured lender enticed the trustee to conduct a sale by offering a carveout to cover administrative expenses, providing a distribution to the estate estimated by the trustee to be approximately twenty-five percent, and waiving any deficiency claim.[293]

After the court approved the sale, the trustee filed an interim fee application which calculated the trustee's commission by including the credit bid, and the court approved the fee application.[294] When the trustee submitted his final report, he sought confirmation for interim payments he had received, but did not seek additional confirmation.[295] One year later, the United States Trustee filed an objection to the final report, arguing that the amount of the credit bid had been improperly included in the trustee's commission calculation.[296]

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284 *Id.* Interestingly, the mortgagee did not object to the compensation request, despite the fact that the surcharge would have directly impacted the mortgagee.

285 *Id.*

286 *Id.*

287 *Id.* at *3-4.

288 *Id.* at *5-6. The district court remanded to the bankruptcy court with instructions to consider whether quantum meruit entitled the Chapter 11 trustee to compensation.

289 *In re Lan Assocs. XI, L.P.*, 192 F.3d 109 (3d Cir. 1999); *see also Matter of England*, 153 F.3d 232 (5th Cir. 1998) (property transferred to *unsecured* creditors as part of settlement could not be included as moneys disbursed).

290 *Id*. at 111.

291 *Id.* at 112.

292 *Id.*

293 *Id.*

294 *Id.*

295 *Id.*

296 *Id.* at 113.

After a hearing on the final report, the bankruptcy court concluded that because the secured lender had consented to the arrangement and the unsecured creditors received a benefit from the sale, the trustee was entitled to base his commission on the total purchase price of the asset transferred, including the credit bid.[297] Thereafter, the United States Trustee appealed to the district court, which reversed because under section 326(a) the value of a credit bid does not constitute "moneys disbursed or turned over . . . to a party interest and cannot be used to calculate the maximum allowable amount of trustee compensation."[298]

The trustee subsequently appealed to the Third Circuit Court of Appeals, arguing that the district court erroneously determined that the credit bid could not be used to calculate the trustee's compensation.[299] According to the trustee, "because the encumbered property was actually sold to [the mortgagee] and not simply abandoned or turned over, an exchange of value occurred which was sufficient to bring the transaction within the meaning of 11 U.S.C. § 326(a)."[300] The trustee further contended that no reason existed to distinguish between a credit bid sale and a sale free and clear of liens and that any distinction "elevates form over substance."[301] In response, the United States Trustee argued that both case law and the legislative history support exclusion of the amount of the credit bid from the trustee's compensation.[302]

The Third Circuit first noted that under section 326(a), compensation is awarded "upon all moneys disbursed or turned over in the case by the trustee to parties in interest, excluding the debtor, but including holders of secured claims."[303] Because the court found the term "monies" in section 326(a) to be ambiguous, it undertook a review of the legislative history, which revealed that a commission should not be based on a situation where the trustee either turns over or abandons property to the secured creditor and the secured creditor is permitted to foreclose.[304] Moreover, the court emphasized that although the trustee presumably participated in negotiating the credit bid sale, the trustee did not actually disburse anything to the secured creditors other than the property.[305] The court found that the credit bid sale more closely resembled an abandonment or turnover to the secured creditor than a sale to a third party.[306] As such, the Third Circuit held that Congress did not intend to include credit bids in the trustee's compensation base.[307]

The Ninth Circuit Court of Appeals recently reached a similar result when it held that a trustee was not entitled to a commission based on a credit bid.[308] In *Hokulani Square*, the

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297 *Id.* at 113-14.

298 *Id.* at 114.

299 *Id.*

300 *Id.* at 114-15.

301 *Id.* at 115.

302 *Id.*

303 *Id.* (citing 11 U.S.C. § 326(a)).

304 *Id.* at 116 (citing *In re Pink Cadillac Assocs.*, 1997 WL 164282, at *3 (S.D.N.Y., April 8, 1997)).

305 *Id.* at 117.

306 *Id.*

307 *Id.* at 118. The Third Circuit also rejected the trustee's reliance on the constructive disbursement theory, under which a trustee is entitled to receive compensation for disbursements of property or other consideration which are deemed to be "moneys disbursed or turned over" under section 326(a).

308 *Tamm v. UST (In re Hokulani Square, Inc.)*, 776 F.3d 1083 (9th Cir. 2015).

debtor's secured creditors submitted a credit bid at an auction and were deemed the winning bidders.[309] Thereafter, the Chapter 11 trustee requested compensation which included the credit bid amount, thereby drawing an objection from the United States Trustee.[310] The United States Trustee contended that section 326(a) did not authorize the trustee to include the value of the credit bid when seeking his commission.[311]

After the bankruptcy court allowed the trustee to include the value of the credit bid, the United States Trustee appealed to the Bankruptcy Appellate Panel, which reversed.[312] On appeal to the Ninth Circuit, the court began its analysis by observing that a bankruptcy court has discretion to award a trustee fees up to a cap that is calculated as a percentage of "all moneys disbursed or turned over" by the trustee.[313] The court focused on the plain meaning of the term "all moneys disbursed or turned over" and concluded that it requires a generally accepted medium of exchange.[314] As such, the court noted that the trustee may collect fees only on transactions for which he pays the secured creditors in some form of generally accepted medium of exchange.[315]

The court next considered whether a credit bid would fall within this "medium of exchange."[316] The court noted that regardless of how broadly "moneys" is defined, it is not expansive enough to encompass real estate, which "is about as far from a 'medium of exchange' as one can get."[317] The court observed that the legislative history to section 326(a) does not contemplate a commission based on the turnover of property to a secured creditor, or the abandonment of property so as to allow foreclosure by the secured creditor.[318] As such, the court agreed with the Fifth and Third Circuits, both of which similarly reviewed the legislative history and concluded that a credit bid should not be included in determining a trustee's compensation.[319]

Finally, the court rejected the trustee's argument that past practice and prior decisions of the Ninth Circuit counsel in favor of permitting a trustee to include the value of a credit bid when calculating a commission.[320] The court also noted that while its result may be "harsh and misguided," it does not "rise to the level of absurdity" such that the value of the credit bid to be included.[321]

The *Hokulani*, *Lan Assocs.*, and *Pink Cadillac* decisions arose in connection with requests by trustees to include the value of a credit bid in calculating their compensation. In

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309 *Id*. at 1085.
310 *Id*.
311 *Id*.
312 *Id*.
313 *Id*.
314 *Id*. at 1085-86.
315 *Id*. at 1086.
316 *Id*.
317 *Id*.
318 *Id*.
319 *Id*. (citing *In re Lan Assoc. XI, L.P.*, 192 F.3d 109 (3d Cir. 1999); *Matter of England*, 153 F.3d 232 (5th Cir. 1998)).
320 *Id*. at 1086-87.
321 *Id*. at 1088.

those cases, the courts considered whether a credit bid could constitute "moneys disbursed or turned over." The Bankruptcy Court for the Eastern District of North Carolina was confronted with a slightly different issue when it considered whether a credit bid is considered a "disbursement" for purposes of calculating the quarterly fee due under 28 U.S.C. § 1930(a)(6).[322] In *WM Six Forks*, the debtor sold its assets to the first mortgage holder pursuant to a credit bid in conjunction with a confirmed plan of liquidation.[323] When the debtor subsequently filed its quarterly fee statement and post-confirmation report, the debtor listed total disbursements of only approximately $111,000, notwithstanding the credit bid of approximately $37 million.[324] Upon the motion of the bankruptcy administrator, the court entered an order to show cause for its failure to pay the correct quarterly fee, which, according to the bankruptcy administrator should have been $30,000, not $975 as calculated by the debtor.[325] The bankruptcy administrator contended that the word "disbursements" is entitled to a broad interpretation under 28 U.S.C. § 1930(a)(6), while the debtor asserted that "disbursements" is narrow in scope.[326]

In holding that "disbursements" under 28 U.S.C. § 1930(a)(6) should be interpreted broadly, the court relied on several factors.[327] The court first noted that the term is not defined by the Bankruptcy Code or in its legislative history.[328] The court then turned to, and distinguished, sections 326(a) and 543, both of which utilize the term "disbursement" or a derivation thereof.[329] The court next observed that other courts have broadly interpreted the term "disbursement" in contexts other than credit bidding.[330] The court further observed that the congressional purpose underlying quarterly fees supports a broad reading, as the intention was to establish a revenue generating mechanism to fund the United States Trustee Program other than the taxpayer.[331] Finally, citing *RadLAX*, *Spillman*, and *HNRC*, among other decisions, the court noted that section 363(k) treats credit bids the same as if cash had been paid and then immediately reclaimed.[332] The court therefore held that the credit bid at issue should be treated as a "disbursement" for purposes of calculating the quarterly fee under 28 U.S.C. § 1930(a)(6).

IX. CONCLUSION

As loan-to-own strategies have been employed with more frequency, the ability of secured creditors to credit bid has assumed a central role in bankruptcy cases. To date, case law concerning the amount a secured creditor is entitled to credit bid has been fairly consistent, at least in principle. However, courts will continue to be confronted with credit bidding issues that will, in large part, be determined by the particular facts of each case.

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322 *In re WM Six Forks, LLC*, 502 B.R. 88 (Bankr. E.D. N.C. 2013).
323 *Id*. at 90.
324 *Id*.
325 *Id*.
326 *Id*. at 90-91.
327 *Id*. at 91-94.
328 *Id*. at 91.
329 *Id*. at 92.
330 *Id*. at 92-93.
331 *Id*. at 93.
332 *Id*. at 93-94.

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~~Stopping~~ Slowing Down the Loan-to-Own Process

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Not all loans are made with the same intent. Most loans are made with the expectation of a full return of capital with interest. Some loans are initiated with the "pawn shop" mentality of "lend[ing] a few dollars against the goods they … can [later] sell … at [higher] market value." Thomas C. Prinzhorn and David Peress, "Nontraditional Lenders and the Impact of Loan-to-Own Strategies on Restructuring Process," XXV *ABI Journal* 3, p 48, April 2006. Regardless of initial intentions, even an innocuous loan can turn into a different animal if the initial lender seeks to sell the credit facility, especially at a discount. The sale of a loan at a discount led, in part, to the case of *In re ALT Hotel, LLC*, 479 B.R. 781 (Bankr. N.D. IL 2002).

After a series of transactions, a 2006 mortgage loan was assigned in May 2010 to DiamondRock Allerton Owner, LLC ("DiamondRock"), during the pendency of a foreclosure proceeding. *Id.* at 789. The loan sale proceeds were reportedly $8,000,000 less than the face value of the indebtedness. *Id.* The property owner and its parent each commenced bankruptcy and initiated two adversary proceedings to stop DiamondRock from acquiring the property (DiamondRock advertised its goal of becoming the owner of the collateral, the Allerton Hotel, in its full corporate name: DiamondRock Allerton Owner, LLC).

The debtors raised various points in an attempt to block DiamondRock's path to ownership. The debtors alleged pre-petition breach of contract, breach of implied covenant of good faith, unjust enrichment, post-petition breach of contract and equitable subordination, among other claims. *Id.* at 792. One important count unique to the proceedings was the debtors'

allegation that DiamondRock would be unjustly enriched if allowed to foreclose on a $69 million loan for which it paid only $61 million. Judge Goldgar held that the debtors could not prove unjust enrichment as they were unable to meet the second element under New York law: "(1) the defendant was enriched; (2) at the plaintiff's expense; and (3) equity and good conscience require restitution." *Id.* at 797. Because the initial lender suffered the harm, the debtors' unjust enrichment count failed as a matter of law. *Id.* at 798. Accordingly, DiamondRock was not prevented from any attempt to collect upon the full amount of the acquired debt. Ultimately, DiamondRock did not become the owner of the Allerton Hotel, but was paid off as a fully secured creditor, earning a substantial return on its $61 million investment.

Loan-to-own lenders attempt to secure ownership through fast-track proceedings, typically involving 363 sales. Parties seeking to derail or at least slow down the ownership freight train need to act quickly. While an unjust enrichment argument is unlikely to slow matters, there are a number of other avenues available to parties in interest as set out in the sections below addressing Credit Bidding in Section 363 Sales in Bankruptcy.

The following is excerpted with the permission of the American Bankruptcy Institute (www.abi.org) and the authors of the forthcoming book to be published by ABI:

American Bankruptcy Institute

CREDIT BIDDING IN BANKRUPTCY

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A. "Cause" to Deny A Credit Bid Under Section 363(k)

Despite the general acknowledgement that credit bidding is an important right for secured creditors, section 363(k) of the Bankruptcy Code expressly permits a bankruptcy court to deny or limit credit bidding "for cause."[1] What constitutes cause, of course, is not defined in the Bankruptcy Code and, thus, is left for courts to determine on a case-by-case basis.[2] In *In re Philadelphia Newspapers, LLC,* 599 F.3d 298 (3d Cir. Pa. 2010), the Third Circuit Court of Appeals captured the law as follows:

> As an initial matter, the Code plainly contemplates situations in which assets encumbered by liens are sold without affording secured lenders the right to credit bid. The most obvious example arises in the text of § 363(k), under which the right to credit bid is not absolute. A secured lender has the right to credit bid "unless the court for cause orders otherwise." In a variety of cases where a debtor seeks to sell assets pursuant to § 363(b), courts have denied secured lenders the right to bid their credit.[3]

Expanding on the concept of "cause", the Third Circuit went on to state that section 363(k) empowers bankruptcy courts to "deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment."[4] Despite this broad pronouncement regarding the scope of "cause" under section 363(k), courts have traditionally limited "cause" to a handful of specific factual scenarios, which are discussed below.[5]

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[1] 11 U.S.C. § 363(k).

[2] *In re Old Prairie Block Owner, LLC,* 464 B.R. 337, 348 (Bankr. N.D. Ill. 2011) (citations omitted); *see also In re NJ Affordable Homes Corp.,* 2006 WL 2128624 at *16 (Bankr. D. N.J. June 29, 2006) (noting that "cause" is "intended to be a flexible concept enabling a court to fashion an appropriate remedy on a case-by-case basis"); *In re River Rd. Hotel Partners, LLC,* 2010 WL 6634603 at *1 (Bankr. N.D. Ill. 2010) (holding that "[s]ection 363 gives courts the discretion to decide what constitutes 'cause' and the flexibility to fashion and appropriate remedy by conditioning credit bidding on a case-by-case basis").

[3] *In re Philadelphia Newspapers, LLC,* 599 F.3d at 315-16 (internal citations omitted).

[4] *Id.* at 315 n. 14.

1. When There is a Dispute as to the Validity or Amount of a Creditor's Claim or Lien

First, a number of courts have found that "cause" exists to limit a secured creditor's right to credit bid when there is a pending dispute as to the validity or the amount of a creditor's claim or lien and a rapid sale of the assets is important to preserve value. Section 363(k) only allows creditors to credit bid "allowed" secured claims.[6] Without a valid secured claim, the sold property could be transferred to a putative secured creditor using a credit bid as part of the consideration, only to have that creditor's lien subsequently deemed invalid.[7] Thus, it is logical to limit credit bidding when there is a dispute as to the validity of a secured creditor's claim.

Under section 502(a) of the Bankruptcy Code, the filing of a proof of claim by a creditor results in that claim being allowed unless and until a party in interest objects to such claim.[8] Thus, it is important that a secured creditor seeking to credit bid at a section 363 sale promptly and timely file a proof of claim. In chapter 11 cases, this requirement may be lessened somewhat if the creditor was listed with a secured claim in the debtor's schedules and such claim is not listed as disputed, contingent or unliquidated. The scheduling of a claim in such a manner results in the claim being deemed allowed.[9]

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[5] For additional discussion regarding "cause" with respect to section 363(k) of the Bankruptcy Code, see Gregg, Hon. John T., *A Review of Credit Bidding Under 11 U.S.C.A. § 363(k),* 2008 Ann. Surv. of Bankr. Law 17 (2008); Winikka, Daniel P. and Simpson, Debra K., *Will Bankruptcy Courts Limit the Right to Credit Bid?,* 17 J. Bankr. L. & Prac. 6 Art. 6 (2008); Erens, Brad B. & Hall, David A., *Secured Lender Rights in 363 Sales and Related Issues of Lender Consent,* 18 Am. Bankr. Inst. L. Rev. 535, 558 (2010).

[6] *In re Merit Group, Inc.,* 464 B.R. 240, 252 (Bankr. D. S.C. 2011) (citing *Bank of Nova Scotia v. St. Croix Hotel Corp. (In re St. Croix Hotel Corp.),* 44 B.R. 277, 279 (Bankr. D. V.I. 1984)).

[7] *Id.*

[8] 11 U.S.C. § 502(a) ("A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest ... objects.").

Once the claim is allowed, however, the debtor, the trustee, a creditors' committee or any other party in interest may object to the claim or file an adversary proceeding to challenge the creditor's lien. Upon a timely objection, the claim is no longer deemed allowed and may only be allowed after notice, hearing, and the court's determination.[10] The issue then becomes whether a creditor should be permitted to credit bid its claim despite the fact that such claim is the subject of a pending objection. Recognizing the potential for abuse that would exist if a creditor, whose claim is the subject of a bona fide dispute, is permitted to credit bid that claim at the auction sale, a number of courts have found that "cause" exists to deny or limit the opportunity to credit bid in such cases.

Courts have disagreed about what level of dispute with respect to the secured creditor's claim is necessary to constitute "cause" under section 363(k). While most courts agree that a pending claim objection is sufficient "cause" to limit credit bidding,[11] in cases where only allegations have been made and no formal claim objection has been filed, courts have held that sufficient facts did not exist to warrant a finding of "cause."[12] Most courts agree that more is required than mere suspicions or unsubstantiated allegations.[13]

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[9] *See* Fed.R.Bankr.P. 3003(b)(1) which provides, in pertinent part: "[t]he schedule of liabilities filed pursuant to § 521(a)(1) of the Code shall constitute prima facie evidence of the validity and amount of the claims of creditors, unless they are scheduled as disputed, contingent, or unliquidated."

[10] 11 U.S.C. 502(b). Where resolution of a claim cannot occur timely and would unduly delay the administration of the case, the court may estimate the allowed claim under section 502(c)(1) of the Bankruptcy Code.

[11] *See e.g., In re Old Prairie Block Owner,* 464 B.R. 337, 348 (Bankr. N.D. Ill. 2011) (stating that "cause" exists "under section 363(k) to bar a secured creditor from credit bidding when the creditor's lien is questioned or otherwise in dispute."); *Morgan Stanley Dean Witter Mortg. Capital, Inc. v. Alon USA LP (In re Akard Street Fuels, L.P.),* 2001 WL 156332 (Bankr. N.D. Tex. Dec. 4, 2001) (finding that "a bona fide dispute as to a creditor's liens satisfies [section] 363(k)'s requirement of 'for cause' in disallowing a secured creditor to credit bid at a sale").

One frequently cited case where a court found that "cause" existed to limit credit bidding under section 363(k) due to a bona fide dispute with respect to the secured creditor's claim is *Nat'l. Bank of Commerce of El Dorado v. McMullan (In re McMullan).*[14] In that case, a mortgagee sought to foreclose on several notes and mortgages belonging to the debtors, who filed bankruptcy after a foreclosure was filed in state court, removed the foreclosure action to bankruptcy court, and formally disputed the liens on various grounds. One year later, after trial on some of the issues in the case, the court found that the secured creditor's lien was disputed, and that the proceedings with respect to such dispute had not yet concluded.[15] Therefore, the court held that the secured creditor could not credit bid should there be any sale by the estate's trustee. Rather, any such sale would be for cash with liens and other claims of ownership, if any, attaching to the proceeds of the sale.

In *In re Daufuski Island Props., LLC,*[16] the debtor sought to sell certain real property by auction. The bidding procedures approved by the court contemplated that secured creditors could credit bid their indebtedness at the auction sale. Various disputes regarding credit bid rights arose. One such dispute involved the claim of a purported secured creditor who alleged that he should be allowed to credit bid to purchase certain real property on which he asserted a

[12] *See e.g., In re Merit Group, Inc.,* 464 B.R. 240, 252 (Bankr. D.S.C. 2011) (surveying a number of opinions regarding the extent of dispute with respect to a secured creditor's claim that was necessary for a finding of "cause" and ultimately concluding that the committee's general assertions that the secured creditor's claims should be reclassified as equity were not sufficient to deny the creditor's right to credit bid.).

[13] *Id.* at 255.

[14] *Nat'l. Bank of Commerce of El Dorado v. McMullan (In re McMullan),* 196 B.R. 818, 835 (Bankr. W.D. Ark. 1996).

[15] *Id.* at 835.

[16] *In re Daufuski Island Props., LLC,* 441 B.R. 60, 64 (Bankr. D.S.C. 2010).

mortgage. The bidding creditor had filed a proof of claim in the amount of roughly $35 million, which claim was subsequently disputed.

The trustee and two secured creditors of the debtor who asserted senior positions with respect to the property up for auction objected to the proposed credit bid. The objecting creditors argued that the bidding creditor could not credit bid because his secured claim was disputed. Additionally, they argued that if the bidding creditor was allowed to credit bid, he should be required to pay off all of the mortgages that were senior to his asserted mortgage.

The court found that "cause" existed to deny the bidding creditor's credit bid rights under section 363(k).[17] The court noted that the bidding creditor's claim was disputed, as both the trustee and one of the secured creditors had filed adversary proceedings against the bidding creditor to invalidate and/or subordinate his asserted secured claim. More specifically, the trustee had sought to avoid the mortgage granted to the purported credit bidder as a preferential transfer under section 547(b) of the Bankruptcy Code and the objecting creditor had brought claims for equitable subordination. The court reasoned that the bidder's "mortgage and claim are disputed, and thus [the bidder] is not eligible to credit bid his asserted mortgage to purchase property under 11 U.S.C. 363(k)."[18] Even if the bidding creditor was permitted to bid, the court continued, he could not credit bid unless he paid off the mortgages and liens, which had priority senior to the bidding creditor's mortgage.[19]

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[17] *Id.* at 63.

[18] *Id.* (citing *National Bank of Commerce of El Dorado v. McMullan (In re McMullan),* 196 B.R. 818, 835 (Bankr. W.D. Ark. 1996) and *In re Octagon Roofing,* 123 B.R. 583, 592 (Bankr. N.D. Ill. 1991)).

[19] *Id.*

More recently, in *In re L. L. Murphrey Co.,*[20] the court found that cause existed to deny a lender the right to credit bid because the allegations advanced by the trustee in a draft adversary complaint showed that the creditor's claim was disputed. In that case, the chapter 7 trustee filed a motion to sell the debtor's real and personal property free and clear of liens pursuant to section 363(f)(4) (requiring a bona fide dispute),[21] with any such liens transferring to the proceeds of the sale. The Debtor owed nearly $12 million to its largest creditor, over $9 million of which was allegedly secured by certain real and personal property to be sold at the auction. Shortly after the sale motion was filed, the trustee submitted to the court a draft of a complaint that he anticipated filing in an adversary proceeding against the secured creditor, asserting that the creditor's liens were avoidable under section 544 of the Bankruptcy Code because the creditor failed to properly document and perfect such liens.

In finding that "cause" existed to limit the secured creditor's credit bid rights under section 363(k), the court explained: "courts have found 'cause' to deny the opportunity to credit bid when a sufficient dispute exists regarding the validity of the lien forming the basis for the credit bid."[22] Based on the record and the allegations in the draft complaint, the court found that a "bona fide dispute" existed regarding the validity of the secured creditor's liens, and that such

[20] *In re L. L. Murphrey Co.,* 2013 WL 2451368 (Bankr. E.D.N.C. June 6, 2013).

[21] The purpose behind section 363(f)(4) is to "allow the sale of property of the estate free and clear of disputed interests so the liquidation of assets is not unnecessarily delayed while the disputes are being litigated." *In re L.L. Murphrey Co.,* 2013 WL 2451368 at *4 (Bankr. E.D.N.C. June 6, 2013) (citing *In re N.J. Affordable Homes Corp.,* 2006 WL 2128624 at *10 (Bankr. D. N.J. June 29, 2006)). The case law generally provides that the court does not need to resolve the dispute to allow the sale to go forward but, rather, need only determine that such a dispute exists. *Id.* (citations omitted). As in *In re Murphrey Co.,* cases involving section 363(f)(4) frequently also involve an attempt by a debtor to disallow the lien holder's credit bid right for "cause" under section 363(k), due to the dispute with respect to the validity of that creditor's lien.

[22] *Id.*

dispute constituted sufficient "cause" to eliminate the secured creditor's right to credit bid under section 363(k).[23]

The existence of a dispute regarding a secured creditor's lien does not mean that the court must necessarily eliminate the creditor's right to credit bid in its entirety. Rather, citing section 363(k), some courts simply limit the credit bid to the amount of the secured creditor's secured claim that is not disputed.[24] Other courts have placed conditions on a purported secured creditor's credit bid. For example, some courts have fashioned relief so as to preserve a secured creditor's right to credit bid the full amount of their filed claim, subject to putting cash in escrow or furnishing a letter of credit such that the estate can be repaid if the secured creditor's claim is ultimately disallowed in full or in part as a result of the claim objection or other dispute.[25]

2. When Improper or Inequitable Conduct is Present

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[23] *Id.*

[24] *See e.g., In re RML Development, Inc.,* 2014 WL 3378578 at *5 (Bankr. W.D. Tenn. July 10, 2014) (holding that the secured creditor could only credit bid "the uncontested portion of its claim" due to allegations of wrongful conduct by the secured creditor and certain pending claim objections).

[25] *See e.g., In re Octagon Roofing,* 123 B.R. 583, 592 (Bankr. N.D. Ill. 1991) (allowing bank to credit bid the full amount of its claim pending resolution of a claim objection but requiring the bank to post an irrevocable letter of credit in the amount of the challenged portion of the claim, guaranteeing payment in the event the objection succeeded); *In re Miami General Hospital, Inc.,* 81 B.R. 682, 688 (S.D. Fla. 1988) (approving credit bid sale in light of stipulation preserving trustee's right to challenge secured claim and creditor's obligation to pay cash in the amount of any disallowed portion of the claim); *In re St. Croix Hotel Corp.,* 44 B.R. 277, 279 (Bankr. D. V.I. 1984) (permitting bank to credit bid full amount of claim pending resolution of adversary proceeding challenging claim with understanding that bank would have to pay cash for any amount of claim disallowed); *In re Diebart Bancroft,* 1993 WL 21423 at *5 (E.D. La. Jan. 26, 1993) (requiring the secured creditor to place a deposit in escrow, as a condition to credit bidding, pending the resolution of a priority dispute with respect to its lien); *In re Charles Street African Methodist Episcopal Church of Boston,* 510 B.R. 453 (Bankr. D. Mass. 2014) (limiting the right to credit bid by requiring the secured creditor to submit a $50,000 cash deposit in order to participate in the auction).

Other courts have suggested that the "for cause" exception under section 363(k) should be applied in situations in which improper or inequitable conduct exists.[26] As one might expect, the determination of whether conduct by the debtor, a trustee or a secured creditor is sufficiently improper or inequitable such that it is appropriate to limit or deny credit bidding is determined by courts on a case-by-case basis.

Perhaps the best example of a court finding "cause" due to improper or inequitable conduct is in *In re Aloha Airlines, Inc.*[27] In that case, the court found that "cause" existed under section 363(k) to deny a secured creditor's right to credit bid where the evidence demonstrated that a prospective purchaser had acted improperly. The debtor, one of two regional airlines that had done business in Hawaii for over fifty years, filed a chapter 11 case that was quickly converted to a chapter 7 upon the failure of the debtor's business operations. The chapter 7 trustee filed a motion for an order approving competitive bidding and sales procedures for the sale of the debtor's intellectual property, including the airline's name, frequent flyer programs, web sites and related trademarks and service marks. The purchaser of such intellectual property would have the ability to operate a regional commercial airline in Hawaii under the Aloha name.

The motion was contested by various creditors of the debtor, including certain unions representing former employees, because the debtor's secured creditor, who intended to credit bid at any sale, had entered into a contract outside of the bankruptcy court to license the intellectual property once acquired to another airline, Mesa, which allegedly had contributed to the failure of the debtor's businesses. Mesa, the record showed, had obtained valuable trade secrets and propriety information from the debtor pre-petition, subject to confidentiality agreements between

[26] *In re Philadelphia Newspapers,* 599 F.3d at 316 n. 14 (noting that cause is not "limited to situations in which a secured creditor has engaged inequitable conduct").

[27] *In re Aloha Airlines, Inc.,* 2009 WL 1371950, at *8 (Bankr. D. Hi. May 14, 2009).

the parties. Not only had Mesa violated the confidentiality agreements, it had engaged in "improper predatory pricing and unfair competition designed to drive [Aloha] out of business."[28] Given the size of the secured creditor's claim, there was no dispute that any credit bid by the secured creditor would prevail at an auction. Thus, the court noted, a section 363 sale that allowed the secured creditor to credit bid would, essentially, result in a sale of the debtor's intellectual property to Mesa.

The court framed the issue as follows: "Can the past misconduct of a prospective purchaser of property of a bankruptcy estate disqualify that entity from acquiring property of a bankruptcy estate."[29] The court recognized that although it was a court of equity, its equitable powers are limited, stating:

> There are, of course, limits on the use of equitable powers in bankruptcy. In *Norwest Bank Worthington v. Ahlers,* 485 U.S. 197, 10 S.Ct. 963, 99 L.Ed.2d 169 (1988), the [Supreme Court] disapproved the use of equitable powers to nullify the absolute priority rule of reorganizations under Chapter 11. The court observed that, "Whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Id.* at 206. Therefore, a bankruptcy court cannot deny to a creditor rights specifically accorded by the Code.[30]

The court concluded, however, that the secured creditor in the present case was not being denied any rights specifically given to it by the Bankruptcy Code. The closest Bankruptcy Code provision on point, the court reasoned, was section 363(k), which specifically allowed courts to limit credit bidding for "cause."

The court held that the secured creditor's sponsorship of Mesa's acquisition of a substantial interest in the debtor's intellectual property constituted "cause" to deny the secured

[28] *Id.* at *3-4.

[29] *Id.* at *6.

[30] *Id.* at *8.

creditor's credit bid right under section 363(k). Standing alone, the court explained, "with no connections to Mesa," and appropriate assurance that no interest in the Aloha intellectual property would ever pass to Mesa, "there is no apparent cause to deny [the secured creditor] the ability to credit bid."[31] However, since the trustee's motion did not mention Mesa as one of the purchasers, or even mention the agreement by the secured creditor to license the intellectual property to Mesa, "cause exists to deny the credit bid, and neither [section 363(k)] or any other provision of § 363 gives to [the secured creditor] any rights which are immune to a bankruptcy court's equitable powers."[32]

Recognizing, perhaps, the uniqueness of its ruling, the court stated:

> Mesa succeeded in inflicting great harm, not only upon the Aloha corporate entities, but also upon thousands of Aloha employees and their families. Now, through [the secured creditor], Mesa seeks to perfect its wrongdoing by becoming Aloha. While no cases have been found with comparable facts, it is difficult to imagine a court overlooking what Mesa has done and putting its stamp of approval on [Mesa] becoming Aloha.[33]

The court concluded by stating that it had an independent power and duty to examine the propriety of any proposed sale and credit bid, and could not allow its authority to be misused in a way that would reward Mesa for its misconduct.

In another case involving alleged misconduct, *In re Theroux,*[34] the court found that the proposed sale to a credit bidding party "was contrived specifically for the purpose of wiping out the interests of [taxing authorities]," which held superior liens. In that case, a chapter 7 trustee requested that the bankruptcy court approve a notice of intent to sell a liquor license to the

[31] *Id.*

[32] *Id.*

[33] *Id.* at *9.

[34] *In re Theroux,* 169 B.R. 498 (D. R.I. 1994).

debtor's secured creditor, free and clear of all liens, in exchange for a credit bid of $3,000. The secured creditor, the court found, would "then be able to sell the license at its market value ($20,000 to $30,000) and to retain all of the proceeds."[35]

The local taxing authorities objected to the sale, contending that the sale price was unreasonably low and that the intent of the sale was to benefit the secured creditor to the detriment of the taxing authorities, which held liens senior to those of the secured creditor.[36] The taxing authorities alleged collusion, and argued that the correct procedure would be for the secured creditor to move for relief form the automatic stay and conduct a public foreclosure sale which, in the view of the taxing authorities, would produce a sale price more accurately reflecting the fair market value of the liquor license.[37] Such a sale, they asserted, would likely result in the payment of all outstanding tax obligations, with the excess (if any) being paid to the secured creditor.

The court sustained the objection of the taxing authorities to the proposed sale, finding that the sale was specifically designed to wipe out the interests of the taxing authorities while providing a windfall to the secured creditor. The court questioned the trustee's motivations, stating, "While the secured creditor's incentive to acquire the license as proposed is understandable, we are more concerned with the motivation of the Trustee in co-sponsoring this procedure, given the fact that the sale, as proposed, can benefit *only* the secured creditor, while inflicting considerable financial damage upon the taxing authorities."[38] Because the liquor

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[35] *Id.* at 498.

[36] *Id.* at 498-99.

[37] *Id.* at 499.

[38] *Id.*

license was so greatly over-encumbered, the court noted, the trustee should have abandoned the estate's interest due to the estate's lack of any equity in the license. Moreover, the court inferred collusive behavior and a secret deal to compensate the trustee, stating: "while we are not privy to any agreement for compensation that may exist between [the secured creditor] and the Trustee, there now exists the presumption of a conflict of interest, vis-à-vis the taxing authorities, which the Trustee has not even begun to rebut."[39]

The court emphasized that while section 363(k) and other law generally provides a right for a secured creditor to credit bid, that statute allows the court to deny the credit bid for "cause."[40] The court stated that it believed "this is precisely the type of situation in which the Court would find that cause exists to deny [the secured creditor's] right to credit bid, i.e. there is no absolute entitlement to credit bid … and that option would not be available where the sale price is so clearly inadequate."[41] That was particularly true, the court reasoned, because of the apparent collusive behavior between the secured creditor and the trustee.

3. When One or More Parties Fail to Comply With Court Ordered Procedures

Some courts have found "cause" to restrict credit bidding where parties failed to comply with court ordered procedures.[42] For example, in *In re Takeout Taxi Holdings, Inc.,*[43] substantially all of the debtor's assets were subject to, among other liens, the secured claims of

[39] *Id.*

[40] *Id.* at 499, n.3.

[41] *Id.*

[42] *See e.g., Greenblatt v. Steinberg,* 339 B.R. 458 (N.D. Ill. 2006) (bidder was denied right to credit bid when it failed to comply with an order which limited credit bidding to the priority lienholder and required any party contesting that lienholder's status to object and attend a hearing).

[43] *In re Takeout Taxi Holdings, Inc.,* 307 B.R. 525 (Bankr. E.D. Va. 2004).

five individuals, each with the same priority. Shortly after the petition date, the chapter 7 trustee filed a motion seeking to sell the debtor's assets (intellectual property related to a fast food restaurant) to certain franchisees of the debtor, who claimed they needed such intellectual property in order to continue operating.[44] Williamson, one of the five individual secured creditors, initially objected to the proposed sale but later consented so long as he had the right to credit bid at the auction.

At the sale hearing, the court noted that, contrary to its orders, the trustee had not properly served the four other secured creditors of equal priority with Williamson with the sale motion and, indeed, two of them did not even receive a copy of the notice of proposed sale.[45] The court was also troubled by the fact that the four other secured creditors and Williamson were secured by the same security agreement and financing statement.

The court noted that although section 363(k) authorizes credit bids in general, "they may be denied for cause."[46] According to the court, cause existed to deny the opportunity to credit bid in this case because the other four members of equal priority were not provided with sufficient notice and, thus, were denied the opportunity to object to the credit bid. The court found the potential for objection likely, especially in light of the fact that the proposed sale would not yield any excess cash proceeds for distribution to the other four secured parties. Concerned that the proposed auction sale and credit bid would wipe out the other four creditors' secured claims without providing them with sufficient due process, the court denied the trustee's sale motion.

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[44] *Id.* at 529.

[45] *Id.* at 531, 534.

[46] *Id.* at 536.

Similarly, in *In re Diebart Bancroft,*[47] a secured creditor and the IRS both objected to the proposed sale by a chapter 7 trustee of their collateral, a foundry and a rolling mill, to two separate third parties. The secured creditor argued that the property should be deeded to it for the balance due on the secured loan ($706,000), which exceeded the proposed sale price by more than $200,000.[48] Alternatively, the secured creditor asked the court to lift the automatic stay and allow it to foreclose on the collateral. The IRS, which held a lien against the debtor for unpaid taxes of about $270,000, also objected to the sale of the property, and claimed that it had a first lien on the property to be sold because the secured creditor's mortgage had been extinguished under applicable state law.[49] Accordingly, the IRS argued, the secured creditor could not credit bid its claim without paying the IRS claim in full.

After ordering a public auction sale of the assets, the bankruptcy court held that, because of the dispute between the IRS and the secured creditor regarding lien priority, the secured creditor's bid would have to include cash sufficient to satisfy the IRS' lien, with the intent that such funds would be placed in escrow until the court could determine the lien-priority issues. Although the secured creditor thereafter submitted a bid that included the required cash component, the creditor failed to timely submit a 10% deposit in accordance with the bid procedures order entered by the court. Accordingly, because the secured creditor failed to comply with the court's procedures order, the bankruptcy court denied the proposed credit bid and approved the sale of the assets to the original third party purchasers.[50]

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[47] *In re Diebart Bancroft,* 1993 WL 21423 (E.D. La. 1993).

[48] *Id.* at *1.

[49] *Id.* at *2.

[50] *Id.* at *2-3.

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In affirming the bankruptcy court's decision, the district court stated that section 363(k) "allows a lienholder to bid its lien, unless the court for cause orders otherwise. In this case, there was cause shown: namely the need for cash in escrow to satisfy the lien dispute."[51] Because the secured creditor had not complied with the requirement of the bankruptcy court's bid procedures order to submit a deposit with respect to the IRS claim, it was appropriate for the court to eliminate the creditor's credit bid right.

4. When Allowing Credit Bidding Will Likely Chill Bidding

Finally, although there was, until recently, limited authority for the proposition, it is frequently argued, often by creditors' committees objecting to a sale agreed to between the debtor and its secured creditor, that "cause" exists to eliminate a secured creditor's credit bid rights when allowing a credit bid will chill bidding and prevent a competitive auction process for the benefit of the estate. This concept was captured by the court in *In re Antaeus Technical Services, Inc.,* which stated:

> While the Bankruptcy Code quite reasonably and appropriately recognizes a right to credit bid pursuant to [section] 363(k), such fact cannot alter the economic realities that an auction sale in which one bidder is an existing lender who does not have to put up new money, but can rely on money previously advanced and which the lender has no other actual way to recover, is not a sale in which the bidders are on a level playing field.[52]

At first glance, it would appear that there is limited merit to the argument that credit bidding should be prohibited because of the impact that a credit bid would have on other creditors.[53] Indeed, the fact that the secured creditor's claim is often substantially greater than

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[51] *Id.* at *5.

[52] *In re Anataeus Technical Servs., Inc.,* 345 B.R. 556, 564 (Bankr. W.D. Va. 2005).

[53] *See In re Morgan House Gen. P'ship,* 1997 WL 50419 at *1 (E.D. Pa. Feb. 7, 1997) (summarily rejecting a bid chilling argument); *see also In re River Rd. Hotel Partners, LLC,* 2010 WL 6634603 at *2 (Bankr. N.D. Ill. Oct. 5, 2010) ("The potential to chill the bidding

what the assets are worth and, thus, what other prospective purchasers might be willing to pay in cash, does not necessarily mean that the estate is harmed by a credit bid. This is because the secured creditor would generally be entitled to any proceeds from a non-credit bid sale up to the full amount of its claim. Thus, if the secured creditor is undersecured, a cash sale would still provide no benefit to the estate. In fact, if the collateral is worth less than the secured creditor's claim, and if the secured creditor credit bids its entire claim for the assets, the unsecured creditors may actually benefit from a credit bid because it eliminates any unsecured deficiency claim.

The issue is, however, far more complex than that. The process of conducting due diligence, submitting a qualifying bid and participating in a section 363 auction can be expensive, and it is always possible that a bidder would determine not to commit the time and resources necessary to go through that process if it concludes at the outset that such efforts are futile in light of an inevitable winning credit bid by a secured creditor. Without multiple bidders who have conducted due diligence, and who want to participate in the auction process, the auction will be a short one indeed and the estate will be deprived of any opportunity for multiple rounds of competitive bidding which, in many cases, has resulted in a substantial increase in purchase price.[54]

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process has been recognized as a reason to deny credit bidding. The Debtors, however, did not provide any specific evidence to show this assertion to be true in this case. Instead, the Debtors were content to assert that credit bidding generally chills the bidding process. Such an assertion, without any evidence showing that credit bidding will chill the process in this case, does not satisfy the Debtors' burden.").

[54] *See In re Moonraker Assocs. Ltd.*, 200 B.R. 950, 955 (Bankr. N.D. Ga. 1996) (noting that credit bidding can result in a distortion of value because a "dominant creditor could submit a bid over and above a 'reasonable' assessment of the value it actually perceives," and that "[s]uch a bid could effectively displace all other bids and any benefit to be achieved through such competitive bidding … would be virtually nonexistent").

As discussed in more detail below, the courts in *In re Fisker Automotive Holdings, Inc.*[55] and *In re The Free Lance-Star Publishing Co. of Fredericksburg, VA* [56] noted the chilling effect that credit bidding can have on a competitive auction process as part of their respective rationale for finding "cause" to limit credit bidding in those cases. Before those cases, however, there was limited authority for objectors to cite to when arguing that a credit bid's potential chilling effect on other prospective purchasers constitutes "cause" under section 363(k). Rather, objectors generally relied on the broad definition of "cause" articulated in *In re Philadelphia Newspapers* (*i.e.* section 363(k) empowers bankruptcy courts to "deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to … foster a competitive bidding environment")[57] and language contained in *Collier on Bankruptcy,* a leading bankruptcy treatise, which notes simply that courts "might [deny credit bidding] if permitting the lienholder to bid would chill the bidding process."[58]

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[55] *In re Fisker Automotive Holdings, Inc.,* 510 B.R. 55, 60 (Bankr. D. Del. 2014) ("The evidence in this case is express and unrebutted that there will be *no* bidding—not just the chilling of bidding—if the Court does not limit the credit bid. The Committee, which strongly opposes any credit bidding by [the secured creditor], will abandon its opposition to the Sale Motion if there is no auction—and there will be no auction if the credit bid is not capped. It is through the Committee's efforts that [the competing bidder] is now prepared to bid [and] increase its offer in an auction…. Thus, the "for cause" basis upon which the Court is limiting Hybrid's credit bid is that bidding will not only be chilled without the cap; bidding will be frozen.").

[56] *In re The Free Lance-Star Publishing Co. of Fredericksburg, VA,* 512 B.R. 798, 806 (Bankr. E.D. Va. 2014) ("Credit bidding can be employed to chill bidding prior to or during an auction, or to keep prospective bidders from participating in the sales process. [The secured creditor's] motivation to own the Debtors' business rather than to have the Loan repaid has interfered with the sales process.").

[57] *In re Philadelphia Newspapers, LLC,* 599 F.3d 298, 315 n. 14 (3d. Cir. 2010).

[58] 3 COLLIER ON BANKRUPTCY, ¶ 363.09[1] (Alan N. Resnick & Henry J. Sommers eds., 16th ed. 2013).

The other frequently cited authority in support of the proposition that "cause" exists to limit credit bidding when allowing a credit bid could potentially chill bidding at an auction was *In re Antaeus Technical Servs., Inc.*[59] In that case, the debtor's largest secured creditor filed a proof of claim alleging an $8 million secured claim. The chapter 7 trustee then filed: (i) a complaint against the secured creditor seeking to avoid certain preferential transfers and to subordinate some of the secured creditor's security interests and claims, and (ii) an objection to the filed proof of claim.

Thereafter, the trustee filed a motion to approve a settlement with the secured creditor, which resolved all disputes between the parties. The settlement agreement provided, among other things, that if the trustee found a purchaser for the debtor's assets prior to December 31, 2004, the secured creditor would: (a) receive the first $1,000,000 of the net sale proceeds, and (b) be entitled to a credit bid of up to $1,500,000 for the assets.[60] The agreement also provided that if the trustee did not sell the assets before December 31st, the secured creditor would have two options: (i) pay the Trustee $50,000 for the assets before January 15, 2005, or (ii) be deemed to have released its lien on the assets and abandoned any claim in the debtor's estate. The settlement agreement was approved by the bankruptcy court.

Shortly thereafter, the trustee suffered a heart attack, which caused him to miss work until January 17, 2005. In the interim, the assets were not sold and the secured creditor did not pay the $50,000 to purchase the assets consistent with the settlement agreement. Months later, the trustee located a new purchaser, who offered to pay $52,000 for the debtor's assets. The trustee filed a motion to approve the proposed sale, and the secured creditor objected claiming that it

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[59] *In re Antaeus Technical Servs., Inc.,* 345 B.R. 556, 565 (Bankr. W.D. Va. 2005).

[60] *Id.* at 558.

had a right to credit bid up to $1,500,000 under the court-approved settlement agreement.[61] The trustee and the prospective purchaser responded, stating that the secured creditor's contractual right to credit bid had expired per the terms of the settlement agreement, and its statutory right as a secured creditor under section 363(k) had expired because its claim was abandoned when it failed to exercise its right to purchase the assets for $50,000 on or before January 15th. The secured creditor replied, asserting that there was an implicit agreement between the trustee and the secured creditor to extend the settlement agreement beyond January 15th due to the trustee's heart attack.

The court first held that the settlement agreement was not, and could not have been, extended because any modifications to the settlement agreement would have been subject to court approval. Because no such approval was sought, and because creditors were not provided with notice of any modification, the settlement agreement was not extended and, per the terms of that agreement, the secured creditor's claims were abandoned on January 15th.[62] Accordingly, the secured creditor had waived any right that it had to credit bid in the auction sale.

The court could have stopped there but instead, continued by discussing section 363(k) and credit bidding generally. The court stated:

> While the Bankruptcy Code quite reasonably and appropriately recognizes a right to credit bid pursuant to § 363(k), such fact cannot alter the economic realities that an auction sale in which one bidder is an existing lender who does not have to put up new money, but can rely upon money previously advanced and which the lender has no other actual way to recover, is not a sale in which the bidders are on a level playing field. Such a sale is like getting into an auction in which the other party is actually the owner of the property being sold, whose interest is not in actually obtaining the subject property but in playing poker to see what is the highest bid which the independent bidder is willing to make. In short, the owner wants to be not the winning bidder, but rather the next-to-last bidder to the highest

[61] *Id.* at 561.

[62] *Id.* at 562-63.

> bid any other cash bidder is willing to advance. It is quite evident from the documentation and [the secured creditor's] course of conduct in this case that its sole interest is maximizing the value of its purported lien rights against the patents. It has only exhibited interest in actually making a bid to purchase the patents with "new" money when other potential purchasers have surfaced and has not demonstrated such interest when other interested parties were not to be found. There's certainly nothing wrong with that, but to accord [the secured creditor] a right to credit bid inherently skews the proposed sale in which [the prospective purchaser] agreed to act as a "stalking—horse" bidder….[63]

While it can be argued that this language was mere dicta because of the court's prior finding that the secured creditor had abandoned its secured claims and, thus, its right to credit bid by failing to act in accordance with the settlement agreement, the *Antaeus* court's language has been repeatedly cited by litigants and even courts as support for the proposition that "cause" to limit credit bidding exists when permitting such a bid would chill bidding and preclude a fully competitive cash auction process.[64]

5. The Loan to Own Conundrum and Increased Judicial Scrutiny With Respect to Credit Bidding

In recent years, as the market to buy and sell distressed debt has become more prevalent, credit bidding has increasingly been used for strategic purposes.[65] For example, a party that is interested in acquiring the assets of a struggling company (usually a hedge fund or a private equity group) will sometimes lend money to, or purchase (often at a deep discount) the secured debt of, the company. Thereafter, the investor may steer the company into bankruptcy and seek

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[63] *Id.* at 564.

[64] *See e.g., In re Philadelphia Newspapers, LLC,* 599 F.3d 298, 316 (3d. Cir. 2010); *In re Fisker Automotive Holdings, Inc.,* 510 B.R. 55, 60 (Bankr. D. Del. 2014); *In re The Free Lance-Star Publishing Co. of Fredericksburg, VA,* 512 B.R. 798, 805 (Bankr. E.D. Va. 2014).

[65] For an excellent discussion on the "loan to own" phenomenon, see Sontchi, Hon. Christopher S., *Loan to Own is Back – With a Twist,* Journal of Corporate Renewal, Vol. 27, No. 6, p. 31 (2014).

to purchase the assets through a credit bid in the inevitable section 363 sale. This strategy is colloquially referred to as "loan to own."

In "loan to own" cases, the credit bid right has arguably been turned from a shield intended to protect secured creditors into a sword. As noted earlier in this chapter, applicable law generally permits the investor to credit bid the full face amount of the debt that it purchased regardless of the price that it paid for the loan or the true value of its collateral. For example, an investor might pay 25 cents on the dollar for $10 million in undersecured debt pre-petition. Despite the fact that it only paid $2.5 million to purchase the debt, and regardless of the true value of the collateral, the buyer will generally have the right under section 363(k) to credit bid the full $10 million at the 363 sale. It is easy to see how such a strategy could chill or even eliminate bidding and a competitive auction process.[66]

This problem is further exacerbated because, in a "loan to own" case, the investor (and secured creditor) wears many hats and has a great deal of influence. For example, the investor usually enters into a form of asset purchase agreement with the debtor shortly before or after the bankruptcy filing in which it is entitled to credit bid its debt and serves as the stalking horse purchaser. As the stalking horse purchaser, the investor usually aids in the drafting of the proposed sale procedures order and the form of the asset purchase agreement that any competing

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[66] One bankruptcy court described this situation as follows:

> [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.

See In re Moonraker Associates, Ltd., 200 B.R. 950, 955 (Bankr. N.D. Ga. 1996).

bidders must follow in order to participate in the auction (absent an order from the court to the contrary). These documents will likely include various stalking horse bid protections, including bid increments and a breakup fee/expense reimbursement (generally totaling about five percent of the purchase price) if someone should successfully out-bid the stalking horse bidder at the auction.

Additionally, the investor will often provide limited, short-term, debtor in possession financing sufficient to get the debtor through the 363 sale process (but likely nothing else). By providing the debtor in possession financing, the investor can compel a sale structure that favors itself, to the possible detriment of potential competing bidders and unsecured creditors, in that the financing order will likely require an expedited sale process with various milestones that must be met in order for the debtor to avoid a default on the post-petition loan. These milestones sometimes do not permit sufficient time for competing bidders to conduct due diligence, or the creditors' committee[67] to fully investigate and challenge the validity and amount of the investor's secured claim. The financing documents generally will also include language requiring the debtor to acknowledge the amount and validity of the investor's secured claims, thereby ensuring that the debtor will not challenge the investor's "allowed claim" which, as noted previously, is a prerequisite to credit bidding under section 363(k).[68]

As discussed below, "loan to own" is increasingly being met with hostility by bankruptcy courts and commentators. This is because it is arguably contrary to the fundamental purposes of

[67] The creditors' committee is often further constrained because it is usually not appointed until weeks into the case and, once appointed, its professionals are limited by a relatively small carve out for paying their fees.

[68] However, the unsecured creditors committee will typically be provided with a specified period of time to raise any challenges to the validity, priority or perfection of the secured creditors' liens and claims.

chapter 11, namely maximizing value and rehabilitating the debtor for the benefit of all creditors.[69] The investor's goal in a "loan to own" case is not to maximize the value of the assets for all creditors but, rather, to acquire the debtor's assets as quickly and inexpensively as possible, often leaving unsecured creditors with little or no recovery. As one commentator argued:

> 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 purposes of Chapter 11. In order to prevent this apparent inequity, Bankruptcy Courts should consider exercising their discretion to disallow credit bidding by loan-to-own lenders.[70]

Arguably, when a "loan to own" investor is permitted to credit bid its entire indebtedness, chapter 11 becomes a tool utilized solely for the purpose of allowing the investor to acquire the debtor's assets "free and clear" of the claims against the debtor.[71] Such a sale, it has been asserted, provides no value to other creditors and can and should be conducted outside of the bankruptcy courts.

The "loan to own" phenomenon was almost certainly not anticipated by the drafters of the Bankruptcy Code when it was enacted over thirty-five years ago. In recent years, it has led to some controversial opinions by bankruptcy courts in the credit bidding context that have generated a great deal of commentary.[72] Increasingly, it appears, courts are requiring "loan to

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[69] *See e.g., Pioneer Investment Services Company v. Brunswick Assoc. L.P.,* 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.")

[70] Richman, Michael P. & Salerno, Thomas J., *Resolved: Loan-to-Own DIP Lenders Should Not Be Allowed to Credit Bid,* 041207 ABI-CLE 85 (2007).

[71] *Id.*

[72] *See e.g.,* Pinkas, Oscar N. & Selby, Joseph G., *Is Fisker Automotive Holdings a New Limit on Credit Bidding?,* 33-APR Am. Bankr. Inst. J. 14 (2014); Brown, Tyler P., Harbour, Jason W. & Paget, Justin F., *Secured Lender's Credit-Bid Capped in Free Lance-Star,* 33-APR Am. Bankr.

own" investors to bid cash for the debtor's assets, at least until a fair amount of time has been permitted for parties to investigate the investor's actions, and the court to determine the amount and validity of the investor's purported secured claims. Because a secured creditor's liens attach to the proceeds of any sale of their collateral under the Bankruptcy Code, it can be argued that the investor will not be harmed by this result as it will likely receive all of the proceeds of its collateral if and when the court determines that it was, in fact, fully secured by the assets that are sold.

Of the recent opinions on this topic, perhaps the most notable is *In re Fisker Automotive Holdings, Inc.*[73] In that case, the debtors were a plug-in hybrid electric car company who had obtained a lending facility from the United States Department of Energy for the purpose of bringing Fisker's line of vehicles to market. Due to a variety of challenges, including safety recalls related to battery packs and the loss of a material portion of their existing unsold vehicle inventory in the United States during Hurricane Sandy, the Department of Energy advised Fisker that it would cease all funding under the loan agreement and would not permit any further disbursements.

Out of a total of $203 million in indebtedness owed by Fisker prepetition, approximately $168.5 million related to the Department of Energy loan. Approximately one month before the petition date, Hybrid Tech Holdings, LLC purchased the Department of Energy's loan in a public auction for $25 million (approximately 15 cents on the dollar). Thereafter, Fisker entered into discussions with Hybrid regarding Hybrid's potential acquisition of its assets. Ultimately, the parties entered into an asset purchase agreement whereby Hybrid would acquire substantially all

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Inst. J. 30 (2014).

[73] *In re Fisker Automotive Holdings, Inc.,* 510 B.R. 55 (Bankr. D. Del. 2014).

of the assets of Fisker in a section 363 sale in exchange for a partial credit bid of $75 million. Hybrid's deal required a late-November bankruptcy filing, a January 3rd sale and no marketing efforts.

Consistent with their agreement, Fisker commenced a bankruptcy case for the stated purpose of selling substantially all of its assets to Hybrid. Asserting that the Hybrid credit bid transaction was the greatest offer for the assets, and arguing that the cost and delay arising from a competitive auction process was unwarranted, the debtors filed a motion on the petition date seeking approval of the Hybrid transaction in a private sale. The newly formed creditors' committee objected, arguing that a competitive auction should be conducted involving its favored purchaser, Wanxiang America Corporation. The committee further argued that Hybrid should not be permitted to credit bid its claim at any auction sale or, alternatively, that the credit bid should be capped at $25 million, the amount Hybrid paid for the debt.

At the hearing on the sale motion, counsel for the debtors and counsel for the committee announced several stipulated agreements to limit the areas for dispute, specifically: (i) if Hybrid's credit bid was capped or denied, there would be a strong likelihood of an auction that would create material value for the estate; (ii) if Hybrid's credit bid was not capped or denied, a competitive auction likely would not occur, (iii) limiting Hybrid's ability to credit bid would likely foster and facilitate a competitive bidding environment, (iv) the highest and best value for the estate would be achieved only through the sale of all of the debtors' assets as an entirety, and (v) a material portion of the assets being sold were not subject to a properly perfected lien in favor of Hybrid or were subject to a lien in favor of Hybrid that was in bona fide dispute.[74]

[74] *Id.* at 57-58.

The court identified the issue as follows: "whether Hybrid is entitled to credit bid its claim and, if so, whether the Court may properly limit, or cap, the amount that Hybrid may credit bid."[75] The court concluded that Hybrid was unquestionably permitted to credit bid pursuant to section 363(k) of the Bankruptcy Code. Nevertheless, the court noted that the statute authorized it to limit a secured creditor's credit bid right "for cause."

Ultimately, the court limited Hybrid's credit bid to what it paid for the DOE loan, $25 million, and ordered an auction of the debtors' assets. The court articulated three bases for its ruling. First, it found that if it did not limit Hybrid's credit bid, the auction process would not only be chilled, but it would likely not occur at all. Second, the court criticized the timing of the proposed sale, noting that the debtors provided a mere 24 business days for parties in interest to challenge the sale motion. The court reasoned that neither the debtors nor Hybrid were able to justify the asserted need for speed, stating: "it is now clear that Hybrid's 'drop dead' date … was pure fabrication."[76] The expedited sale process, the court found, was inconsistent with notions of fairness in the bankruptcy process. Finally, the court noted that the parties had agreed that Hybrid's claim was partially secured, partially unsecured, and partially of uncertain status for the remainder. Distinguishing cases cited by Hybrid, the court held that the law leaves no doubt that the holder of a lien the validity of which has not been determined, as here, may not bid that lien.

Accordingly, the court held that "cause" existed to limit Hybrid's credit bid to $25 million and ordered that an auction be conducted.[77] After a three-day auction between Hybrid

[75] *Id.* at 59.

[76] *Id.* at 60, n. 4.

[77] While the court capped Hybrid's credit bid at $25 million, the amount that Hybrid paid for the debt, the court did not state in its opinion why it was establishing that number as the cap. The authors are not aware of any other authority for the proposition that a credit bid should be limited to the amount paid by the secured creditor for the debt.

and Wanxiang, including 19 rounds of bidding, the assets of the debtors were sold to Wanxiang for approximately $150 million (including $126 million in cash), which was roughly twice the amount of Hybrid's initial credit bid offer.

Months after the *Fisker* ruling, the United States Bankruptcy Court for the District of Virginia issued a similar ruling in *In re The Free Lance-Star Publishing Co. of Fredericksburg, VA.*[78] In that case, the debtors were a family-owned newspaper, radio and communications company that had been in business for more than 130 years. In 2007, in an attempt to diversity its business, the debtors expanded into the commercial printing business and entered into a $50 million loan facility from BB&T to finance the construction of a printing plant. The loans under the facility were secured by certain assets of the debtors, but not by the debtors' "tower assets," which were associated with the debtors' radio broadcasting operations. Accordingly, BB&T did not record financing statements to assert liens on the "tower assets."

Prior to the petition date, BB&T sold its secured loan to an entity called DSP Acquisition LLC, which sought to push the debtors into chapter 11 and acquire the debtors' assets. DSP informed the debtors that it wanted the company to file for chapter 11 and to sell substantially all of its assets to DSP in a section 363 sale. While negotiations were ongoing, and even though it knew that it did not have liens on the debtors' "tower assets," DSP nonetheless recorded financing statements in various jurisdictions on those assets without giving any notice to the debtors. When negotiations collapsed in January 2014, the debtors filed for chapter 11 and sought both a sale process and avoidance of certain of DSP's asserted liens.

Shortly after the petition date, DSP filed a complaint seeking a declaration that it had valid and perfected liens on substantially all of the debtors' assets and that it had the right to

[78] *In re The Free Lance-Star Publishing Co. of Fredericksburg, VA,* 512 B.R. 798 (Bankr. D. Va. 2014).

credit bid its claim at the sale. DSP also filed a motion seeking summary judgment on all counts set forth in its complaint. The debtors filed a cross-motion for summary judgment, arguing that "cause" existed to limit DSP's credit-bid amount in any sale under section 363(k).

At a combined evidentiary hearing, the court found that DSP: (i) did not have valid, properly perfected liens on certain contested property, (ii) could not credit bid a claim against the property on which it lacked a valid lien, and (iii) had engaged in "inequitable conduct" that required the court to limit its credit bid right to foster a competitive bidding process.[79] Regarding the last factor, the court specifically found that DSP had improperly influenced the asset-sale process by exerting pressure on the debtors for a speedy bankruptcy filing, insisting that the debtors shorten the marketing period for the sale, and insisting that the debtors conspicuously advertise DSP's credit bidding right in the sale marketing materials.

The court addressed the problems associated with permitting credit bidding in "loan to own" cases, stating:

> From the moment it bought the loan from BB&T, DSP pressed the Debtor "to walk hand in hand" with it through an expedited bankruptcy sales process. It was a classic loan-to-own scenario. DSP made no secret of the fact that it acquired the Loan in order to purchase the Company. It planned from the beginning to effect a quick sale under § 363 of the Bankruptcy Code at which it would be the successful bidder for all of the Debtors' assets utilizing a credit bid.
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> The credit bid mechanism that normally works to protect secured lenders against the undervaluation of collateral sold at a bankruptcy sale does not always function properly when a party has bought the secured debt in a loan-to-own strategy in order to acquire the target company. In such a situation, the secured party may attempt to depress rather than to enhance market value. Credit bidding can be employed to chill bidding prior to or during an auction, or to keep prospective bidders form participating in the sales process. DSP's motivation to own the Debtors' business rather than to have the Loan repaid has interfered with the sales process. DSP has tried to depress the sales price of the Debtors' assets, not to

[79] *Id.* at 800-801.

> maximize the value of those assets. A depressed value would benefit only DSP, and it would do so at the expense of the estate's other creditors. The deployment of DSP's loan-to-own strategy has depressed enthusiasm for the bankruptcy sale in the marketplace.[80]

Ultimately, the court held that "cause" existed "to limit DSP from bidding the full amount of its claim" in order to foster "a fair and robust sale."[81] The court reasoned: "[t]he confluence of (i) DSP's less than fully-secured lien status; (ii) DSP's overly zealous loan-to-own strategy; and (iii) the negative impact DSP's misconduct has had on the auction process has created the perfect storm, requiring curtailment of DSP's credit bid rights."[82]

Without any evidence being offered by DSP, the court requested that the debtors' expert witness provide testimony on the best procedure for fashioning a competitive auction sale and credit bid price. The debtors' expert eliminated the unencumbered assets (as determined by the court) and applied a market analysis to develop an appropriate cap for the credit bid. The court accepted this approach and limited DSP's credit bid right, pursuant to section 363(k) of the Bankruptcy Code, to $13.9 million.[83]

One month later, nine bidders (including DSP) participated in a live auction for the debtors' assets. Following multiple rounds of bidding, DSP was deemed to be the highest and best bidder, acquiring substantially all of the debtors' assets. The $30.2 million bid included the $13.9 million credit bid and $16.3 million in cash. Thereafter, the bankruptcy court entered an order approving the sale to DSP.

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[80] *Id.* at 806.

[81] *Id.* at 807.

[82] *Id.*

[83] *Id.*

While *In re Fisker Automotive Holdings, Inc.* and *In re The Free Lance-Star Publishing Co. of Fredericksburg, VA* have generated a lot of discussion, they arguably represent nothing more than a bankruptcy court utilizing its discretion to find "cause" to limit credit bidding where the Bankruptcy Code expressly authorizes it to do so. Such cases do suggest that courts are increasingly likely to expand traditional understandings of what constitutes "cause", at least when the facts and the equities warrant doing so. These opinions also suggest that courts are now scrutinizing attempts to credit bid in a section 363 sale more closely in "loan to own" cases because the motivations of investors in such cases are very different from those of a traditional secured creditor who wants simply to be repaid on its loan.

Given the foregoing, lenders and distressed debt investors who seek to credit bid should expect parties in interest, particularly creditors' committees, and even the courts to look more closely at their conduct, both pre and post-petition to determine if one of the traditional examples of "cause" under section 363(k) exists. Additionally, courts are increasingly likely to cap a secured creditor's credit bid right in order to foster a competitive bidding process, at least in cases where the secured creditor is not a traditional lender and it appears that the creditor's credit bid substantially exceeds the value of its collateral.[84]

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[84] In the Final Report and Recommendations of the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11, which was released in December, 2014, the Commission recommended the following with respect to a credit bid's potential chilling effect and section 363(k) of the Bankruptcy Code:

> In a sale under section 363 of the Bankruptcy Code involving a secured creditor's collateral, the secured creditor should be permitted to credit bid up to the amount of its allowed claim relating to such collateral unless the court orders otherwise for cause. For purposes of this principle, the potential chilling effect of a credit bid alone should not constitute cause, but the court should attempt to mitigate any such chilling effect in approving the process. Section 363(k) should be clarified accordingly.

See ABI COMMISSION TO STUDY THE REFORM OF CHAPTER 11 FINAL REPORT AND

RECOMMENDATIONS, p. 146-47 (2014). The Commission's report has not been enacted as law.

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LOAN TO OWN STRATEGIES

A View from the Investor's Perspective

22nd Annual ABI Central States Workshop

June 11-14, 2015

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A. Current State of "Loan-to-Own" Strategies

So-called "loan-to-own" investing strategies have become so commonplace that they are now part of the basic fabric of the restructuring industry. Numerous investors are focused on this niche, many of them exclusively so. Some of the factors driving the continued growth of loan-to-own investing include the yield appetites for private equity and hedge funds, increased liquidity in distressed debt markets and the decreased risk tolerance of more traditional lenders. Recent trends in bankruptcy cases, however, threaten the practice in meaningful ways and investors and practitioners need to be aware of these additional risks when considering loan-to-own and other acquisition strategies.

B. What Exactly Does "Loan-to-Own" Mean?

"Loan-to-own" typically describes a situation where an investor leverages debt holdings into a control position over all or substantially all of a borrower's assets or equity. The name "loan-to-own" is aptly descriptive: a lender to a distressed entity uses its debt position to force or control one or more transactions, after which the lender owns the borrower's business. This is essentially a hostile takeover effected using a company's debt, rather than its equity.

This basic definition covers a number of different strategies in practical terms. For example, an investor in a loan-to-own situation may be the originator of the loan or may have purchased a position from another party in a secondary market transaction, often at a deep discount. Additionally, the original loan may or may not have been made at a time when the borrower was already distressed. Also, the transaction or series of transactions that results in the investor taking control of the business may take place in bankruptcy or a similar insolvency proceeding or out of court. Thus, it is easy to see that Loan-to-Own comes in a variety of flavors.

The following materials describe several common loan-to-own strategies, and explain the role played in loan-to-own by credit bidding in asset sales under section 363 of the Bankruptcy Code. The materials also illustrate challenges that investors in this space may encounter as courts in recent years have limited credit bidding and other debt acquisition strategies.

C. Loan-to-Own Strategies

1. Distressed Debt Acquisitions

Probably the most common method of employing a loan-to-own strategy starts with the acquisition of a distressed company's "fulcrum security." The fulcrum security is the security

(most often these days a secured debt instrument) most likely to be converted into equity in a Chapter 11 reorganization. In other words, holders of the fulcrum security comprise the senior class of impaired creditors in the capital structure. Classes of debt that are more senior to the fulcrum security are likely to be over-secured, and holders should be repaid in full or treated in a manner that renders them unimpaired (e.g., reinstated under Section 1124). The fulcrum security is the first under-secured class of securities that will not be repaid in full and, thus, should have a right to receive the company's equity in exchange for the shortfall. Classes of debt junior to the fulcrum security are likely to be wiped out and receive nothing.

Active secondary markets exist for virtually all parts of a company's capital structure. Many traditional lenders who in the past may have moved distressed credits to a workout department have scaled back or eliminated those departments. Primarily for regulatory reasons, these lenders may not have the risk tolerance to hold distressed loans in their portfolios. They may sell these credits to opportunistic investors in a secondary market. It is common in the lending industry to define as distressed any loan that is trading on the secondary market to yield more than 1000 basis points (10%) over the benchmark Treasury rates. Determining which tranche of debt is the fulcrum security requires investors to determine the value of the target's assets which often isn't readily determinable and certainly may change over time. Often, investors may acquire positions in several tranches of the capital structure if the identity of the fulcrum security isn't immediately discernable. One can readily see how complicated distressed investing and loan-to-own strategies are to employ successfully.

After acquiring a position in a company's debt, a distressed investor typically will gain access to private information about the company and may be able to exert negotiating leverage in any restructuring discussions. If the borrower seeks to raise additional capital, triggers covenant violations or commits other events of default, or otherwise wants to take actions requiring the approval of its lenders, there will be opportunities for the debt holders to exercise some level of control. For example, a debt holder may be in a position to obtain board representation at the borrower, compel operational or capital structure changes, oust members of a management team, or even demand a bankruptcy filing and an auction of the borrower's assets.

One key consideration for investors is what amount of a tranche of debt to acquire. This consideration depends on the type of debt and relevant portions of the governing documents, including voting requirements. Most commonly, investors acquire interests in a secured credit facility or notes issued under a trust indenture. In either case, the governing documents will provide for required percentages of debt necessary to enforce remedies, instruct a trustee to act or refrain from acting, or take other actions. It is critical for investors to review the documents to understand the requisite voting percentages, which may be different depending

upon the action to be taken. While investors may not be able to acquire an entire required voting bloc, they may be able to obtain a sufficient voting percentage that, when combined with the voting power of other "friendly" or like-minded investors, aggregates to more than the required percentage.

Under the documentation governing the debt, whether in the form of revolving or term loans, bonds or some other instrument, a senior secured creditor will often have significant rights and remedies that create even greater leverage if the borrower files a Chapter 11 case. In such a case, the creditor may be entitled to a variety of remedies and rights, including the right to receive adequate protection (i.e., the right to be protected against diminution in its collateral value and preservation of foreclosure rights), the right to credit bid at an auction sale of its collateral and the leverage to exert substantial influence in the process of formulating a plan of reorganization.

2. DIP Financing

Another method by which an investor might pursue a loan-to-own strategy is by extending debtor-in-possession ("DIP") financing after the borrower has filed for Chapter 11 protection. DIP lenders may be one or more of the pre-petition lenders or entirely new lenders who enter the capital structure in a "priming" position (i.e. a loan with liens ranking senior in priority to the liens of existing secured lenders–such new senior loans are said to "prime" the existing lenders). Whether a lender is the senior secured lender prior to or after the commencement of a Chapter 11 case is not generally relevant to the availability of loan-to-own strategies. However, because of the leverage created in favor of DIP financing lenders, without which financing a debtor may incapable of surviving, DIP financing lenders likely will be able to obtain additional rights and remedies that are not available under pre-existing debt agreements.

3. Acquiring Ownership

Once the borrower has commenced a bankruptcy case, a loan-to-own strategy may come into play in the context of either a section 363 asset sale or a plan of reorganization. In both circumstances, the senior secured creditor may be able to acquire ownership of the assets of its borrower–this conversion of debt to ownership is the crux of loan-to-own. In a section 363 asset sale context, a senior secured creditor may credit bid up to the value of its collateral at the auction instead of paying cash, as would be required by other bidders. This can be a significant advantage. Junior secured creditors may only credit bid their debt after they pay the senior secured creditors in full in cash.

Section 363 credit bids may be complicated if the bidding investor does not own the entire tranche of debt. Here, again, is where governance documents and voting rights come into play.

If the investor does not have the legal right or standing to bid its debt, then the strategy will hit a road block. Case law generally provides that where a trust indenture or loan agreement provides that the trustee or agent has the exclusive right to credit bid, a holder of debt, even of a substantial majority, may not be able to bid. *See, e.g.*, *In re GWLS Holdings, Inc.*, 2009 Bankr. LEXIS 378 (Bankr. D. Del. Feb. 23, 2009) (holding that a loan agreement provisions concerning post-execution waivers, amendments, supplements or modifications did not override another provision regarding the loan agent's right to credit bid); *see also Beal Sav. Bank v. Sommer*, 865 N.E.2d 1210 (2007) (holding that syndicated loan agreement provision requiring unanimous consent of lenders to amend, waive or modify terms did not prevent loan agent from acting on behalf of all lenders following borrower's default).

A senior secured creditor also has significant leverage in a Chapter 11 reorganization effected through a plan of reorganization. The senior secured creditor often will either be able to assert negotiating leverage to steer the reorganization or it may obtain payment for the full amount of its claim. This is because even if the senior secured creditor votes against the plan, the ability of the debtor to "cram-down" the plan on the objecting secured creditor is limited–the debtor must either (1) make deferred payments under the plan of a face value equals the amount of the secured claim and whose present value equals the value of the creditor's collateral or (2) conduct an auction under the plan that provides the senior secured creditor with the right to credit bid.

D. Recent Examples of Loan-to-Own Strategies

In re Flat Out Crazy, LLC, Bankr. S.D.N.Y., Case No. 13-22094. In *Flat Out Crazy*, the debtors' prepetition secured lender, HillStreet Capital IV Inc., formed an investor group that successfully credit bid the amount of its DIP loan plus a portion of the prepetition secured loan it held to purchase the assets of a restaurant chain. The auction, held in April 2013, was competitive, with 5 qualified bidding parties and multiple rounds of bidding. HillStreet had acquired the prepetition loan, and extended new financing under the facility, before the bankruptcy, and had successfully fended off a priming fight with an alternate proposed DIP lender during the case. At the auction, HillStreet steadily increased its stalking horse bid, outlasting all other bidders.

Florida Gaming Centers Inc. ("FGCI"), Bankr. S.D. Fla., Case No. 13-29597. In *FGCI*, the debtor's largest secured lender, ABC Funding LLC, won a competitive auction among 4 bidding parties, to acquire the debtor's primary asset, a Miami-area casino. The winning bid of $155 million consisted of a credit bid of $101.5 million, roughly $40 million in cash and assumption of $14 million in liabilities, the majority of which are owed to the local government. The bid represented a significant increase over the stalking horse bid of $115 million submitted by another party.

In re Crumbs Bake Shop, Inc., Bankr. D. N.J., Case No. 14-24287. In *Crumbs*, the debtors' prepetition lender, the owner of the Dippin Dots chain, assigned $5.5 million in prepetition secured claims to a newly formed affiliate, Lemonis Fischer Acquisition Co. LLC, who extended an additional $1 million in DIP financing. In October 2014, the DIP lender successfully acquired the Crumbs cupcake shops assets using a $6.5 million credit bid.

In re Seal123, Inc. ("Wet Seal"), Bankr. D. Del., Case No. 15-10081. In April 2015, the bankruptcy court in *Wet Seal* approved the bid of Mador Lending LLC, an affiliate of Versa Capital Management LLC, to acquire the assets of the Wet Seal retail chain. Mador had failed in 2 attempts to be approved as Wet Seal's DIP lender, losing the privilege to B. Riley. At auction, Mador agreed to provide $7.5 million in cash, a $20 million replacement DIP (which it was able to credit bid), and assume certain other liabilities of the business. Mador also lined up $10 million in exit financing. As stalking horse, B. Riley had bid $5 million in cash plus a credit bid for the $20 million DIP facility in exchange for 80% of the equity of the reorganized company in a plan sponsorship deal. The auction procedures allowed bidders to propose alternate plan sponsorship deals or a 363 asset sale bid.

In re The Standard Register Co., Bankr. D. Del., Case No. 15-10541. In *Standard Register*, a case that is ongoing, Silver Point Capital LP submitted a $275 million bid and is seeking to act as stalking horse to purchase the assets of the information management company. Silver Point is owed approximately $210 million and has agreed to contribute a $30 million term loan of a DIP financing package that totals $155 million. The bankruptcy judge denied a request by the Official Committee of Unsecured Creditors to cap Silver Point's ability to credit bid, but did scale back certain bid protections. An auction is expected to occur in mid-June 2015.

E. Limitations on Credit Bidding for Cause

Loan-to-own strategies are not without risk. Often, other creditors who are either out of the money or in impaired positions have incentive to attack the senior secured creditors' claims or the transactions they propose. Disputed issues often include: (1) the valuation of the company, which may determine the level of the capital structure representing the fulcrum security; (2) the extent and sufficiency of the process used by the debtor to identify alternative transactions; and (3) whether the debtor's management and board of directors satisfied their fiduciary duties. Depending on the facts and circumstances, parties might also seek to equitably subordinate the claims of the investor/lender, or to recharacterize the debt as equity.

As loan-to-own strategies have become more commonplace, so has scrutiny from bankruptcy courts. Many loan-to-own strategies use credit bidding in asset sales to transfer control of the business from the debtor's pre-bankruptcy equity holders to its secured creditors. Some courts

recently have capped the amount that secondary market buyers are permitted to credit bid at less than the full face amount of their acquired claims.

Section 363(k) of the Bankruptcy Code permits credit bidding: "At a sale under [Section 363(b) of the Code] 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, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property." 11 U.S.C. § 363(k). Thus, in a sale of assets outside the ordinary course of business, a secured creditor is allowed to bid the allowed amount of its claim against the purchase price, unless the court orders otherwise.

In *In re Fisker Automotive Holdings, Inc.*, 510 B.R. 55, 61 (Bankr. D. Del. 2014), possibly the most widely scrutinized case in this area, the Delaware bankruptcy court limited a secured creditor's ability to credit bid a claim with a face amount of $168.5 million to $25 million, the amount it paid to acquire the claim from the Department of Energy, who was the original lender. The court noted that the value of the secured creditor's allowed claim was not yet determined and that it was undisputed that allowing the creditor to bid the full amount of its claim would result in no other parties participating in a competitive auction for the debtor's assets. *Id*. at 60. In addition, there was a good faith dispute regarding the extent of the secured creditor's lien on certain property of the debtor. In this case, the parties had identified a credible third party bidder willing to participate in an auction if the creditor's ability to credit bid were capped. The court determined that discouraging a competitive auction was sufficient "cause" to limit credit bidding under section 363(k).

The *Fisker* court relied in large part on *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 315 n.14 (3rd Cir. 2010), where a divided panel of the Third Circuit found that "cause" under 363(k) could be something less than a finding of inequitable conduct by the creditor, and held that the "right to credit bid is not absolute." Somewhat expansively, the court stated that in the context of section 1129(b)(2)(A) cram-down plans, "[a] court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment." *Id*. The *Philadelphia Newspapers* holding was directly refuted by the Supreme Court in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S.Ct. 2065 (2012), when it held that section 1129(b)(2)(A) unambiguously bars debtors from preventing secured creditors' ability to credit bid up to the amount of their collateral under a plan of reorganization.

The upshot of *Fisker* is that, in Delaware at least, loan-to-own investors who buy debt claims at a discount may have their ability to credit bid capped. In this regard, an interesting aspect of *Fisker* is that because the creditor purchased its claim from the U.S. government, the price paid was publicly disclosed. Neither the Bankruptcy Code nor the Bankruptcy Rules explicitly

requires claim transferees to disclosure the price paid for acquired claims and it is not normal practice to voluntarily disclose this information. It remains to be seen whether courts seeking to limit credit bidding might compel disclosure of this information going forward.

It appears that the threat to loan-to-own credit bidding could be expanding outside the Third Circuit as well. In April 2014, several months after *Fisker*, the U.S. Bankruptcy Court for Eastern District of Virginia capped a loan-to-own investor's ability to credit bid in *In re The Free Lance-Star Publishing Co. of Fredericksburg, VA*, 512 B.R. 798 (Bankr. E.D. Va. 2014). The court held that, while the ability of parties to credit bid up to the full value of their claims, "is an important safeguard that insures against the undervaluation of the secured claim at an asset sale"…"[c]redit bidding…is not an absolute right." *Id*. at 804-05. In contrast to *Fisker*, the court in *Free Lance-Star* determined that the creditor had engaged in inequitable conduct when it recorded financing statements against certain unencumbered property of the debtor without the debtor's consent or knowledge and tried to hinder the debtor's efforts to generate interest in a competitive auction for its assets. *Id*. at 806-07. The *Free Lance-Star* court concluded that the creditor, in pursuing an "overly zealous loan-to-own strategy," determined that its position was not fully secured and attempted, inequitably, to unilaterally correct the deficiency. *Id*. at 807-08. It also tried to discourage the debtor from hiring an investment bank to conduct the sale and required that the marketing materials clearly state that the creditor could credit bid up to $39 million–the full amount of its claim. The court capped credit bidding at $13.9 million–the proven amount of the creditor's properly perfected liens–rather than the full amount, for cause because the "loan-to-own strategy has depressed enthusiasm for the sale in the marketplace," by discouraging other potential bidders from participating in what was communicated to the market as a "*fait accompli*" sale to the secured creditor. *Id*.

In March 2015, the U.S. Bankruptcy Court for the Southern District of New York heard challenges to the ability of Standard General LP, a secured creditor and would-be stalking horse, to credit bid in *In re RadioShack Corp.*, Bankr. S.D.N.Y., Case No. 15-10197. Several parties, including Salus Capital Partners LLC, another secured creditor who submitted a rival bid, challenged Standard General's ability to credit bid the full amount of its claims, arguing, among other things, that the sale violated provisions of the debtor's intercreditor agreements and that Salus' liens were superior to Standard General's. The debtor and the committee disagreed, and from the bench, the court refused to limit Standard General's ability to credit bid, finding that Standard General's bid was the only one received that sought to keep the debtor operating as a going concern.

Putting aside this recent case law, there is another, far simpler opportunity for an attack on the right to credit bid. Yet, this opportunity seemingly is often ignored by those who would oppose credit bidding. The express terms of section 363(k) limit the right to credit bid to holders of an

"allowed" claim. Consequently, the holder of a claim that has not been determined to be valid may not bid its claim. Under Bankruptcy Rule 3001(f), a timely filed proof of claim is prima facie evidence of the validity and amount of the claim. Under section 502(a), a claim is deemed "allowed" to the extent a party in interest has not objected. In many, if not most, section 363 sales recently, the sale takes place in the early months of a case and often before a proof of claim deadline has been set. In the absence of a proof of claim filed by the secured creditor desirous of making a credit bid, or if a good faith objection to a filed proof of claim is, filed prior to the section 363 sale, the court arguably should deny the right to credit bid.

Courts have sometimes allowed a party to credit bid up to the undisputed portion of a secured claim, when resolving a claim objection is not possible in advance of a section 363 asset sale. For example, in *In re RML Dev., Inc.*, 2014 Bankr. LEXIS 3024 (Bankr. W.D. Tenn. July 10, 2014), the bankruptcy court reduced the secured lender's maximum credit bid by the disputed portion related to fees and interest calculations and allowed it to assert a maximum credit bid equal to the portion of the its claim that the debtor did not dispute. *Id*. at *12-13.

F. **Potential Limitations on Transferred Claims**

It is possible that a court may disallow a transferred claim under section 502(d) of the Bankruptcy Code (11 U.S.C. § 502(d)), to the extent that the claim is subject to an avoidable transfer. This may limit or disqualify altogether the claim holder from credit bidding in an asset sale or converting its position to equity under a plan. Disallowance has become an issue particularly for claim transferees in recent years, and some courts have distinguished between a "sale" and an "assignment" of a claim against a debtor in determining whether a claim transferee remains subject to the same defenses to which the transferor was subject, even if the defense existed only because of the identity or actions of the transferor. *Enron Corp. v. Springfield Associates, LLC (In re Enron Corp.)*, 379 B.R. at 425, 435–36 (S.D.N.Y. 2007) (distinguishing between sales and assignments for purposes of § 502(d)); but see *In re KB Toys, Inc.*, 470 B.R. 331 (Bankr. D. Del. 2012) (no distinction between sales and assignments for purposes of § 502(d)). If the defense to the transferred claim was caused by a "personal disability" of the transferor that is not present in the transferee, the form of the transfer may impact whether the personal disability will travel with the claim and survive the transfer.

It is fairly well established that an assignee "steps into the shoes" of an assignor and is capable of asserting any rights, claims, or defenses that were available to the assignor. *See, e.g*., *Enron*, 379 B.R. at 435–36; *In re Snyder*, 436 B.R. 81, 90–91 (Bankr. C.D. Cal. 2010); *Green Point Funding, Inc. v. Jacobs (In re Jacobs)*, 2007 Bankr. LEXIS 3967 at *23 (Bankr. E.D.N.Y. Nov. 21, 2007)*; New Falls Corp. v. Boyajian (In re Boyajian)*, 367 B.R. 138, 145 (B.A.P. 9th Cir. 2007). The reasoning employed by the *Enron* court (in NY) suggests that loan-to-own investors can

structure claim transactions as sales in order to insulate their position from defects resulting from a predecessor's behavior under the good faith purchaser doctrine.

However, the United States Bankruptcy Court for the District of Delaware has explicitly recognized the problems presented by *Enron* and declined to follow the decision. Instead, the bankruptcy court found that section 502(d) continues to apply to a claim in the hands of a transferee even when the transfer was in the form of a sale. *KB Toys,* 470 B.R. at 340–41. The court explained that even if there were a way to clearly distinguish between sales and assignments, doing so in the context of section 502(d) "is unhelpful and unrevealing of the appropriate outcome." *Id*. at 341. The court reasoned that today's claim purchasers are highly sophisticated entities fully capable of performing due diligence prior to acquiring a claim and are aware of the possibility of avoidance actions. Thus, there is no concern that subjecting claim transferees to section 502(d) would disrupt the claim trading market. The court held that "a claims purchaser is not entitled to the protections of a good faith purchaser," concluding that "a trade claim purchaser holds that claim subject to the same rights and disabilities under Bankruptcy Code § 502(d) as does the original trade claimant." *Id*. at 343. Moreover, the claim purchasers were on constructive notice of the existence of possible avoidance actions based on the disclosures in the debtor's statement of financial affairs. For these and other reasons, the court concluded that it was entirely proper for claims in the hands of purchasers to remain subject to section 502(d). In affirming the *KB Toys* decision, the Third Circuit zeroed in on the plain language of 502(d), which provides that the court can disallow "any claim of any entity," meaning that avoidable transfers follow the claim, regardless of the owner. *In re KB Toys*, 736 F.3d 247 (3d Cir. 2013).

G. Conclusion

Loan-to-own strategies can, and often are, very successful, as demonstrated in the *Flat Out Crazy, FGCI, Crumbs* and *Wet Seal* cases identified above. Investors, however, face increasing challenges to these strategies, including their ability to credit bid the full amount of their claims, particularly where some or all of their claims may be in dispute or where they are found to have used their leverage to unduly discourage a competitive auction for the debtor's assets. Investors also must be aware of the emerging split between bankruptcy courts in New York and Delaware regarding transferred claims and should take steps to protect themselves from the risk of exposure to personal disabilities that may accompany transferred claims.

Loan-to-Own Intercreditor Issues with A/B and Mezzanine Loans

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I. Introduction

Lenders primarily interested in taking over ownership of a company -- so-called loan-to-own lenders -- often acquire their interests in a subordinate position to tradition first mortgage lending. Two primary ways this is done is by acquiring a so-called "B piece" of the first mortgage or by providing a "mezzanine" loan to the borrower. These materials discuss some basic elements of both types of lending and the bankruptcy issues that can arise when the loan-to-own lender seeks to take action to acquire its target, with a special focus on the issues that arise between the loan-to-own lender and the senior lender.

II. A/B Loan Basics

A/B loans consist of two promissory notes, both secured by the same deed of trust or mortgage. The B Note is junior in priority to the A Note. The same loan servicer services both loans taking their respective priority into account.

Prior to an event of default, the waterfall generally provides for the payment first of non-default interest to the A noteholder, then regular principal payment to the A noteholder followed by non-default interest to the B noteholder followed by regular principal payment to the B noteholder.

After an event of default, the waterfall generally provides for the payment first of non-default interest to the A noteholder, then principal to the A noteholder until the principal is satisfied in full. Payments then go to reimburse any cure amounts paid by the B noteholder, then to non-default interest of the B noteholder and principal of the B noteholder until the principal is satisfied in full. Any remaining amounts go to the noteholders' default interest as specified in their agreement.

III. Rights of the B Noteholder to Cure and Repurchase

If the borrower fails to make any payment of principal or interest under the loan, the B noteholder has the right to cure as set forth in the Co-Lender Agreement. The Co-Lender Agreement may or may not provide for a notice of default requirement, but written notice should be provided. If the B noteholder cures, then the loan will not be treated as being in default for the purposes of application of payments.

The B noteholder must receive notice of its rights to repurchase the A noteholder's loan upon the occurrence of the following events: (1) payments of principal or interest become more than 90 days delinquent; (2) the loan has been accelerated; (3) the borrower files for bankruptcy; or (4) the Loan becomes a "specially serviced" loan. The B noteholder has 85 days from delivery of the notice to purchase the A note at the defaulted mortgage loan purchase price. The defaulted mortgage loan purchase price equals: (1) principal and non-default interest; (2) unreimbursed advances and interest thereon; and (3) servicing fees. There generally are no default interest or prepayment fees.

IV. Exercise of Remedies

The servicer on behalf of the A noteholder has the sole and exclusive authority with respect to the administration and the exercise of the rights and remedies with respect to the loan. The servicer can take such actions as modifying the loan, waiving certain provisions, voting all claims in a bankruptcy, accelerating the loan, instituting foreclosure, accepting a discounted pay off and selling the property after it obtains title to it. However, the servicer generally cannot exercise remedies or modify the loan without the consent of the "directing holder". Generally, the directing holder is the B noteholder unless a "Control Appraisal Event" has occurred, in

which case it is the A noteholder. A "Control Appraisal Event" occurs if the initial Note B principal balance minus (2) the sum of (x) any principal payments allocated to, and received on, Note B, (y) any "Appraisal Reduction Amounts" for the loan, and (z) any "Realized Principal Losses", is less than (b) 25% of the initial Note B principal balance.

V. Mezzanine Loan Basics

Unlike a first mortgage loan, a mezzanine loan is not secured by a lien on the borrower's real estate. Instead, the mezzanine loan is generally secured by an ownership interest in the borrower (although it sometimes is also secured by a junior lien on the real estate). Oftentimes the goal of the mezzanine lender is to acquire control of real estate borrower. Such control allows control of property management and a potential bankruptcy filing by the borrower (and cram-down attempt on the mortgage lender).

Mezzanine loans allow the borrower to obtain additional financing beyond normal first lien loan-to-value ratios, often with less comprehensive personal guarantees. Because usually the only collateral is a pledge of the mezzanine borrower's equity interests in the property owner, less of the borrower's equity is diluted.

VI. Rights of Mezzanine Lender to Foreclose, Cure and Repurchase

The main right of a mezzanine lender is typically to foreclose on the ownership interests in the borrower. However, there are certain conditions to doing so, usually contained in Section 5 of the Intercreditor Agreement. First the mezzanine lender must show that it is a "qualified transferee". Second, it must replenish any reserves the borrower failed to fund or institute hard cash management. Third, it may have to deliver a replacement guaranty. Finally, the foreclosure must not cause a "significant modification" of the senior loan.

Whether the mezzanine lender is a "qualified transferee" depends on the language of the Intercreditor Agreement and the characteristics of the mezzanine lender. The definition is usually limited to institutional investors and often contains financial thresholds that must be met, such as $650,000,000 in assets under management and capital/statutory surplus or shareholder's equity of $250,000,000.

Whether an entity was a "qualified transferee" was the issue that faced the court in *In re Meridian Sunrise Village, LLC*, 2014 WL 909219 (W.D.Wash. 2014). In 2008, Meridian borrowed $75 million from U.S. Bank to construct a shopping center. The loan agreement prohibited the lender from assigning its rights to anyone other than an "eligible assignee," defined as "any Lender or any Affiliate of a Lender or any commercial bank, insurance company, financial institution or institutional lender . . . ." The court found that such language was important to Meridian based on prior bad experiences with "predatory investors — investors who purchase distressed loans in the hope of obtaining control of the underlying collateral in order to liquidate it for rapid repayment."

Shortly after the loan was made, U.S. Bank assigned portions of its loan to three other financial institutions, including Bank of America. In 2012, these lenders declared Meridian in default based on inadequate debt-service coverage ratio under its loan. U.S. Bank sought to sell its portion of the loan and requested Meridian's permission to waive the "eligible assignee" restrictions in the loan documents. When Meridian refused, U.S. Bank started charging Meridian default interest (at 20%). Meridian then filed for Chapter 11. Bank of America thereafter transferred its interest to NB Distressed Debt Limited Fund, which then assigned that interest to several of its funds, entities the court described as "hedge funds that acquire distressed debt and engage in predatory lending." In response, Meridian sought to enjoin the hedge funds from

exercising rights under the loan documents, including voting on Meridian's plan, on the ground they were not an "eligible assignee".

The bankruptcy court granted Meridian an injunction and denied the hedge funds the right to vote on the plan, which the court later confirmed. The hedge funds then appealed to the district court. The district court rejected the hedge funds' argument that the term "financial institutions" should be read to include any enterprise that specializes in the handling and investment of funds. Instead, the district court found that such term — in the context of the loan documents — meant entities that make loans, such as the other entities specifically mentioned in the definition, namely commercial banks, insurance companies and institutional lenders. It also considered extrinsic evidence showing that Meridian specifically wanted to restrict the definition of "financial institutions" to exclude "loan-to-own" lenders. As a result, the district court affirmed the bankruptcy court's decision precluding the hedge funds from voting on the plan.

Sometimes, the mezzanine lender believes it would benefit from a borrower bankruptcy. The Intercreditor Agreement (usually Section 10(c)) typically bars the mezzanine lender from filing a bankruptcy petition for the borrower and from soliciting, directing or causing the mezzanine borrower or any entity that controls the borrower from having a bankruptcy filed for borrower or any "SPE Constituent Entity" (usually meaning any borrower affiliate up the chain). An injunction may be available if the mezzanine lender voices an intent to breach Section 10(c).

The breadth of restrictions was examined by the court in *Bank of America v. PSW NYC LLC*, 29 Misc.3d 1216(A), 2010 WL 4243437 (N.Y.Sup.Ct. 2010) (unreported). This case arose out of the financial distress of the Peter Cooper Village and Stuyvesant Town property in New York City. Tishman Speyer Development Corp. acquired the property in 2007 with financing that consisted of first lien mortgage debt as well as junior mezzanine debt secured by the

ownership interests in the various mezzanine borrowers. The senior and junior lenders entered into an intercreditor agreement spelling out their respective rights against each other. In particular, the intercreditor agreement prevented the junior lenders from soliciting or causing a bankruptcy petition to be filed against any borrower. After the loans went into default, the senior lenders accelerated their loan and the junior lenders transferred their $300 million of loans to PSW for $45 million. The senior lenders requested that PSW prove that it was a "qualified transferee" under the intercreditor agreement and confirm that it would cure any defaults under the senior loan if it acquired the interests of any of the mezzanine borrowers. After PSW balked, the senior lenders moved for a preliminary injunction prohibiting PSW from orchestrating a bankruptcy by the borrowers until the senior loan was paid in full and for a declaration that PSW had to cure all senior loan defaults prior to obtaining any of the mezzanine borrowers' interests.

Although the court found that PSW had not yet taken any action to solicit the filing of a bankruptcy case by any of the borrowers, it found that the language of the intercreditor agreement unambiguously required PSW to cure all senior loan defaults (and pay the $3.6 billion first lien debt in full) if it acquired any of the mezzanine borrowers' interests. The court further rejected PSW's request that the senior lenders post a bond equal to the face amount of the junior debt ($300 million) for the potential harm PSW might suffer from the injunction, finding it more relevant to tie the bond amount to the amount PSW paid for the junior debt ($45 million). As a result, the court ordered the posting of a bond for just $4.5 million.

The court in *Highland Park CDO I Grantor Trust v. Wells Fargo Bank NA*, 2009 WL 1834596 (S.D.N.Y. June 16, 2009) also examined the limitations on a mezzanine lender's rights. In that case, the borrower obtained a first mortgage loan that was guaranteed by four individuals. It also obtained a mezzanine loan that was guaranteed by those same four individuals. The

mortgage lender and the mezzanine lender executed an intercreditor agreement specifying their rights against each other. Among other things, the agreement subordinated the mezzanine lender's rights to recovery to the mortgage lender's rights to recovery under the mortgage loan documents, which included the guarantees. Highland ultimately acquired the interests under the mezzanine loan and sued the guarantors to collect on their guarantees. Soon thereafter, the mortgage lender filed a foreclosure suit. Highland then sought a declaration that it had the right to sue the guarantors even though the mortgage loan remained unpaid. The mortgage lender filed a counterclaim seeking a declaratory judgment that Highland was barred from enforcing the guarantees until the mortgage loan was repaid in full.

The court reviewed the plain language of the intercreditor agreement and found that it clearly prevented the mezzanine lender from receiving any payment until the mortgage loan was repaid in full. In particular, the court noted that the intercreditor agreement subordinated all of the mezzanine loan documents (including the guarantees) to the mortgage loan documents. As a result, the court entered a declaratory judgment barring Highland from recovering on its guarantees until the mortgage loan was repaid in full. It also directed the mortgage lender to submit a formal application to recover its fees and expenses.

As in the A/B loan structure, the Intercreditor Agreement usually permits the mezzanine lender to cure any defaults of the borrower under the senior loan (typically found in Section 11(c)). If no cure is forthcoming, the senior lender can complete its foreclosure.

Also as in the A/B loan structure, the mezzanine lender has the right to purchase the senior loan after default, but before completion of a foreclosure. In that regard, the senior loan purchase price consists of the total amount due (including protective advances), but excluding default interest, yield maintenance, late charges, and any securitization liquidation fee (if

purchased fewer than 90 days after securitization). If there are multiple mezzanine levels, the lowest level gets first right, but must buy all loans senior to it.

VII. Exercise of Remedies

The main remedy of a mezzanine lender is to conduct a UCC foreclosure of the borrower's ownership interest that has been pledged to it, although sometimes there is a right to exercise control over the borrower prior to foreclosure. Typical language in an Intercreditor Agreement states that any Qualified Transferee takes "subject to the senior loan" which shall not be accelerated by the senior lender provided, however, that the Qualified Transferee must reaffirm the debt to the senior lender and cure all defaults under the senior loan that remain uncured as of the date of such acquisition by the Qualified Transferee.

If the mezzanine lender desires to sell its loan, as with foreclosure it must satisfy certain conditions, such as the following: (1) the purchaser must be a "Qualified Transferee; (2) notice must be sent to the senior lender; (3) the applicable rating agency must review and approve the transfer; (4) a new replacement guarantor must be offered; (5) a professional property manager must be retained; and (6) reserves must be replenished.

VIII. Senior Lender's Rights if Mezzanine Lender is Deemed a Creditor of Borrower

A typical intercreditor agreement provides (in Section 10(d)) that if the mezzanine lender is deemed a creditor of the senior lender's borrower in a bankruptcy case, the senior lender can file proofs of claim for the mezzanine lender and, if the senior lender is impaired under the plan, can vote the mezzanine lender's claims and can make the Section 1111(b) election for the mezzanine lender. The extent to which courts will enforce these rights is not uniform.

For instance, in *In re 203 N. LaSalle St. P'ship*, 246 B.R. 325 (Bankr. N.D.Ill. 2000) the debtor attempted to confirm a new Chapter 11 plan after the case was remanded from the

Supreme Court of the United States. Under that plan, it classified a second mortgage loan it had obtained from its general partner. The debtor's first mortgage lender, Bank of America, filed an adversary proceeding asserting that it had the right to vote the claims of the debtor's general partner under the terms of a subordination agreement.

The court first distinguished the bank's right to payment from its right to vote another creditor's claims. For the former, the court ruled that the subordination agreement would be enforceable under applicable state law. For the latter, the court found that the right to vote is a core bankruptcy right that cannot be overridden by contract. As a result, the court allowed the debtor's general partner, as holder of a claim, to vote its claim notwithstanding the subordination agreement terms.

The court in *In re SW Boston Hotel Venture, LLC*, 460 B.R. 38 (Bankr. D. Mass. 2011) found *203 N. LaSalle* persuasive. In that case, the debtor obtained a first mortgage loan from Prudential as well as a separate, junior loan from the City of Boston. Prudential and the City entered into an intercreditor agreement pursuant to which the City, among other things, granted Prudential the right to vote any of its claims in a subsequent bankruptcy by the debtor. The debtor filed a plan that Prudential rejected on behalf of the City, but the City voted to accept. Prudential contended that only its vote should count as the City had assigned its right to vote its claim to Prudential.

Following *203 N. LaSalle*, the court rejected Prudential's contention and counted the City's vote. In particular, the court found that agreements cannot nullify Bankruptcy Code provisions and that Section 1126(a) affords holders of claims the right to vote their claims. *Accord In re Croatan Surf Club, LLC*, 2011 WL 5909199 (Bankr. E.D.N.C. Oct. 25, 2011)(declining to enforce subordination agreement provision granting senior creditor right to

vote junior creditor's claim). *See also Beatrice Foods Co. v. Hart Ski Mfg. Co. (In re Hart Ski Mfg. Co.*), 5 B.R. 734 (Bankr. D. Minn. 1980)(declining to enforce agreement by junior creditor not to pursue collection of its claim without senior creditor's prior approval); *but see In re Inter Urban Broadcasting of Cincinnati, Inc*., 1994 WL 646176 (E.D. La. Nov. 16, 1994))(enforcing subordination provision granting senior creditor right to vote junior creditor's claim); *In re Blue Ridge Investors, II, LP v. Wachovia Bank (In re Aerosol Packaging, LLC)*, 362 B.R. 43 (Bankr. N.D. Ga. 2006 (same); *In re Curtis Center Ltd. P'ship*, 192 B.R. 648 (Bankr. E.D. Pa. 1996)(same). Other courts also have recognized the enforceability of pre-petition agreements granting senior creditors the rights of junior creditors in a subsequent borrower bankruptcy. *See Aurelius Capital Master Ltd. v. TOUSA Inc*., 2009 WL 6453077 (S.D. Fla. Feb. 6, 2009)(affirming lower court's enforcement of a provision under which a junior creditor agreed not to object to debtor's use of its cash); *In re Davis Broadcasting, Inc*., 169 B.R. 229 (Bankr. M.D. Ga. 1994)(recognizing in dicta the enforceability of a subordination agreement in bankruptcy).

A typical Intercreditor Agreement also provides that the mezzanine lender cannot act without obtaining the senior lender's prior approval except to realize on its stock pledge or to exercise its rights as an unsecured creditor. Specifically, the mezzanine lender is often prohibited from challenging the validity or amount of the senior lender's claim or the senior lender's valuation of its collateral and cannot take any action adverse to senior lender's enforcement of its claim or receipt of adequate protection.

IX. Section 510(a) of the Bankruptcy Code

"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. § 510(a). A

number of courts have analyzed what that language means. For instance, in *In re Ion Media Networks, Inc.*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009), the debtors entered into a series of agreements several years before filing for bankruptcy with their first lien and second lien lenders, which entered into an intercreditor agreement governing the relationship between themselves. Among other things, the intercreditor agreement prohibited the second lien lenders from challenging the priority of the first lien lenders' claims, effectively agreeing to remain "silent" as to any such issues.

When contemplating bankruptcy, the debtors negotiated a restructuring support agreement that included a debtor-in-possession financing package from the first lien lenders that recognized their rights to the debtors' valuable FCC licenses. One of the holders of second lien debt, Cyrus Select Opportunities Master Fund Ltd., challenged such grants and aggressively opposed the first lien lender's lien claims. Consequently, the debtors filed an adversary proceeding to enjoin Cyrus from challenging the validity or priority of the liens granted to the first lien lenders and objecting to the debtors' plan and disclosure statement.

At the outset, the court noted that Cyrus "is an activist distressed investor that purchased certain deeply discounted second lien debt [of the debtors] for pennies on the dollar." It further noted that Cyrus "has been using aggressive bankruptcy litigation tactics as a means to gain negotiating leverage or obtain judicial rulings that will enable it to earn outsize returns on its bargain basement debt purchases at the expense of the First Lien Lenders" and that Cyrus had made an offer to obtain control of the debtors. The court then took Cyrus to task for not obtaining an early ruling on its ability to take positions that might be barred under the intercreditor agreement it acknowledged applied to it. "Here, a sophisticated, economically motivated and woefully out of the money creditor has deliberately chosen to ignore the terms of

an unambiguous agreement that, read literally, precludes it from opposing confirmation." Worse yet for Cyrus, the court noted that "[i]t is objecting as if it has the right to do so without regard to the incremental administrative expenses that are being incurred in the process," and then noted that such costs may be claimed against Cyrus if they can be traced to breaches of the intercreditor agreement.

The court then found that the intercreditor agreement clearly barred Cyrus from challenging the priority of the first lien lenders' claims and opposing any plan that was consistent with the first lien lenders' rights under the loan documents. The court noted that it was important to enforce bargained for restrictions and was warranted under Section 510(a). In doing so, it distinguished cases refusing to enforce assignments of the right to vote on a plan, finding that no such restriction existed in this case. As a result, the court confirmed the debtors' otherwise consensual plan.

The court in *In re Erickson Retirement Communities, LLC,* 425 B.R. 309 (Bankr. N.D.Tex. 2010) held similarly. In that case, certain of the debtors' creditors entered into pre-petition subordination agreements pursuant to which the junior creditors agreed to subordinate their right to payment until the senior lenders were paid in full, and not to "exercise any rights or remedies or take any action or proceeding to collect or enforce any of the Subordination Obligations" without the prior written agreement of the agent for the senior lenders until the senior lenders were paid in full. Notwithstanding those restrictions, one of the junior lenders filed a motion seeking the appointment of an examiner, arguing that the subordination agreement to which it was a party was unenforceable.

The court agreed with the agent for the senior lenders that the subordination agreement was enforceable under Section 510(a) and the junior creditors therefore lacked standing and/or

had contractually waived their right to seek an examiner in the cases. The court found that until the senior lenders were paid in full, the junior lenders had to "stand still". Because the request for an examiner was tantamount to a collection action, the court found that it was barred by the subordination agreements. Moreover, the court found that the lack of any allegations of fraud or mismanagement combined with the timing of the examiner motion (after the debtors had successfully auctioned their assets and reached settlements with many of their creditors incorporated in a plan), demonstrated that the motion "is unmistakably aimed at slowing down the confirmation process and gaining leverage to enhance or create recoveries for the Subordinated Creditors. This is the very type of obstructionist behavior that the agreements are intended to suppress." Lastly, the court noted that because an examiner would serve no useful purpose, the court would have appointed an examiner with no duties if it was compelled to appoint one under Section 1104(c) on request of a party with standing.

Yet the court in *In re Boston Generating, LLC*, 440 B.R. 302 (Bankr. S.D.N.Y. 2010) refused to enforce a pre-petition subordination agreement under the facts before it. In that case, the debtor filed a motion seeking to sell its assets one day after filing for bankruptcy. The second lien lenders objected to the bid procedures. The first lien lenders claimed that the second lien lenders were barred from doing so under the terms of an intercreditor agreement between them. The court found that the plain language of the intercreditor agreement did not preclude such objection to bidding procedures. When the debtors then sought to sell their assets for less than what the first lien lenders were owed, the second lien lenders objected and the first lien lenders again argued that the intercreditor agreement barred any such objection.

The court first noted that the parties had stipulated that the first lien lenders were not making an election of remedies by consenting to a sale for an amount that was insufficient to pay

them in full under 11 U.S.C. § 363(f)(2). The court stated that had they not so stipulated, it may have found that the second lien lenders lacked standing to object to the sale under the plain language of the intercreditor agreement that barred them from taking any action to hinder an election of remedies by the first lien lenders. The court then found that the language of the intercreditor agreement did not clearly prohibit the second lien lenders from objecting to the sale, as it does in the ABA Model Intercreditor Agreement. In particular, the court found that the second lien lenders reserved their right to assert interests as unsecured creditors, which would include the right to object to a sale. Thus, even though the court found that the second lien lenders' objection to the sale violated the spirit of the intercreditor agreement, it allowed them to object because they were not violating the plain language of that agreement. However, it proved to be a "hollow" victory as the court then approved the sale.

In summary, a bankruptcy court is more likely to restrict a mezzanine lender's actions if the mezzanine lender is out of the money, especially if it is seen as obstructionist.

X. Cramdown and Intercreditor Agreements

Under Section 1129(b)(1), a creditor's claim can be crammed down notwithstanding a subordination agreement. This means that as long as the plan is fair and equitable and does not discriminate unfairly regarding the senior lender's claim, it can still provide for payment to junior creditors before the senior lender is paid in full. The remedy for cram down may be money damages against the junior creditor. For instance, in *In re TCI 2 Holdings LLC*, 428 B.R. 117 (Bankr. D.N.J. 2010), the court refused to enforce an intercreditor agreement prohibiting payments to subordinated creditors under a plan that could otherwise satisfy the cramdown requirements.

XI. Plan Confirmation Challenges for the Mezzanine Borrower

Under Section 1129(a)(10), at least one impaired class of claims must accept the plan. Mezzanine borrowers should only have one creditor — the mezzanine lender. This fact may pose a challenge to a mezzanine lender that wants to cram down a plan on a senior lender, especially in light of the recent trend in the case law.

In *JPMorgan Chase Bank, N.A. v. Charter Communications Operating, LLC (In re Charter Communications)*, 419 B.R. 221 (Bankr. S.D.N.Y. 2009), the bankruptcy court confirmed a chapter 11 plan of reorganization over the objection of a group of noteholders, which argued that the classification of claims was done to gerrymander an accepting impaired class of claims to satisfy section 1129(a)(10). In *dicta*, the court noted that even if the noteholders were classified together with other unsecured creditors, the plan could still be confirmed because compliance with section 1129(a)(10) is tested on a per plan, not per debtor, basis. The court further noted (at great length) how the plan in that case was the result of negotiations during the height of the 2008 financial industry meltdown and likely presented the only possibility of a successful exit from bankruptcy.

In *In re Enron Corp*., No. 01-16034, 2004 Bankr. LEXIS 2549, *232 (Bankr. S.D.N.Y. July 15, 2004), the bankruptcy court confirmed a chapter 11 plan for multiple debtors on the basis of a "deemed consolidation" where the various debtors were treated as one entity and the plan had considerable non-insider support. In *In re SGPA, Inc*., No. 1-01-02609, 2001 WL 34750646, at *17 (Bankr. M.D. Pa. Sept. 28, 2001), the court confirmed a joint chapter 11 plan of reorganization of multiple debtors over the objection of bondholders because "[w]hether these Debtors were substantively consolidated or jointly administered would have no adverse effect on the Subordinated Bondholders." Finally, the court in *In re Station Casinos, Inc*., No. BK-09-

52477, 2010 Bankr. LEXIS 5380, at *81-82 (Bankr. D. Nev. Aug. 27, 2010) confirmed a joint chapter 11 plan for multiple debtors with no independent analysis of section 1129(a)(10), instead relying exclusively on the prior decisions of *Charter Communications, Enron*, and *SGPA*.

Yet the two most recent decisions in *In re Tribune Co.*, 464 B.R. 126 (Bankr. D. Del. 2011), and *In re JER/Jameson Mezz Borrower II, LLC*, 461 B.R. 293 (Bankr. D. Del. 2011), provide an extensive examination of section 1129(a)(10) and conclude that it must apply per debtor absent substantive consolidation of the bankruptcy estates. In *Tribune*, the court noted that "[t]here exists little decisional authority on whether § 1129(a)(10) is to be applied 'per debtor' or 'per plan.'" Examining the statutory text of section 1129(a)(10), which requires "at least one class of claims that is impaired *under the plan*," the court explained that the Bankruptcy Code contains certain rules of statutory construction, including that "the singular includes the plural" (citing 11 U.S.C. § 102(7)). Accordingly, the use of the singular "plan" in section 1129(a)(10) is insufficient to conclude that only one accepting impaired class is required for a joint chapter 11 plan involving more than one debtor. The court then noted that the joint plan in that case specifically stated that it was not substantively consolidating the debtors' bankruptcy estates, explaining that the "practical effect" of such a provision means that the joint plan actually consists of a separate plan for each debtor. Accordingly, the court held that the requirements for confirmation of a Chapter 11 plan set forth in section 1129(a)—including subsection (10)—must apply for *each debtor* and not just the one joint plan. The court ruled that this interpretation of section 1129(a)(10) is the only way to reconcile the various other requirements for plan confirmation in section 1129(a). The *Tribune* court distinguished *Charter Communications*, *Enron* and *SGPA*, concluding that "none of the three courts considered the § 1129(a)(10) issue central to its decision in the matter before it."

In *JER/Jameson*, the court dismissed a chapter 11 filing by numerous related mezzanine debtors, holding that a chapter 11 plan was not feasible because the debtors could not obtain an accepting impaired class for each debtor as required under section 1129(a)(10). The joint filing in *JER/Jameson* involved an entity created to facilitate mezzanine financing ("Mezz II"). Mezz II had only one creditor (the mezzanine lender), which objected to the chapter 11 plan of reorganization. Consequently, the court held that the debtors had no reasonable prospects of confirming a chapter 11 plan, explaining:

> Although the Debtors collectively have 103 Inns and related assets and many creditors, Mezz II has only one creditor and one asset. Mezz II cannot confirm a plan over [the mezz lender]'s objection because it could get no accepting class. Therefore, in the absence of substantive consolidation, Mezz II does not have any chance of confirming a plan.

Thus, if a court follows the *JER/Jameson* and *Tribune* holdings, a mezzanine lender that forecloses on the equity pledged to it and then files a bankruptcy petition for the borrower is not likely to be able to effectuate a cram down on the senior lender.

BARNES & THORNBURG LLP

Overview of Asset Sales Under Section 363 of the Bankruptcy Code

Loan to Own and Other Section 363 Bidding and Acquisition Strategies

American Bankruptcy Institute
Central States Workshop, June 11 – 14, 2015
Traverse City, Michigan

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Introduction

- Statutory Authority
  - A Debtor (or Trustee), "after notice and a hearing, may...sell..., other than in the ordinary course of business, property of the estate."

    See 11 U.S.C. § 363(b)(1); Commission Report, pp. 135 - 138
- Sales Free and Clear of Liens and Claims
  - Generally, the property sold under Section 363 may be "free and clear of any interest in such property" if at least one of the following elements is satisfied:
    - Applicable nonbankruptcy law permits sale of such property free and clear of such interest
    - Such entity consents
    - Such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property
    - Such interest is in bona fide dispute
    - Such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest

      See 11 U.S.C. § 363(f); Commission Report, pp. 141-145

Introduction – cont'd

– Certain claims or liabilities might not be avoided or eliminated through a Section 363 sale:
  - Environmental Liabilities
  - Products Liability
  - Easements and Restrictive Covenants
  - Other claims based upon "overriding policy" or "successor liability" doctrine (*e.g.*, under federal labor laws)
  - "Future" claims

    See Commission Report, pp. 143 - 144

-- In addition, a Section 363 sale should not violate or impede enforcement of a governmental unit's police or regulatory powers that are within the purview of Section 362(b)(4) and not subject to the Automatic Stay of Section 362(a)

See Commission Report, p. 145

Introduction – cont'd

- Maximizing Value through the "Auction" Process
  - Bankruptcy Rule 6004(f)(1) provides that "[a]ll sales not in the ordinary course of business may be by private sale or by public auction."
  - However, because of the Debtor's duty and the creditors' desire to maximize value, virtually all sales in Bankruptcy Court have the essential elements of an auction, where a proposed transaction is subjected to higher and better bids before approval.

Standards for Approval of a Proposed Section 363 Sale

- There is no statutory requirement that a sale of all or substantially all of a Chapter 11 Debtor's assets be made pursuant to or under either a plan of reorganization or a plan of liquidation
- Some courts, particularly in earlier cases under the Bankruptcy Code, required that an "emergency" existed in order for a sale to be accomplished prior to confirmation of a plan

  See, e.g., In re: White Motor Credit Corp., 14 B.R. 584 (Bankr N.D. Ohio 1981) (concluding that section 363 does not permit sales of all assets, though recognizing "emergency exception").
- However, a large majority of courts have not required an emergency and generally permitted Debtors to sell their assets outside of the strictures and creditor protections included in the plan confirmation process

  See, e.g., In re Gen. Motors Corp., 407 B.R. 463 (Bankr. S.D.N.Y. 2009), *aff'd., In re Motors Liquidation Co.,* 430 B.R. 65 (S.D.N.Y. 2010); *Chrysler LLC,* 576 F.3d 108 (2d Cir. 2009); *In re Lionel Corp.,* 722 F.2d 1063 (2nd Cir. 1983); *In re Nicole Energy Servs., Inc.,* 385 B.R. 201 (Bankr. S.D. Ohio 2008). *See generally Commission Report*, pp. 137 - 138, 205 - 206.

Assumption and Assignment of Executory Contracts and Unexpired Leases as Part of a Sale Proceeding

- A sale may include rights of the Debtor (or Trustee) under "executory contracts" and unexpired leases. Generally, a Debtor (or Trustee) may "assume" an executory contract or unexpired lease and "assign" its rights under the contract / lease to a third party (purchaser) if:
  - Defaults under the contract / lease are "cured" (or will be "promptly" cured)
  - There is "adequate assurance" of the assignee's "future performance" under the contract / lease

  11 U.S.C. § 365(b), (f)(2)
- Typically, the Debtor has the ability to assign a contract / lease even though there are provisions in the contract / lease prohibiting its assignment

  11 U.S.C. § 365(f)(1)

Assumption and Assignment of Executory Contracts and Unexpired Leases as Part of a Sale Proceeding – cont'd

- But some contracts / leases are not assignable
  - Contracts to make a loan
  - Personal service contracts
  - Contracts "not assignable under applicable non-bankruptcy law" (without the consent of the non-Debtor party)
    - Patent licenses
    - Government contracts

  11 U.S.C. § 365(c). See e.g., In re Sunterra Corp., 361 F.3d 257 (4th Cir. 2004) (debtor could not assume non-exclusive software license without the licensor's consent); *In re N.C.P. Mktg. Group,* 337 B.R. 230 (D. Nev. 2005) (trademark license not assignable as a matter of federal law); *Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.),* 165 F.3d 747 (9th Cir. 1999) (patent license could not be assumed and assigned); *In re West Electronics, Inc.,* 852 F.2d 79 (3d Cir. 1988) (government contract could not be assumed where federal law barred assignment absent consent)

Various Alternatives to a Section 363 "Going Concern" Sale in a Chapter 11 Case

Outside of a Bankruptcy Case	Inside a Bankruptcy Case
• "Regular" Sale • Article 9 (Secured Party Sale) • Assignment for Benefit of Creditors • Foreclosure / Deed of Trust • Receivership • Other "Statutory" or "Judicial" Proceedings	• Sale pursuant to a Chapter 11 Plan of Liquidation or Reorganization • Change of control under a Chapter 11 Plan of Reorganization • Chapter 7 "liquidation" / "piecemeal" sale or abandonment

Contrast in Situations – "Ordinary" Sale vs. "Distressed" Section 363 Sale

	Ordinary Sale	Section 363 Sale
Posture	• "We don't have to sell"	• "We need to sell"
Objective	• Maximize value to shareholders / equity owners	• Achieve liquidity while maximizing value to stakeholders "at the margin"
Venue	• Open Market	• Court–supervised, approval required
Timing	• Open-ended (timing not a constraint)	• Need to move expeditiously as value often erodes, and creditors exert pressure
Posture	• Controlled carefully	• Eventually / inherently "public"

Comparison of Different Possible Settings for the Acquisition of Assets: The Purchaser's Perspective

	Outside of Bankruptcy	Section 363 Sale in Bankruptcy	Change of Ownership Under Plan
Speed / Expense	1	2	3
Extent of Involvement or Standing of "Third Parties"	1	2	3
Setting / Potential for Competitive Bidders	1	3	2
Purchaser Obtaining a "Bargain"	1	3	2
Flexibility on Types / Timing of Consideration Paid	2	3	1
Ability to Undertake Due Diligence / Review	3	2	1
Ability to Obtain "Assignment of Contracts / Leases"	3	2	1
Certainty in Avoiding Claims Existing Prior to Purchase	3	2	1
Releases, Injunctions, or Other Provisions Favoring Purchaser	3	2	1
Treatment of Environmental, Product Liability, Tax and Other "Special Claims"	3	2	1

1 = "Most Desirable"; 3 = "Least Desirable"

Bankruptcy Sale Process: A Typical Timeline

- Bankruptcy Petition
- Motion to Sell Assets / Assume and Assign Contracts - Leases
- Motion to Approve Sale Procedures
- Hearing on Sale Procedures
- Notice issued
- Objections by parties to contracts / leases with respect to cure amounts and assignability
- Pre-Qualification of Bidders / Bids
- Submission of bids
- Final qualification of bidders / bids
- "Best" initial bid selected / announced
- Auction
- Determination of highest / best bid
- Objections by parties to contracts / leases with respect to future performance by buyer-assignee
- Sale Hearing
- Order Approving Sale
- Closing
- Post-Closing Adjustments

Establishing Sale Procedures

Courts have broad discretion in establishing (and modifying) sale procedures, including:

- Requirements on forms and terms of bids
  - All material terms to be the same
  - Differences permitted, with changes from initial (Stalking Horse) "bid" (or a form asset purchase agreement) often required to be shown in "blacklined" document
  - No uniformity requirements

- Scheduling of auction and sale hearing, and timing of all activities prior thereto

Establishing Sale Procedures - cont'd

- Auction procedures
  - Conducted by judge, debtor representative, third party
  - Individual assets, segments, and/or whole business
  - Sealed bids or open outcry

- Possible break-up fee, expense reimbursement, and/or other protections for an initial bidder / "Stalking Horse"

- Qualifications, rights and obligations of bidders
  - Who determines whether a bidder is "qualified"
  - Deposit requirements
  - "Stand-By" obligation for second highest bidder

Arguments About Stalking Horse Protective Provisions

There are variety of arguments for and against providing for a "break-up fee" and/or other protections to an initial bidder, otherwise known as a "stalking horse", that submits a bid which will be exposed to the market and subjected to the possibility of being out-bid in its desired purchase

FOR

- If it is paid, that means more value has been created for the estate
- Typical in M&A transactions outside of bankruptcy
- Compensates the initial party for its expenses, personnel time, lost alternatives
- Gets the bidding started
- Establishes a "floor" for future bidding and the auction

AGAINST

- Can "chill" additional bidding
- Buyers are obtaining bargains in bankruptcy cases
- Bidders can adjust their risk / reward calculations to reflect the absence of a breakup fee
- Not needed to attract interested parties
- Does not necessarily reflect the "highest" bid of the offeror

Arguments that Compensate or Protect a Stalking Horse

- Possible payments to the Stalking Horse if it is out-bid or not the successful purchaser:
  - Break-up fee
    - Fixed amount payable if Stalking Horse purchase is not completed
  - Topping Fee
    - Percentage of amount by which the final price exceeded the Stalking Horse's initial bid (in lieu of break-up fee)
  - Expense Reimbursement
    - Actual fees and expenses incurred by the Stalking Horse, usually up to a maximum amount (sometimes in addition to a break-up fee)

Arguments that Compensate or Protect a Stalking Horse – cont'd

- Amount of break-up or other fees for the Stalking Horse
  - Such fees should be reasonably related to the risk, effort, and expenses incurred by the Stalking Horse
  - Generally, Bankruptcy Courts have approved such fees in the range of 1% to 4% of the purchase price
    - *See, e.g., In re Tama Beef Packing, Inc.,* 312 B.R. 192 (Bankr. N.D. Iowa 2004) (collecting cases), *reversed on other grounds,* 321 B.R. 496 (8th Cir. B.A.P. 2005)

- Priority / Carve-out for break-up or other fees for the Stalking Horse
  - Direct claim against proceeds of sale to another party
  - Administrative claim status
  - "Carve-out" from lien of secured creditor

Arguments that Compensate or Protect a Stalking Horse – cont'd

- Minimum overbid amount
  - The minimum amount by which any other bid must exceed the Stalking Horse's initial bid (typically covering the amount of any payments due to the Stalking Horse as a break-up fee and/or expense reimbursement, plus an additional sum)

- Break-up fee credit
  - Possible provision for Stalking Horse to be able to credit amount of break-up fee in any additional rounds of bidding

Various Possible Standards for Approval of Stalking Horse Protections

Courts have used three possible standards to review and consider proposed break-up fees and other compensation / protections for a Stalking Horse:

- "Business judgment" rule

  See, e.g., In re ASARCO LLC, 650 F.3d 593 (5th Cir. 2011); *In re Global Crossing Ltd.,* 295 B.R. 726 (Bankr. SDNY 2003)*; In re Integrated Resources, Inc.,* 147 B.R. 650 (S.D.N.Y. 1992)

- "Best interest of creditors" test

  See, e.g., In re Comm. Mortgage and Fin. Co., 414 B.R. 389 (Bankr. N.D. Ill. 2009); *In re S.N.A. Nut Co.,* 186 B.R. 98 (Bankr. N.D. Ill. 1995)

- "Administrative claim" requirement

  See, e.g., In re Reliant Energy Channelview LP, 594 F.3d 200 (3d Cir. 2010); *In re O'Brien Environmental Energy, Inc.,* 181 F.3d 527(3d. Cir. 1999)

Desired Characteristics of a Stalking Horse

The ideal Stalking Horse candidate would have the following attributes:

- Has executed and delivered a definitive asset purchase agreement ("APA")
  (or a detailed letter of intent with a required date to submit a conforming APA)
- Has completed its due diligence
  (or is nearly completed in its due diligence, with an agreed deadline for completion)
- Is satisfied with, or has waived, other "typical" contingencies (financing, environmental, etc.)
  (or it has agreed to specific dates by which such contingencies will be satisfied or waived)
- Is perceived to be interested in and capable of completing the transaction
- Understands (and will not unrealistically attempt to alter) its role as Stalking Horse

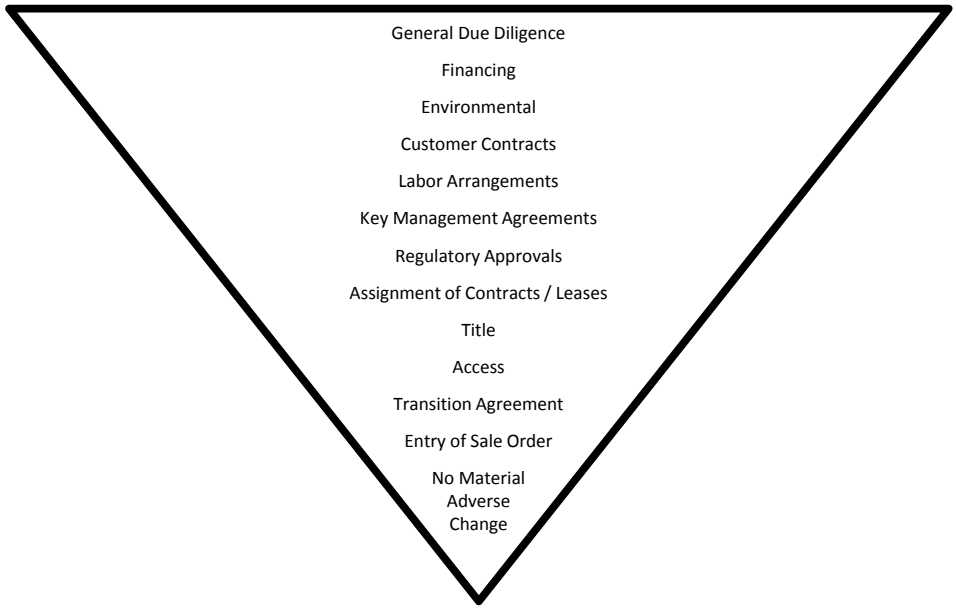
Possibilities on Timing of Selection of a Stalking Horse

- Prior to commencement of the Chapter 11 case

- After commencement of the Chapter 11 case
  - Before motion to sell is filed
  - Before hearing on sale procedures, breakup fee, etc.
  - Before auction

- The closer to the auction date, the greater the tendency for various parties to participate along with the Debtor in the selection of a Stalking Horse, such as:
  - Official Unsecured Creditors' Committee
  - DIP Lender (and/or primary secured creditor)

Purchaser's Typical Conditions Before Closing



CLOSING

Determining the Highest and/or Best Bid

- A proposed sale may be approved by the Bankruptcy Court if:
  - In "good faith"
  - There has been sufficient marketing to or solicitation of prospective bidders
  - Appropriate notice of the sale has been issued
  - The purchase price is "fair and reasonable"
- Generally, Bankruptcy Courts defer to the Debtor's "sound business judgment"

  See, e.g., In re Chrysler LLC, 576 F.3d 108 (2d Cir. 2009); *In re Lionel Corp.,* 722 F.2d 1063 (2d Cir. 1983) (sound business justification for a sale); *In re Encor Healthcare Assocs.,* 312 B.R. 52 (Bankr. E.D. Pa. 2004) (disapproving sale in absence of any business justification)
- Heightened scrutiny if insiders / management / "control persons" involved

  S*ee, e.g., Official Comm. of Unsecured Creditors of Enron Corp. v. Enron Corp.,* 335 B.R. (S.D.N.Y. 2005); *WK Lang Holdings,* 2013 Bankr. LEXIS 5224 (Bankr. D. Kan. 2013)*; In re Medical Software Solutions*, 286 B.R. 431 (Bankr. D. Utah 2002)

Determining the Highest and/or Best Bid – cont'd

- There is authority for the possibility of Bankruptcy Courts to consider "other factors" and to accept a "lower" bid as being a "better" bid overall, and even to choose a different bid than the one recommended by the Debtor

  See, e.g., In re Broadmoor Place Invs., 994 F.2d 744, 745-46 (10th Cir. 1993) (upholding bankruptcy court's denial of Chapter 11 debtor's request to sell to higher bidder and approval of lower bid that had "fewer contingencies and facilitated a more immediate closing;" a court "has the power to disapprove a proposed sale" if the court "has an awareness there is another proposal in hand which, from the estate's point of view, is better or more acceptable"); *In re Von Behren Electric, Inc.*, 2002 Bankr. LEXIS 1232, *3 (Bankr. C.D. Ill. 2002))("the highest bid is not always the best bid"); *In re After Six, Inc.,* 154 B.R. 876, 882 (Bankr. E.D. Pa. 1993)("lower bidder" may be approved as purchaser if the bidder had "other factors" such as "'societal needs'" in its favor).

Basics of Credit Bidding

- Secured creditors generally have the right to "credit bid"

  See 11 U.S.C. § 363(k); RadLax Gateway Hotel, LLC v. Amalgamated Bank, 132 S. Ct. 2065, 2070, n. 2 ("[t]he ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price")

- The right to credit bid is not absolute
  - Permitted under Section 363(k) only to the extent a lien "secures an **allowed** claim"
  - In accordance with Section 363(k), a court may deny the right to credit bid "**for cause**"
  - "[A] court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment." *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 315-16 (3d Cir. 2010)

Basics of Credit Bidding – cont'd

- Examples where credit bidding not permitted:
  - Validity or amount of lien is disputed, uncertain or limited

    See, e.g., In re Fisker Auto. Holdings, Inc., 510 B.R. 55 (Bankr. D. Del. 2014); *In re Old Prairie Block Owner, LLC*, 464 B.R. 337 (Bankr. N.D. Ill. 2011)
  - Credit bid would undermine a "fully competitive" auction

    See, e.g., In re Free Lance-Star Publishing Co., 512 B.R. 798 (Bankr. E.D. Va. 2014); *In re Fisker Auto. Holdings, Inc.*, *supra*; *In re Antaeus Technical Services, Inc.*, 345 B.R. 556 (Bankr. W.D. Va. 2005)
  - Improper creditor conduct

    See, e.g., In re Free Lance-Star Publishing Co., *supra, 512 B.R. at* 807-08 (curtailment of credit bid rights justified by "overly zealous loan- to-own strategy" and "misconduct" impacting on the sale proceeding)

AMERICAN BANKRUPTCY INSTITUTE

COMMISSION TO STUDY THE REFORM OF CHAPTER 11

2012~2014

FINAL REPORT AND RECOMMENDATIONS

SPONSORED BY THE ANTHONY H.N. SCHNELLING ENDOWMENT FUND

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ISBN: 978-1-937651-84-8

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2. Timing of Section 363x Sales

Recommended Principles:

- The trustee should not be permitted to conduct an auction of, or to receive final approval of a sale transaction involving, all or substantially all of the debtor's assets within 60 days after the petition date or date of the order for relief, whichever is later. The court should not shorten this 60-day moratorium unless (i) the trustee or a party in interest demonstrates by clear and convincing evidence that there is a high likelihood that the value of the debtor's assets will decrease significantly during such 60-day period, and (ii) the court finds that the proposed sale satisfies the standards set forth in the principles for section 363x sales. *See* Section VI.B, *Approval of Section 363x Sales*. For the purposes of this rule, the court may authorize a sale whether or not the secured creditor has requested or received adequate protection of its interests under section 361 of the Bankruptcy Code if the risk of decrease in the value of the debtor's assets is sufficient to warrant a sale before the expiration of the 60-day moratorium.

Timing of Section 363x Sales: Background

Section 363 of the Bankruptcy Code currently allows the trustee[314] to sell assets in the ordinary course of business as well as outside the ordinary course of business during the chapter 11 case.[315] A sale outside the ordinary course of business requires, among other things, notice and a hearing. It also typically requires an auction and public sale process.[316] Although courts frequently use the

314 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

315 11 U.S.C. § 363(b), (c).

316 *See* Rachael M. Jackson, *Survey: Responding to Threats of Bankruptcy Abuse in a Post-Enron World: Trusting the Bankruptcy Judge as the Guardian of Debtor Estates*, 2005 Colum. Bus. L. Rev. 451, 469–70 (2005) ("The process of conducting an auction generally establishes that a successful bidder has paid the fair market value for the asset. Therefore, considering the tremendous emphasis that bankruptcy courts place on maximizing the value of the estate, auction sales are advisable because judges do not tend to scrutinize closely such transactions before approving the final sale. In addition, the security of an auction sale is enhanced because appellate courts review bankruptcy court confirmations with considerable deference and, therefore, disgruntled bidders are rarely successful in challenging a court-approved sale."); Brett Rappaport & Joni Green, *Calvinball Cannot Be Played on This Court: The Sanctity of Auction Procedures in Bankruptcy*, 11 Norton J. Bankr. L. & Prac. 189, 193 (2002) ("Public auctions are preferred over private auctions to ensure a market price, so that optimal return can be realized for creditors."); Philip A. Schovanec, *Bankruptcy: The Sale of Property Under Section 363: The Validity of Sales Conducted Without Proper Notice*, 46 Okla. L. Rev. 489, 498 n. 63 (1993) ("While bankruptcy sales may be conducted privately, a public auction is usually held because

auction process as a means to ensure that the assets are sold for the best and highest price, the plain language of section 363 and of the Bankruptcy Rules do not expressly require an auction and public sale process, and courts will, in certain instances, approve private sale transactions.

Courts also have long debated whether section 363 permits the sale of all or substantially all of a debtor's assets prior to the filing and confirmation of a chapter 11 plan.[317] The primary concerns of courts and commentators with this practice are premised on the absence of stakeholder protections that are otherwise incorporated into the section 1129 plan process: section 1125 requires meaningful disclosures; section 1126 requires a vote by holders of impaired claims and interests; section 1129 requires, among other things, that the plan (i) satisfy administrative and certain other claims against the estate; (ii) be in the best interests of creditors; and (iii) be accepted by all impaired classes of creditors, or have the support of at least one class of impaired creditors and be fair and equitable.[318] In addition, sales of all or substantially all of a debtor's assets on an expedited basis, particularly early in the chapter 11 case, can raise concerns about (a) the proper valuation and marketing of assets, (b) whether other restructuring alternatives were fully explored, and (c) whether the court, the U.S. Trustee, and stakeholders have sufficient information and time to review and comment on the proposed transaction.[319]

Courts have been increasingly willing to approve expedited sales of all or substantially all of a debtor's assets, provided that a debtor can demonstrate exigency and certain other showings. This section addresses the timing of such sales; the requirements for the approval of such sales are discussed below.[320]

Prior to the early 2000s, a traditional chapter 11 sale process under section 363 could take at least three months, if not more.[321] This course typically involved a thorough postpetition marketing and

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competitive bidding ensures that fair and valuable consideration is received, thus helping to avoid any suspicion of collusion or impropriety.").

317 The Second Circuit in *Lionel* examined this debate, as well as whether a sale of all or substantially all of a debtor's assets should be permitted absent an emergency situation. *In re Lionel Corp.*,722 F.2d 1063, 1066 (2d Cir. 1983) (explaining, among other things, the history of section 363 sales, which the court traced to the Bankruptcy Act of 1867, and noting that under the 1867 Bankruptcy Act, "when it appears . . . that the estate of the debtor, or any part thereof, is of a perishable nature or liable to deteriorate in value, the court may order the same to be sold, in such manner as may be most expedient") (internal quotation marks omitted). The Second Circuit determined that such sales should be permitted but not without standards:

> Just as we reject the requirement that only an emergency permits the use of § 363(b), we also reject the view that § 363(b) grants the bankruptcy judge *carte blanche* . . . such construction of § 363(b) swallows up Chapter 11's safeguards. . . . [T]here must be some articulated business justification, other than appeasement of major creditors for using, selling or leasing property out of the ordinary course of business before the bankruptcy judge may order such disposition under 363(b).

Id. at 1069–70.

318 11 U.S.C. § 1129(a), (b).

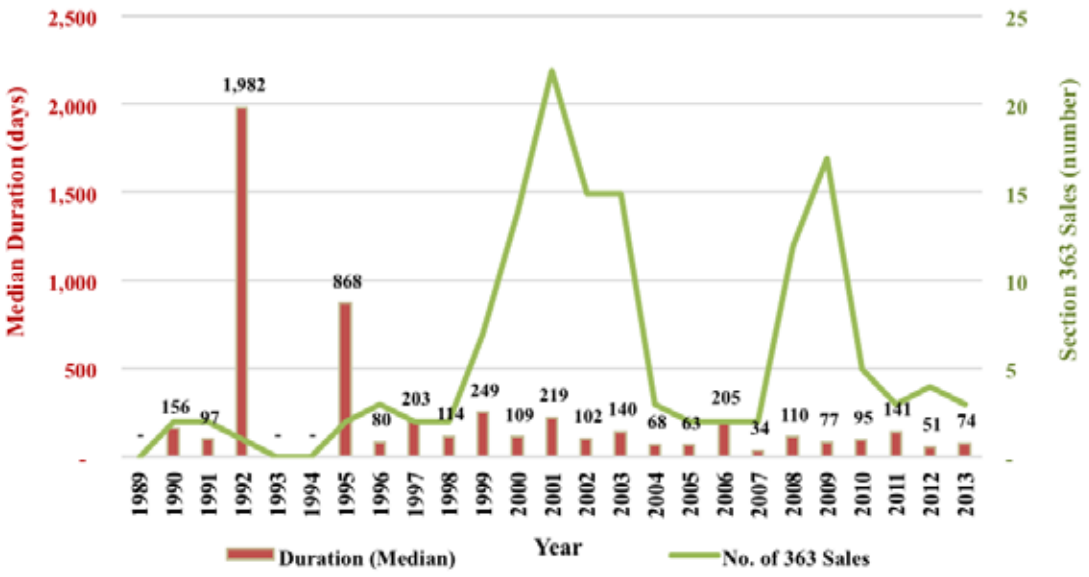
319 *See, e.g., In re* Fisker Auto. Holdings, Inc., 510 B.R. 55, 60–61 (Bankr. D. Del. 2014) ("It is the Court's view that Hybrid's rush to purchase and to persist in such effort is inconsistent with the notions of fairness in the bankruptcy process. The Fisker failure has damaged too many people, companies and taxpayers to permit Hybrid to short-circuit the bankruptcy process."); *In re* On-Site Sourcing, Inc., 412 B.R. 817, 824 (Bankr. E.D. Va. 2009) (listing the following nine areas of concern when analyzing a section 363 motion seeking expedited relief: (1) Is there evidence of a need for speed? (2) What is the business justification? (3) Is the case sufficiently mature to assure due process? (4) Is the proposed APA sufficiently straightforward to facilitate competitive bids or is the purchaser the only potential interested party? (5) Have the assets been aggressively marketed in an active market? (6) Are the fiduciaries that control the debtor truly disinterested? (7) Does the proposed sale include all of a debtor's assets and does it include the 'crown jewel'? (8) What extraordinary protections does the purchaser want? (9) How burdensome would it be to propose the sale as part of confirmation of a chapter 11 plan?) (citation omitted).

320 *See* Section VI.B, *Approval of Section 363x Sales*.

321 Cases typically provided set deadlines for a meaningful auction process and then sufficient time for objections to, and a hearing on, the sale transaction itself. In addition, Bankruptcy Rule 2002(a)(2) requires 21 days' notice by mail of "a proposed use, sale or lease of property of the estate other than in the ordinary course of business, unless the court for cause shown shortens the time or directs another method of giving notice." Fed. R. Bankr. P. 2002(a)(2).

auction process; sufficient opportunity for notice, objections, and hearings on both the auction process and sale transaction; and the closing of the sale.[322] This practice allowed the court, the debtor in possession, the U.S. Trustee, and parties in interest a full opportunity to consider the value of the assets and alternatives to a sale, instilled a certain level of confidence in the bankruptcy sale process, and resulted in the conclusion that the approved sale was in the best interests of the estate.

In recent years, the sale process has become much more abbreviated. Although the *General Motors* and *Chrysler*[323] chapter 11 cases — in each case a section 363 sale was completed in approximately 41 days — were more fast-paced than many cases, the average time between the petition date and the sale date has steadily decreased, as illustrated by the following chart.[324]



Note: In this bar chart above, the y-axis shows the number of days between the petition date and the date of the sale order for a sale of all or substantially all of the debtor's assets. The median number of days between the petition date and the sale order approving a section 363 sale has declined from a high of 1982 days in 1992 to 51 days in 2012. Notably, in some years, the data only show one (*e.g.*, 1992) or just a few orders approving section 363 sales for substantially all of the debtor's assets. (These data may not have captured sales, for example, consummated through a plan of reorganization, which was coded separately in the dataset.) The table below identifies the number of section 363 sale orders per year, as well as the mean and median duration between the petition date and the sale order.

322 For a general description of the steps required in a typical sale and auction process under section 363(b), see, *e.g.*, *In re* Adoption of Amended Guidelines for the Conduct of Asset Sales, General Order Amending M-331, M-383 (Bankr. S.D.N.Y. Nov. 18, 2009), *available at* http://www.nysb.uscourts.gov/sites/default/files/m383.pdf.

323 *See, e.g.*, *In re* Gen. Motors Corp., 407 B.R. 463, 491–92 (Bankr. S.D.N.Y. 2009), *aff'd sub nom. In re* Motors Liquidation Co., 430 B.R. 65 (S.D.N.Y. 2010); *In re* Chrysler LLC, 405 B.R. 84, 96 (Bankr. S.D.N.Y. 2009), *appeal dismissed*, 592 F.3d 370 (2d Cir. 2010). *See also In re* Lehman Bros. Holdings Inc., Case No. 08-13555 (Bankr. S.D.N.Y 2008) (sale approved within seven days of petition date).

324 Mr. Shrestha prepared this chart and table for the Commission based on data from the UCLA-LoPucki Bankruptcy Research Database. Accordingly, it was limited to large public companies. The duration above is the time between the petition date and the date of the sale order.

Duration Between Bankruptcy Filing and Section 363 Sale Order							
Year	**Mean No. of Days**	**Median No. of Days**	**No. of 363 Sales**	**Year**	**Mean No. of Days**	**Median No. of Days**	**No. of 363 Sales**
1989	-	-		**2002**	287	102	15
1990	156	156	2	**2003**	227	140	15
1991	97	97	2	**2004**	72	68	3
1992	1,982	1,982	1	**2005**	63	63	2
1993	-	-	-	**2006**	205	205	2
1994	-	-	-	**2007**	34	34	2
1995	868	868	2	**2008**	187	110	12
1996	127	80	3	**2009**	81	77	17
1997	203	203	2	**2010**	134	95	5
1998	114	114	2	**2011**	116	141	3
1999	470	249	7	**2012**	63	51	4
2000	137	109	14	**2013**	82	74	3
2001	275	219	22				

The speed with which section 363 sales are now approved and consummated causes some courts, stakeholders, and commentators to question whether value is being removed from the estate by permitting a value realization event such as a sale too early and too quickly in a chapter 11 case.[325] Many commentators recognize that there could be exceptions — true "melting ice cubes" that require immediate resolution to preserve any value for the estate — but those exceptions, they argue, should not define the rules.[326]

Timing of Section 363x Sales: Recommendations and Findings

The Commissioners examined the process relating to a sale of all or substantially all of a debtor's assets (referred to as a "section 363x sale" in these principles) at great length. In addition to reconsidering

325 *See, e.g.,* Jessica Uziel, *Section 363(b) Restructuring Meets the Sound Business Purpose Test with Bite: An Opportunity to Rebalance the Competing Interests of Bankruptcy Law*, 159 U. Pa. L. Rev. 1189, 1214 (2011) ("Section 363 sales' expedited process and lesser disclosure requirements make investigation of the purchaser's behavior vital in order to protect creditors, equity security holders, and debtors from exploitation. Increased potential for abuse threatens creditors' interests as well as the debtor's ability to maximize the value of the estate."); Elizabeth B. Rose, *Chocolate, Flowers, and § 363(b): The Opportunity for Sweetheart Deals Without Chapter 11 Protections*, 23 Emory Bankr. Dev. J. 249, 272 (2006) ("Without comprehensive information available to the court and the committee the sale is vulnerable to sweetheart deals or unfair dealing."). *See generally* Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 Mich. L. Rev. 1 (2007) (comparing recoveries from bankruptcy sales of large corporations to those of bankruptcy reorganizations from 2000 to 2004). *But see Written Statement of Honorable Melanie Cyganowski (Ret.), former U.S. Chief Bankruptcy Judge, E.D.N.Y.: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4 (Nov. 15, 2012) (asking the Commission not to impose a delayed time frame for section 363 sales), *available at* Commission website, *supra* note 55. "In the SMEs and middle-market cases, the Chapter 11 debtors have, in many instances, little flexibility, little bargaining power and even more minimal lines of credit. The Court needs in many instances to force a sale on very short notice . . . to maximize value for the estate." *Id. But see Written Statement of Robert D. Katz, Managing Director of Executive Sounding Board Associates Inc.: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–4 (Nov. 15, 2012) (asking the Commission not to impose a delayed time frame for section 363 sales), *available at* Commission website, *supra* note 55.

326 A "melting ice cube" case refers to a case involving assets subject to rapid decline because of the nature of such assets (often referred to as "perishable" assets) or unique, exigent circumstances that cannot otherwise be avoided. For a general discussion of these cases and some of the challenges they pose, see Jacoby & Janger, *Ice Cube Bonds*, *supra* note 283. The challenge for most courts is that bankruptcy by its nature often is an emergency procedure, so articulating a need to sell today as opposed to tomorrow is easy; assessing the validity of that assertion is not. *See, e.g., In re* Humboldt Creamery, LLC, 2009 WL 2820610, at *2 (Bankr. N.D. Cal. Aug. 14, 2009) ("[T]he problem with the 'melting ice cube' argument is that it is easy enough for the debtor to unplug the freezer prior to bankruptcy."); *In re* Gulf Coast Oil Corp., 404 B.R. 407, 423 (Bankr. S.D. Tex. 2009) ("The Court must be concerned about a slippery slope. Not every sale is an emergency, and, as discussed more fully below, the reliability of uncontested evidence (and particularly the reliability of testimony that is not adequately cross-examined) is suspect.").

the standard of review and substantive requirements for section 363x sales, the Commission also scrutinized the timing issues surrounding these sales.

The Commissioners discussed the potential benefits to a quick sale — *e.g.*, potentially less time in chapter 11; potentially less expensive reorganization strategy; typically preferred by postpetition lenders and prepetition secured creditors because of faster payoff; and typically preferred by stalking-horse bidders because a quick sale disfavors outside bidders.[327] The Commission also recognized that if a debtor's business assets are of a perishable nature or otherwise subject to a rapid decline in value, then a quick sale may be the best and perhaps only option for maximizing value for the estate and its stakeholders.

The Commission generally agreed, however, that section 363x sales are proceeding more quickly than is necessary in many chapter 11 cases. The Commissioners noted that quicker than necessary sales can potentially reduce the value available for stakeholders in the chapter 11 case. Such a sale may (i) not facilitate a robust auction, (ii) not allow the debtor sufficient time to explore a stand-alone reorganization or other restructuring alternatives, and (iii) take advantage of a decline in the applicable markets without giving parties in interest a reasonable time to assess the likelihood that such markets will rebound during the pendency of the debtor's chapter 11 case. The Commissioners also acknowledged the problems with insufficient notice and opportunity for parties in interest to assert meaningful objections or perform reliable asset valuations within the abbreviated time frames of a quick sale.

After extensive deliberation, the Commission found that in many cases, the potential harm to the estate from a sale that is pushed through the process more quickly than necessary under the circumstances significantly outweighs any potential benefits of such a sale. Accordingly, the Commission agreed that the Bankruptcy Code should include a 60-day moratorium on section 363x sales, absent the most extraordinary of circumstances, which must be established by clear and convincing evidence at the hearing on the motion requesting an expedited sale process.

327 *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 5 (Nov. 15, 2012) ("CFA submits that promoting an efficient sale of collateral to a purchaser who is able to continue to use those assets in a productive form is good for the economy in general and for the selling debtor's stakeholders in particular."), *available at* Commission website, *supra* note 55.

Use, Sale, or Lease of Property of the Estate

Section 363 of the Bankruptcy Code addresses the debtor in possession's use, sale, or lease of property during the chapter 11 case. Section 363(c) permits the debtor in possession to engage in certain of these transactions in the ordinary course of business without court approval.[491] If the debtor in possession wants to use, sell, or lease property outside the ordinary course of business, section 363(b) requires, among other things, notice and a hearing, and prior court approval.[492] Section 363(f), in turn, allows the debtor in possession to sell property free and clear of any interest in such property under certain circumstances.[493]

1. General Provisions for Non-Ordinary Course Transactions

Recommended Principles:

- Except in the context of a sale of all or substantially all of a debtor's assets (*i.e.*, a section 363x sale), the court should approve the use, sale, or lease of a debtor's assets outside the ordinary course of business only if the court finds by a preponderance of the evidence that the trustee exercised reasonable business judgment in connection with the proposed transaction. This approach often is

491 11 U.S.C. § 363(c)(1). Nevertheless, if a debtor is selling, leasing, or using assets that constitute "cash collateral," then the debtor must obtain the secured creditor's consent or court approval. *Id.* § 363(c)(2).
492 *Id.* § 363(b).
493 *Id.* § 363(f).

referred to as an "enhanced" or "intermediate" level of review that considers not only the process adopted by the board of directors (or similar governing body) to approve the transaction but also the reasonableness of the decision itself.

- Only the trustee should be able to propose the use, sale, or lease of a debtor's assets outside the ordinary course of business. Accordingly, no change to existing law is suggested on this point.
- A secured creditor's collateral should not be subject to a mandatory surcharge in favor of the estate but the court should retain the authority to make appropriate allocations of value to the estate as may be warranted under the circumstances pursuant to sections 506(c) and 552(b) of the Bankruptcy Code, as clarified by the related principles. *See* Section VI.C.3, *Section 506(c) and Charges Against Collateral*; Section VI.C.4, *Section 552(b) and Equities of the Case*.
- For the standard of review governing section 363x sales, see Section VI.B, *Approval of Section 363x Sales*.

General Provisions for Non-Ordinary Course Transactions: Background

In general, section 363(b) of the Bankruptcy Code provides that the debtor in possession,[494] "after notice and a hearing, may use, sell, or lease, outside the ordinary course of business, property of the estate."[495] The debtor in possession can use, sell, or lease a single asset, multiple assets, a division, or more. A sale of all or substantially all of the debtor's assets is addressed separately in these principles and is subject to a different standard of review and additional procedures.[496]

Under section 363(b), a debtor in possession generally must provide at least 21 days' notice of a motion to approve a proposed use, sale, or lease of property.[497] In general, any party in interest may object to the motion. At the hearing, the debtor in possession bears the burden of proof on the motion and generally must satisfy that burden by a preponderance of the evidence.[498] Courts generally evaluate section 363(b) motions under a business judgment standard. More precisely, courts often state they will approve the motion only if it represents an exercise of the debtor in possession's sound business judgment.[499] But, courts are not always clear or consistent in explaining the factors they consider under this business judgment standard.

494 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

495 *Id.* § 363(b).

496 *See* Section VI.B, *Approval of Section 363x Sales*.

497 Fed. R. Bankr. P. 2002.

498 *In re* Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983) ("[A] debtor applying under § 363(b) carries the burden of demonstrating that a use, sale or lease out of the ordinary course of business will aid the debtor's reorganization . . . ."); *In re* Telesphere Commc'ns, Inc., 179 B.R. 544, 552 (Bankr. N.D. Ill. 1994) ("[T]he proponent of the sale bears the ultimate burden of persuasion . . . ."); *In re* Ionosphere Clubs, Inc., 100 B.R. 670, 675 (Bankr. S.D.N.Y. 1989) ("[Debtor] clearly bears the burden of demonstrating that a sale of property out of the ordinary course of business under § 363(b) of the [Bankruptcy] Code will aid [debtor's] reorganization and is supported by a good business justification.").

499 *In re* On-Site Sourcing, Inc., 412 B.R. 817, 822 (Bankr. E.D. Va. 2009) ("'A § 363(b) sale is generally viewed as quicker. Only a motion and a hearing are required, and most courts apply a 'business judgment test' to determine whether to approve the sale.'") (quoting *In re* Gulf Coast Oil Corp., 404 B.R. 407, 415 (Bankr. S.D. Tex. 2009)).

General Provisions for Non-Ordinary Course Transactions: Recommendations and Findings

The Commissioners engaged in a detailed review of the various kinds of non-ordinary course transactions pursued by debtors in possession under section 363(b). Debtors in possession have used this provision to enter into long-term equipment lease arrangements or new real property leases that require a substantial outlay of resources; to hire a service provider who is not a professional under section 327; and even to compromise and settle a cause of action.[500] The most common use of section 363(b), however, is to sell the debtor's assets. In each of these instances, the estate is potentially losing something — *i.e.*, cash in the lease, hiring, and settlement scenarios, and assets in the sale context. The Commissioners thus emphasized the important roles of process and review in the approval of these transactions.

The Commissioners examined the various standards of review applicable to similar transactions under state law. In many cases, directors' decisions are protected under state law by the business judgment rule, which presumes that "'in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.'"[501] Courts have articulated slightly different standards for reviewing proposed transactions under either the business judgment rule or some enhanced form of scrutiny. These variations typically depend on the kind of transaction at issue and the parties involved in the transaction.

For example, some courts undertake a very deferential review of a company's business judgment, focusing largely on the process followed by the board of directors to evaluate and approve the proposed transaction; these courts then defer to the company's articulated business justifications.[502] This type of deferential judicial review often is explained by the notion that business decisions are better made in the boardroom than the courtroom.[503] Other courts scrutinize proposed transactions more closely, reviewing not only the process implemented by the company, but also the reasonableness of the board of directors' business judgment under the circumstances of the case.[504] This latter review often is referred to as an "enhanced" or "intermediate" business judgment standard. In certain

500 *In re* Schipper, 933 F.2d 513, 515 (7th Cir. 1991) (holding that debtor had "sound business reasons for making the sale"); *In re* Cont'l Air Lines, Inc., 780 F.2d 1223, 1226 (5th Cir. 1986) ("[F]or the debtor-in-possession or trustee to satisfy its fiduciary duty to the debtor, creditors and equity holders, there must be some articulated business justification for using, selling, or leasing the property outside the ordinary course of business."); *In re* Ionosphere Clubs, Inc., 100 B.R. 670, 680 (Bankr. S.D.N.Y. 1989) (finding that debtor "articulated sound business reasons for, and is appropriately exercising business judgment with respect to, its decision to sell [certain assets]"); *In re* Baldwin United Corp., 43 B.R. 888, 897 (Bankr. S.D. Ohio 1984) (finding that debtors "met their burden of demonstrating that the disposition will aid their reorganization, and is supported by sound business reasons").

501 *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

502 Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45 n.17 (Del. 1994); *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 74 (Del. 2006) (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

503 *See, e.g.,* Brehm v. Eisner, 746 A.2d 244, 266 (Del. 2000) (holding that the Court of Chancery correctly deferred to the business decision of the board because "[t]o rule otherwise would invite courts to become super-directors, measuring matters of degree in business decisionmaking and executive compensation. Such a rule would run counter to the foundation of our jurisprudence"). *See also* King v. Terwilliger, 2013 WL 708495, at *7 (S.D. Tex. Feb. 26, 2013) (finding that compensation issues are business questions "far better suited to the boardroom than the courtroom"); *In re* Curlew Valley Assocs., 14 B.R. 506, 511 (Bankr. D. Utah 1981) ("[D]isagreements over business policy are not amenable to judicial resolution. The courtroom is not a boardroom. The judge is not a business consultant. While a court may pass upon the legal effect of a business decision, (for example, whether it violates the antitrust laws), this involves a process and the application of criteria fundamentally different from those which produce the decision in the first instance. In short, the decision calls for business not legal judgment.").

504 *In re* Netsmart Techs., Inc. Stockholders Litig., 924 A.2d 171, 192 (Del. Ch. 2007). *See also* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1994) ("[C]ourt applying [the *Revlon* standard] should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination.").

limited circumstances, courts apply heightened scrutiny under which the court exercises its own business judgment and determines if the decision is in the best interests of the company.[505] Finally, if the proposed transaction involves potential self-dealing, conflicts of interests, or insiders, the court may require the company to establish the entire fairness of the transaction.[506]

After much deliberation, the Commission determined that an enhanced business judgment standard was appropriate for evaluating general asset sales and other transactions under section 363(b). The court should approve the sale if it represents a reasonable process and a reasonable exercise of the debtor in possession's business judgment. Moreover, the Commission agreed that only the debtor in possession should be permitted to request the use, sale, or lease of property of the estate, which currently is the structure of section 363.

The Commissioners discussed situations in which the debtor in possession sells assets, and unsecured creditors seek recoveries from that sale, despite the fact that such assets are fully encumbered by a secured creditor's lien. The Commissioners recognized that this situation has occurred more frequently in the most recent economic cycle. Debtors have filed chapter 11 cases with substantially all of their assets fully encumbered by prepetition liens, leaving little value for the debtors' other creditors, at least at the outset of the case. The Commissioners noted that, in some cases, secured lenders will agree to set aside certain amounts for administrative or unsecured claims. The Commissioners, however, did not believe that such surcharges should be mandatory in every section 363 transaction. Rather, parties should remain free to negotiate these types of set-asides based on the facts of any given case. In addition, the Commission reviewed the recommended principles relating to sections 506(c)[507] and 552(b),[508] and found that those sections, together with the new procedures proposed for section 363x sales,[509] sufficiently addressed the underlying concerns.

505 *See* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (indicating that judicial business judgment may be warranted in derivative litigation involving a special litigation committee in which demand was excused under applicable state law). *See also, e.g., In re* Telesphere Commc'ns, Inc., 179 B.R. 544, 552 (Bankr. N.D. Ill. 1994) ("Where an objection is made, the standard to be applied by the court in approving a disposition of assets is variously stated, but the general thrust is that the proposed sale should be in the best interests of the estate."); *In re* Am. Dev. Corp., 95 B.R. 735, 739 (Bankr. C.D. Cal. 1989) ("The proposed transaction is certainly not in the ordinary course of business and requires [the court's] approval. Debtor has the burden of proof to persuade [the court] that the proposed transaction is appropriate in light of its reorganization effort and should be approved."). Also, some courts have been less deferential with respect to break-up fees. *See, e.g., In re* Tiara Motorcoach Corp., 212 B.R. 133, 137 (Bankr. N.D. Ind. 1997) ("This court agrees with the position taken in *S.N.A.*, *America West*, and *Hupp*. A sale pursuant to § 363 of the Bankruptcy Code is outside the ordinary course of business, and the business judgment of the debtor should not be solely relied upon. Rather, a court should insure that revenues are maximized and that the best interests of the debtor's estate, creditors and equity holders are furthered. Therefore, 'the proposed break-up fee must be carefully scrutinized to insure that the Debtor's estate is not unduly burdened and that the relative rights of the parties in interest are protected.'") (citations omitted); *In re* Am. W. Airlines, Inc., 166 B.R. 908, 912 (Bankr. D. Ariz. 1994) ("[T]he Court must take into consideration what is in the best interests of the estate. As stated, the standard is not whether a break-up fee is within the business judgment of the debtor, but whether the transaction will 'further the diverse interests of the debtor, creditors and equity holders, alike.'") (citing *In re* Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983)). *But see* Official Comm. of Subordinated Bondholders v. Integrated Res. (*In re* Integrated Res., Inc.), 147 B.R. 650 (S.D.N.Y. 1992), *appeal dismissed by* 3 F.3d 49 (2d Cir. 1993) (finding that the business judgment rule applied in nonbankruptcy contexts and thus relied upon that standard in the bankruptcy context as well to determine whether the proposed breakup fee at issue was appropriate).

506 Telxon Corp. v. Meyerson, 802 A.2d 257, 264 (Del. 2002). *See also* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 42 n.9 (Del. 1994) ("Where actual self-interest is present and affects a majority of the directors approving a transaction, a court will apply even more exacting scrutiny to determine whether the transaction is entirely fair to the stockholders").

507 *See* Section VI.C.3, *Section 506(c) and Charges Against Collateral*.

508 *See* Section VI.C.4, *Section 552(b) and Equities in the Case*.

509 *See* Section VI.B, *Approval of Section 363x Sales*.

2. Finality of Orders

Recommended Principles:

- The court should not be permitted to reconsider a non-ordinary course transaction after the entry of an order approving the transaction or to reopen an auction unless the court finds extraordinary circumstances or material procedural impediments (such as the lack of adequate notice or an improperly conducted sale process) to the auction process that may have had a material effect on the sale results. For purposes of this principle, the potential that a new or continued auction would generate a higher value for the transaction alone does not constitute extraordinary circumstances.

Finality of Orders: Background

In the section 363 sale context, a debtor in possession[510] seeks to obtain the highest and best price for the assets. As explained above, a debtor in possession typically conducts an auction process to facilitate this result.[511] The auction procedures are reviewed and approved by the court and may include a marketing and diligence period and rules governing the auction itself.[512] The auction procedures also may contemplate certain bid protections for any stalking horse bidder.[513] After the auction, the debtor in possession presents the winning bid at the auction to the court for approval under the motion to approve the sale. After the court enters the sale order, parties generally have 14 days to appeal the order or it becomes final.[514] Generally, courts are not permitted to reopen an auction or sale.[515]

510 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

511 *See* Section IV.C.2, *Timing of Section 363x Sales*.

512 One court concluded that "it was necessary to have in place bidding procedures that would provide a reasonable opportunity for the APA to be tested against the market." *In re* Tex. Rangers Baseball Partners, 431 B.R. 706, 711 (Bankr. N.D. Tex. 2010). *See also In re* Innkeepers USA Trust, 448 B.R. 131, 148 (Bankr. S.D.N.Y. 2011) (explaining that bid procedures provide "the market and the Debtors the certainty and the 'rules' that they need to complete the auction process and move on to plan confirmation").

513 A leading bankruptcy treatise explains the rationale for deciding such bid protections in advance of the auction:

> Frequently, the issue of whether the court should approve buyer protections arises upon a motion to approve bidding procedures. The court is asked to approve, before the fact, procedures the propriety of which may be better determined after the "auction" of the property. For example, the reasonableness of a breakup or topping fee may be more difficult to evaluate in a vacuum before the sale. Whether a particular procedure chilled bidding may not be determinable until after the trustee offers the successful bid to the court for approval. However, the fees are to compensate the bidders for facilitating the auction, for example, by guaranteeing a floor on the bidding. If the court were not to approve the fee until after the auction, the leading bidder would not have the assurance necessary to commit to support the auction. Therefore, authorizing the fee only after the auction would defeat its purpose, and the court should address the issues upon a motion to approve the bid procedures."

3 *Collier on Bankruptcy* ¶ 363.02[7].

514 Bankruptcy Rule 6004(h) provides that "[a]n order authorizing the use, sale, or lease of property other than cash collateral is stayed until the expiration of 14 days after entry of the order, unless the court orders otherwise." Fed. R. Bankr. P. 6004(h).

515 *See* Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 333 B.R. 30 (S.D.N.Y. 2005), *aff'd in part and rev'd in part sub nom.* Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231 (2d Cir. 2010). *See also In re* Gil-Bern Indus., Inc., 526 F.2d 627, 628, 629 (1st Cir. 1975) ("[I]t is an abuse of discretion for a bankruptcy court to refuse to confirm an adequate bid received in a fairly conducted sale merely because a slightly higher offer has been received after the bidding has closed."); *In re* Bigler, LP, 443 B.R. 101, 112 (Bankr. S.D. Tex. 2010) ("To reopen the bidding process to allow [a losing bidder] to make its late bid would be an abuse of this Court's discretion. Accordingly, this Court will not reopen bidding.").

Several issues can arise during the course of the sale process, including modifications to the auction procedures without notice to or approval by the court, bidders wanting to submit noncompliant bids, and even late bidders who cause the debtor in possession, the unsecured creditors' committee, or other party in interest to question whether the bid selected at the auction really is the best and highest offer for the debtor's assets. In this context, courts have granted motions to reopen an auction if it would likely result in a better offer.[516] Accordingly, courts face challenging issues and competing interests when confronted with requests to reopen the auction process or to reconsider the order approving the sale under section 363 of the Bankruptcy Code.

Finality of Orders: Recommendations and Findings

The closing of an auction and the entry of a sale order are key steps in the sale of the debtor's assets. They allow the debtor in possession to close the sale and move forward in the case and the successful bidder to take possession of the assets. The Commissioners discussed the importance of the value generated by section 363 sales to the estate, and the common desire to want to ensure that the sale process is extracting as much value as possible from the assets. The Commission reviewed examples in which this desire caused the debtor in possession, the unsecured creditors' committee, or a party in interest to second-guess the auction results or the sale order and to seek related relief from the court.

For example, in the *WestPoint Stevens*[517] chapter 11 case, the debtor in possession obtained approval of the court to conduct an auction for substantially all of the debtor's assets.[518] One of the debtor's secured creditors, Aretex LLC, along with its affiliates, emerged as the winning bidder at the auction.[519] The court approved the sale and entered a sale order permitting the consummation of the sale to Aretex for the highest and best bid.[520] But, before the sale closed, certain other lenders moved for a stay of the sale order pending appeal of certain provisions in the sale order related to lien releases, claim satisfaction, and distributions.[521] On appeal, however, the Second Circuit rejected the appeal as statutorily moot under section 363(m).[522]

The Commission also reviewed a contrary example found in the *Foamex* chapter 11 case. In that case, the debtors had selected an all-cash bid that was $5 million lower than the all-cash bid of the stalking horse because the stalking horse had conditioned its bid on the inclusion of a credit bid if the auction continued past the then-present round. The bankruptcy reopened the auction and directed the debtors in possession to accept the stalking horse bid (which included the credit bid), even though the debtors in possession had complied with the court-approved bid procedures in

516 *In re* Foamex Int'l, Inc., No. 09-10560 (KJC) (Bankr. D. Del. May 27, 2009). *See also* Lithograph Legends, LLC v. U.S. Trustee, 2009 WL 1209469, at *3 (D. Minn. Apr. 30, 2009) ("A bankruptcy court may disapprove a proposed sale recommended by a debtor-in-possession 'if it has an awareness there is another proposal in hand which, from the estate's point of view, is better or more acceptable.'") (quoting G-K Dev. Co v. Broadmoor Place Invs., L.P. (*In re* Broadmoor Place Invs., L.P.), 994 F.2d 744, 746 (10th Cir. 1993)).

517 Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 333 B.R. 30 (S.D.N.Y. 2005), *aff'd in part and rev'd in part sub nom.* Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231 (2d Cir. 2010).

518 *Id.* at 35.

519 *Id.* at 36.

520 Contrarian Funds LLC v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231, 242 (2d Cir. 2010) (noting that bankruptcy court entered order confirming that "the winning bid presented 'the highest and best bid at the Auction'") (citations omitted).

521 Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 333 B.R. 30, 37 (S.D.N.Y. 2005), *aff'd in part and rev'd in part sub nom.* Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231 (2d Cir. 2010).

522 Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231, 247 (2d Cir. 2010).

accepting the previous bid. The court thereafter overruled the objection by the previous winning bidder to the sale.

The Commissioners acknowledged that, in some cases, reopening the auction or reconsidering the sale order may generate additional value for the estate. They also raised concerns, however, that endorsing this type of relief may prevent robust auctions in the first instance because prospective bidders need to understand the rules of the auction and to know that, if they participate according to the rules and win, they will be able to close the sale. This type of certainty and respect for the auction rules and sale order can enhance the auction itself and prevent gamesmanship by prospective bidders.

The Commissioners also noted that courts currently have the ability to reconsider their orders under Rule 60(b) of the Federal Rules of Civil Procedure, which provides that the court may relieve a party from a final order if presented with "newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial" and due to "fraud . . . misrepresentation, or other misconduct of an adverse party." The Commissioners reviewed cases in which courts have reconsidered (or refused to reconsider) sale orders.[523] They acknowledged that a motion to reconsider a section 363 sale order can be clouded by the prospect of more value for the estate. Nevertheless, the Commissioners believed that more value alone as ground for reopening an auction or setting aside a sale order was too low of a barrier, did not comply with Rule 60(b), and would introduce too much uncertainty into the sale process.

Consequently, the Commission voted to recommend codifying the standards governing requests to reopen an auction or to reconsider and set aside a sale order. Specifically, it determined that such relief should be warranted only in instances when the evidence presented at the hearing demonstrates procedural impediments in the auction or sale process or extraordinary circumstances.

3. Transactions Free and Clear of Interests

Recommended Principles:

- In general, the trustee should be able to sell a debtor's assets free and clear of all interests in a debtor's assets, including liens and encumbrances, to the extent permitted by the U.S. Constitution and the guidelines set forth in these principles. In addition, the trustee should be able to sell a debtor's assets free and clear of all claims related to a debtor's assets in the context of a sale of all or substantially all of a debtor's assets under section 363x (or a transaction involving less than substantially all of the debtor's assets if the court determines that the trustee has otherwise complied with the requirements of section 363x).
- A trustee should be able to sell assets free and clear of interests if applicable nonbankruptcy law would permit the owner of such assets to sell them free and clear of such interests. The foreclosure rights of a creditor or other third party

523 For examples of courts considering the finality issue and refusing to reopen auction, see *In re* Bigler, LP, 443 B.R. 101 (Bankr. S.D. Tex. 2010); *In re* Extended Stay Inc., No. 09-13764 (JMP) (Bankr. S.D.N.Y. June 17, 2010) [Docket No. 1102] (transcript of record); *In re* Finlay Enters., Inc., No. 09-14873 (Bankr. S.D.N.Y. Nov. 12, 2009) [Docket No. 378] (transcript of record). *But see* Corporated Assets, Inc. v. Paloian, 368 F.3d 761 (7th Cir. 2004) (auction reopened due to improper procedures).

should not be determinative in this context. Bankruptcy Code section 363(f)(1) and (5) should be amended accordingly.

- A trustee should be able to sell assets free and clear of interests without the consent of any lienholder and regardless of whether the assets generate value in excess of the aggregate value of the liens in the assets, provided that the liens attach to the proceeds of the sale or the lienholder receives another appropriate form of adequate protection of the lien. Section 363(f)(3) should be amended accordingly.
- In the context of a section 363x sale, a trustee should be able to sell assets free and clear of any successor liability claims (including tort claims) other than those specifically excluded from free and clear sales by these principles.
- The court should not approve a sale of a debtor's assets free and clear of the following kinds of interests: (i) easements, covenants, use restrictions, usufructs, or equitable servitudes that are deemed to "run with the land" under applicable nonbankruptcy law; (ii) environmental obligations that are deemed to "run with the land" under applicable nonbankruptcy law; (iii) successorship liability for purposes of federal labor law; and (iv) partial, competing, or disputed ownership interests, except to the extent specified in section 363(h) or (i).
- The sale of a debtor's assets free and clear of executory contracts and unexpired leases should be governed by section 365 or, for collective bargaining agreements, section 1113. Accordingly, the trustee should be permitted to sell the debtor's assets free and clear of executory contracts and unexpired leases only to the extent such contracts and leases are rejected in accordance with section 365 or section 1113, as applicable, and the trustee is permitted by section 365 to recover the property free and clear of the nondebtor counterparty's rights to use or possess such property.
- The court's approval of a sale free and clear of interests or claims under section 363(f) should continue to be considered part of the court's approval of the overall transaction under section 363(b) or (c). Accordingly, no change to existing law is suggested on this point.
- To the extent permitted by these principles for other claims, the trustee should be able to sell a debtor's assets free and clear of any monetary claims by the federal government or a state government against the debtor or the estate, provided that such monetary claims constitute "claims" under section 101(5) under current law. The trustee should not be able to sell a debtor's assets free and clear of any enforcement rights of such government to the extent that such rights are within such government's police or regulatory powers and could be enforced against the debtor or the estate under section 362(b)(4), or to the extent that the state or federal government incurs costs post-sale in the exercise of its police or regulatory powers.

Transactions Free and Clear of Interests: Background

In many chapter 11 cases, some or all of the debtor's property is encumbered or subject to the liens, interests, and claims of various stakeholders. The holders of these liens, interests, and claims may have rights under nonbankruptcy law or prepetition agreements that make the transfer of the debtor's assets difficult or less attractive to prospective lessees and purchasers. These liens, interests, and claims may include mortgages, security interests, easements, or successor liability claims.

Under section 363(f), a debtor in possession[524] may sell its assets under section 363(b) or (c) "free and clear of any interest in such property of an entity other than the estate" only if: (1) "applicable nonbankruptcy law permits sale of such property free and clear of such interest"; (2) "such entity consents"; (3) "such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property"; (4) "such interest is in *bona fide* dispute"; or (5) "such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."[525] Section 363(f) is limited to "any interest in such property." Notably, this language is different from that used in section 1141(c), which speaks to "property dealt with by the plan [being] free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor."[526]

The legislative history of section 363(f) provides little guidance on the scope of the term "interest," other than to acknowledge that a lien should be considered an interest in property.[527] Courts interpreting this section have taken two general approaches: the first construes section 363(f) narrowly and limits its application to liens, security interests, mortgages, and money judgments;[528] and the second takes a more expansive view of interests and captures claims against the debtor or estate property, including successor liability claims, discrimination claims, personal injury claims, and other "claims" within the meaning of section 101(5) of the Bankruptcy Code.[529] Some courts and commentators argue that the expansive approach is necessary to facilitate sales under section 363(f) and to achieve the underlying policy objectives of the Bankruptcy Code.[530]

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524 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

525 11 U.S.C. § 363(f).

526 *Id.* § 1141(c).

527 The legislative history provides, in relevant part:

> At a sale free and clear of other interests, any holder of any interest in the property being sold will be permitted to bid. If that holder is the high bidder, he will be permitted to offset the value of his interest against the purchase price of the property. Thus, in the most common situation, a holder of a lien on property being sold may bid at the sale, and if successful, may offset the amount owed to him that is secured by the lien on the property (but may not offset other amounts owed to him) against the purchase price, and be liable to the trustee for the balance of the sale price, if any.

H.R. Rep. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6302; S. Rep. 95-989 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5842.

528 *See, e.g., In re* White Motor Credit Corp., 75 B.R. 944, 948 (Bankr. N.D. 1987); *In re* New England Fish Co., 19 B.R. 323, 329 (Bankr. W.D. Wash. 1982).

529 *See, e.g., In re* Trans World Airlines, Inc., 322 F.3d 283, 289 (3d Cir. 2003) ("[T]he trend seems to be toward a more expansive reading of 'interests in property' which 'encompasses other obligations that may flow from ownership of the property'") (citing 3 Collier on Bankruptcy ¶ 363.06[1]); *In re* WBQ P'ship, 189 B.R. 97, 105, (Bankr. E.D. Va. 1995).

530 *See, e.g., In re* Trans World Airlines, Inc., 322 F.3d 282, 290 (3d Cir. 2003) (suggesting a trend toward an expansive view of section 363(f) to include claims); Folger Adam Sec., Inc. v. DeMatteis/MacGregor, JV, 209 F.3d 252 (3d Cir. 2000) (holding that pursuant to section 363(f), the debtors' contractual payment rights was free and clear of a contractor's previously unexercised setoff rights, but was not free and clear of the contractor's recoupment rights because by their very nature, recoupment rights simply cannot be considered an "interest" in property extinguished by a section 363(f) free-and-clear sale"); *In re* Tougher Indus., Inc., 2013 WL 1276501, at *6 (Bankr. N.D.N.Y. Mar. 27, 2013).

Courts also take different approaches to whether a debtor in possession has satisfied one of the grounds set forth in section 363(f) to support a sale free and clear of interests in the property.[531] For example, some courts require the sale price to exceed the face value of secured claims asserted against the property to satisfy section 363(f)(3).[532] Other courts require only that the sale price exceed the economic value of the creditors' allowed secured claims under section 506.[533] Courts also disagree as to what constitutes a *bona fide* dispute for purposes of section 363(f)(4).[534] They also have taken different approaches to whether the language in section 363(f)(5) providing that the "entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest" includes a cramdown of a chapter 11 plan under section 1129(b).[535]

Transactions Free and Clear of Interests: Recommendations and Findings

The Commissioners analyzed section 363(f) of the Bankruptcy Code and the concept of sales "free and clear" of liens, interests, and claims. They reviewed the original focus of that section on "interests" in estate assets, and they discussed the expansion of that concept to claims of various kinds. The Commissioners identified different kinds of claims that courts have included within section 363(f), including litigation claims, discrimination claims, and successor liability claims. The Commission agreed that this expansive approach to section 363(f) fostered more competition for the debtors' assets and likely enhanced the value of the assets sold through the section 363(f) sale process. The Commissioners questioned whether the historical nexus between "free and clear" sales under section 363(f) and *in rem* notions of property interests still served bankruptcy policy.

To analyze this question, the Commission considered the language and purpose of section 1141(c) of the Bankruptcy Code and the inclusion of claims in the discharge injunction in connection with a chapter 11 plan. The Commissioners suggested that this difference may relate to the more significant notice and due process provided to creditors in the plan process. Although creditors holding general unsecured claims (including the kinds of litigation and other claims mentioned above) do not have any particular interest in the debtor's property, they receive notice and an opportunity to object to the treatment of their claims under the plan. In the section 363 context, such creditors may or may not receive notice of the sale motion or an opportunity to object.

531 *See generally* George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 Am. Bankr. L.J. 235, 244 (2002).

532 *See, e.g.,* Clear Channel Outdoor, Inc. v. Knupfer (*In re* PW, LLC), 391 B.R. 25, 40–41 (B.A.P. 9th Cir. 2008). *See also* Criimi Mae Servs., Ltd. P'ship v. WDH Howell, LLC (*In re* WDH Howell, LLC), 298 B.R. 527, 534 (D.N.J. 2003). *See also* Robert M. Lawless, *BAP Prohibits Sale Free and Clear of an Underwater Junior Lien*, Bankr. L. Letter, Oct. 2008, at 7 ("Although the result in *Clear Channel* will be controversial, its specific holding on section 363(f)(3) should not be. Its reasoning is compelling on the statutory language, and it reaches a result well within the mainstream of other court decisions. To sell free and clear under section 363(f)(3), the sales price must exceed the total value of all liens regardless of whether those are totally secured or undersecured.") (citations omitted).

533 *See, e.g.,* WBQ P'ship v. Va. Dep't of Med. Assistance Servs. (*In re* WBQ P'ship), 189 B.R. 97, 105–06 (Bankr. E.D. Va. 1995); *In re* Beker Indus. Corp., 63 B.R. 474, 475–76 (Bankr. S.D.N.Y. 1986).

534 *See, e.g.,* Union Planters Bank v. Burns (*In re* Gaylord Grain LLC), 306 B.R. 624 (B.A.P. 8th Cir. 2004).

535 *See, e.g.,* Clear Channel Outdoor, Inc. v. Knupfer (*In re* PW, LLC), 391 B.R. 25, 46 (B.A.P. 9th Cir. 2008). *See also* Lawless, *BAP Prohibits Sale Free and Clear of an Underwater Junior Lien*, *supra* note 532, at 8 ("Instead of the Chapter 11 cramdown, a state foreclosure proceeding would seem to be a proceeding where the second lienholder could be compelled to accept a monetary satisfaction of its lien and thus satisfy the requirements of (f)(5). Indeed, the word 'foreclosure' means exactly that — the foreclosure of junior interests. A hypothetical state foreclosure proceeding seems so obvious that one wonders why the BAP [in *Clear Channel*] did not simply take judicial notice of it to hold that (f)(5) was satisfied. Perhaps the court's concern was the lack of a solid record on how the foreclosure sale process would play out and specifically what value the property would bring at a foreclosure sale, although the bidding at the bankruptcy court would again seem to be an obvious place to look for the value of the property. The concern about the lack of a record perhaps can be seen in the BAP's references to 363 sales being used to bypass the more procedurally robust confirmation requirements of section 1129 that could protect third-party rights.") (citations omitted).

The Commissioners evaluated whether this difference in process should preclude an expansive reading of section 363(f) that would include liens, interests, and claims. With respect to single-asset sales or smaller transactions, the Commission agreed that the notice currently required by the Bankruptcy Rules was likely sufficient, as assets remained in the estate to potentially fund claims through a chapter 11 plan. In a sale of all or substantially all of a debtor's assets, however, the calculus may be different. On that point, the Commissioners noted that these principles recommend notice and due process procedures similar to what creditors are entitled to in the plan context. Accordingly, under the principles applicable to section 363x sales, creditors holding the kinds of claims subject to section 363(f) under the expansive view would receive notice and an opportunity to object to the proposed sale.

The Commissioners were also persuaded that permitting the debtor in possession to transfer clean title to a purchaser under section 363(f) held potentially significant value for the estate. To that end, the Commissioners analyzed the conflicting interpretations of certain subsections of section 363(f) and identified approaches that would foster a competitive sale process while still protecting creditors' rights against the estate. The Commission agreed that the scope of section 363(f)(1) and (5) should be clarified to focus on the property owner's rights under applicable nonbankruptcy law. The Commission also determined, however, that these ambiguities and perceived barriers to free and clear transfers in a chapter 11 case would likely be mitigated by its recommended change to section 363(f)(3). With the additional notice and process being recommended in the context of sales of all or substantially all of the debtor's assets, the Commission determined that adopting an expansive view of section 363(f) was warranted and adequately protected the interests of stakeholders.

The Commissioners further considered whether any particular liens, interests, or claims should be excluded from section 363(f) under this expansive approach. They methodically evaluated different kinds of claims and interests. They decided that the debtor in possession should be able to transfer property free and clear of all liens, interests, and claims, including without limitation: civil rights liabilities; successor liability in tort; and successor liability in contract. The Commissioners also concluded that the debtor in possession should *not* be able to transfer property free and clear of the following: easements, covenants, use restrictions, usufructs, or equitable servitudes that run with the land; environmental liabilities and related social policies that run with the land; successorship liability under federal labor laws; and partial, competing or disputed ownership interests, except to the extent specified in section 363(h) or (i). Moreover, the Commissioners recognized that a debtor in possession should not be able to sell or transfer assets under section 363(f) in a manner that violates or impedes the police or regulatory power of the federal government or a state government to the extent that such government could enforce those rights against the debtor in possession or estate property during the case, notwithstanding section 362(a) of the Bankruptcy Code. The Commission thus recommended that section 363(f) recognize the government's police and regulatory powers to the extent such powers would be enforceable under section 362(b)(4).

4. Credit Bidding

Recommended Principles:

- In a sale under section 363 of the Bankruptcy Code involving a secured creditor's collateral, the secured creditor should be permitted to credit bid up to the amount of its allowed claim relating to such collateral unless the court orders otherwise for cause. For purposes of this principle, the potential chilling effect of a credit bid alone should not constitute cause, but the court should attempt to mitigate any such chilling effect in approving the process. Section 363(k) should be clarified accordingly.

Credit Bidding: Background

A creditor with a perfected lien in the debtor's property has certain rights and remedies against the debtor and property within the creditor's collateral package. Among other things, the secured creditor can credit bid the amount of its allowed claim in any sale of its collateral. A secured creditor's right to credit bid exists under both state law and section 363(k) of the Bankruptcy Code. Section 363(k) provides: "At a sale under subsection (b) of this section 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, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property."[536]

A credit bid allows the secured creditor to purchase the property constituting its collateral if other bidders are not willing to pay sufficient value or the creditor prefers to possess the collateral in lieu of payment. The secured creditor also does not need to pay any cash for the property at the sale to the extent the allowed amount of its claim is sufficient to cover the price of its winning bid. Rather, the secured creditor can set off its secured claim against the debtor or the property against the purchase price it otherwise would be required to pay the estate.[537]

Although credit bidding is an integral part of the secured creditors' rights package, it is not without limit. Specifically, section 363(k) allows the court to limit a secured creditor's credit bid for cause.[538] Courts typically have found cause to limit a credit bid if the amount of the secured creditor's claim is disputed or unliquidated.[539] Courts also have found cause to limit a credit bid, however, based on the conduct of the secured creditor. For example, *In re Free Lance-Star Publishing Co.*, the court held that the secured creditor did not have the right to credit bid on assets that did not secure its allowed claim and found cause to limit the creditor's right to credit bid at the auction based on, among other things, the creditor's "overly zealous loan-to-own strategy," in which the creditor acquired the loan

536 11 U.S.C. § 363(k).

537 *Written Statement of Danielle Spinelli, Partner, WilmerHale, TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 3, 2012) (providing historical overview and describing the evolution of credit bidding in bankruptcy), *available at* Commission website, *supra* note 55.

538 11 U.S.C. § 363(k) ("At a sale under subsection (b) of this section 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, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.").

539 *See, e.g., In re* RML Dev., Inc., 2014 WL 3378578 (Bankr. W.D. Tenn. July 10, 2014) (valid claims objection that could not be resolved without delaying auction was cause to limit amount of credit bid).

for the sole purpose of obtaining the right to credit bid at an expedited sale of the debtor's assets and discouraged any competitive bidding.[540] Similarly, in *Fisker Automotive Holdings*, the court found cause to limit the secured creditor's ability to credit bid the entire amount of its secured claim because the amount was uncertain, and allowing the creditor to credit bid its entire claim would freeze out all competitive bidding by attractive and capable bidders.[541]

Credit Bidding: Recommendations and Findings

The Commission considered credit bidding under section 363(k) in light of recent case law developments and an arguably expanded application of the cause standard for limiting credit bids. The Commissioners discussed the fundamental role of credit bidding under state law and section 363(k).[542] They also acknowledged that all credit bidding chills an auction process to some extent. Accordingly, the Commissioners did not believe that the chilling effect of credit bids alone should suffice as cause under section 363(k).

The Commissioners noted that, in some cases, it may be difficult to discern any chilling effect caused by the credit bid itself from a chilling effect resulting from the conduct of the secured creditor seeking to exercise its right to credit bid. For example, the Commissioners discussed situations in which the secured creditor demands a relatively short period to market the property and conduct the sale, requires the marketing materials to highlight the secured creditor's right to credit bid, or takes other actions to discourage a competitive bidding process. The Commission agreed that such conduct could, in fact, depress the value of the property and preclude the estate from receiving any return from the sale.[543] The Commissioners, however, did not want to endorse a principle that would suggest that the chilling effect of a credit bid warrants restrictions on the right to credit bid.[544] The Commission ultimately agreed to maintain the current standard under section 363(k), with the recommendation that the chilling effect of a credit bid not be deemed sufficient cause to limit a credit bid, but that courts should attempt to mitigate any chilling effect through the auction and sale procedures approved in the case.

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540 *In re* Free Lance-Star Publ'g Co. of Fredericksburg, Va., 512 B.R. 798 (Bankr. E.D. Va. 20141), *appeal denied*, 512 B.R. 808 (E.D. Va. 2014).

541 *In re* Fisker Auto. Holdings, Inc., 510 B.R. 55 (Bankr. D. Del. 2014), *appeal denied*, 2014 WL 576370 (D. Del. Feb. 12, 2014).

542 *See, e.g.,* Brubaker, *The Post-RadLAX Ghosts of* Pacific Lumber *and* Philly News, *supra* note 43, at 3 ("For secured creditors, operating on the assumption that in a free-and-clear sale of its collateral the sale price itself establishes the value of the collateral, credit bidding serves two protective functions — both as an undervaluation protection and a proceeds protection. Not only can the undersecured creditor bid in its claim to acquire the assets when it believes the otherwise prevailing sale price is too low, the undersecured creditor can also bid in its claim to acquire the assets when it believes that the proposed plan would not return to the undersecured creditor the full value of the proceeds generated by sale (*i.e.*, the value) of its collateral."); Ralph Brubaker, *Credit Bidding and the Secured Creditor's Baseline Distributional Entitlement in Chapter 11*, Bankr. L. Letter, July 2012, at 8 ("[T]the legislative record indicates that the Code drafters also considered the credit bidding rights separately codified in § 363(k) to be an integral component of adequately protecting the secured creditor's lien rights."). "By holding that a dissenting secured creditor must be afforded credit-bidding rights under § 363(k) in any free-and-clear sale of its collateral under a plan of reorganization, RadLAX ensures that secured creditors have the same credit-bidding rights in plan sales that they have in § 363 sales." *Id.*

543 *See, e.g.,* Brubaker, *The Post-RadLAX Ghosts of* Pacific Lumber *and* Philly News, *supra* note 43, at 4 ("When the undersecured creditor's collateral is the entirety of the debtor's assets, therefore, credit-bidding rights in any going-concern sale of the debtor's business and assets give that senior secured creditor the leverage to always insist upon capturing all of the debtor's reorganization surplus, to the detriment of unsecured creditors and other junior classes.").

544 *Written Statement of Danielle Spinelli, Partner, WilmerHale, TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 3, 2012) ("To the extent that the argument here is that cash bidders will be chilled because they fear that a secured creditor may outbid them, it lacks force. That would be equally true of any deep-pocketed bidder, and no auction can afford to exclude the bidders with the greatest resources on the ground that they might outbid everyone else."), *available at* Commission website, *supra* note 55.

B. Approval of Section 363x Sales

Recommended Principles:

- The court should approve a sale of all or substantially all of a debtor's assets only if the court finds by a preponderance of the evidence that the proposed sale is in the best interests of the estate and satisfies the following requirements:
    - o The sale complies with the applicable provisions of the Bankruptcy Code. (Comparable plan provision found at 11 U.S.C. § 1129(a)(1).)
    - o The proponent of the sale complies with the applicable provisions of the Bankruptcy Code. (Comparable plan provision found at 11 U.S.C. § 1129(a)(2).)
    - o The sale has been proposed in good faith and not by any means forbidden by law. (Comparable plan provision found at 11 U.S.C. § 1129(a)(3).)
    - o Any payment made or to be made by the debtor or by a person acquiring property in the sale for services or for costs and expenses in or in connection with the case, or in connection with the sale and incident to the case, has been approved by, or is subject to the approval of, the court as reasonable. (Comparable plan provision found at 11 U.S.C. § 1129(a)(4).)
    - o Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the trustee proposes to use or reserve sufficient proceeds from the sale to satisfy in full allowed claims of a kind specified in section 507(a)(2) or (3) incurred through the date of the closing of the sale. (Comparable plan provision found at 11 U.S.C. § 1129(a)(9)(A).)
    - o All fees payable under section 1930 of title 28 of the U.S. Code, as determined by the court at the hearing on the sale, have been paid or the trustee provides for the payment of all such fees on the date of the closing of the sale. (Comparable plan provision found at 11 U.S.C. § 1129(a)(12).)
    - o The trustee has provided adequate notice and an opportunity to be heard to all creditors and equity security holders who may be affected by a release or discharge that provides claims protection for the purchaser in the order approving the sale.
- A section 363x sale is subject to the principles on orders resolving chapter 11 cases. *See* Section VI.G, *Orders Resolving Chapter 11 Case (Exit Orders).*
- These principles refer to "a sale of all or substantially all of a debtor's assets" as a "***section 363x sale***." For the timing of section 363x sales, see Section IV.C.2, *Timing of Section 363x Sales*.
- The other recommended principles relating to transactions outside the ordinary course also apply in the section 363x sale context. *See* Section V.B, *Use, Sale, or Lease of Property of the Estate*.

Approval of Section 363x Sales: Background

As explained above, a debtor in possession[742] may seek to sell all or substantially all of its assets under section 363(b) of the Bankruptcy Code.[743] This kind of sale (referred to in these principles as a "section 363x sale") is a value realization event in the chapter 11 case, as it involves monetizing nearly all of the assets available to satisfy claims against and interests in the estate. Because a section 363x sale terminates the estate's and, in turn, creditors' interests in the assets, the process to facilitate such a sale is critically important to the recoveries ultimately received by creditors. The timing of a section 363 sale can significantly impact value and raises notice and due process concerns; timing issues are addressed separately above.[744]

A section 363x sale transforms the estate from illiquid assets with fluctuating value to a fixed sum of money or securities.[745] Consequently, it potentially alters the value of the estate in a positive or negative direction, depending on factors such as the timing of the sale, the marketing of the assets, the competitive nature of the auction, and the sale and restructuring alternatives explored by the debtor in possession leading up to the section 363x sale. Anecdotal evidence suggests that section 363x sales can facilitate quicker sales that create value for the estate.[746] Such evidence also suggests, however, that a bidder may pursue certain strategies such as a "loan-to-own" strategy or streamlined sale process that may chill bidding and depress the value of the assets.[747]

742 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

743 *See* Section V.B, *Use, Sale, or Lease of Property of the Estate*. *See also* George W. Kuney, *Let's Make It Official: Adding an Explicit Preplan Sale Process as an Alternative Exit from Bankruptcy*, 40 Hous. L. Rev. 1265, 1267–68 (2004) (discussing increasing use of chapter 11 to sell assets).

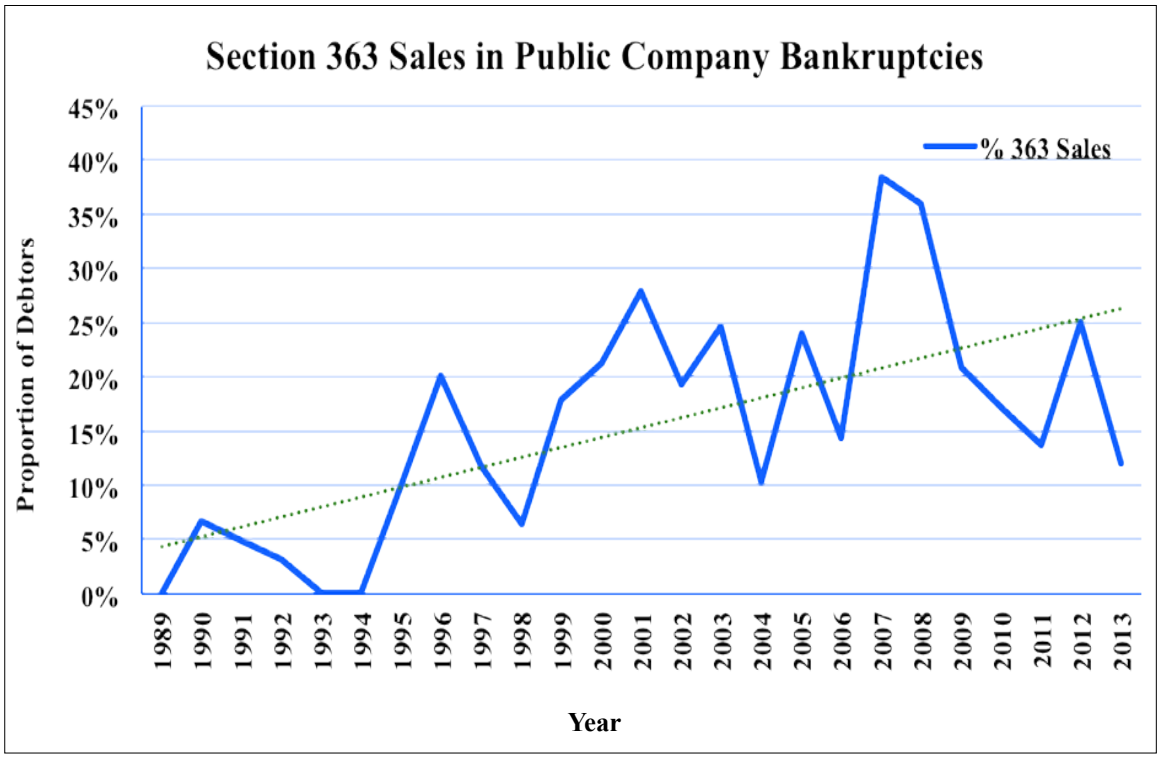
744 *See* Section IV.C.2, *Timing of Section 363x Sales*.

745 *See Written Statement of Maureen Leary: SABA/NAAG Annual Seminar Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 8, 2013) (describing the potential negative consequences to creditors and, in turn, problems with sales of substantially all of a debtor's assets under section 363), *available at* Commission website, *supra* note 55.

746 For a thorough discussion of the competing perspectives on section 363 sales of all or substantially all of a debtor's assets in chapter 11, see *In re* Gulf Coast Oil Corp., 404 B.R. 407, 419 (Bankr. S.D. Tex. 2009) (reviewing the relevant case law, treatises, and academic literature). *See also* Stuart Gilson, *Coming Through in a Crisis: How Chapter 11 and the Debt Restructuring Industry Are Helping to Revive the U.S. Economy*, 24 J. Applied Corp. Fin. 23 (2012) ("Increasingly, distressed companies have also taken advantage of Chapter 11 as a more efficient way to sell assets."); Jared A. Wilkerson, *Defending the Current State of Section 363 Sales*, 86 Am. Bankr. L. J. 591 (2012) (refuting criticism of section 363 sales in chapter 11 and highlighting potential efficiencies of such sales). *See generally* Section IV.C.2, *Timing of Section 363x Sales*.

747 *See, e.g.,* Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors Objectives*, 16 Am. Bankr. L. Rev. 69 (2008) (reporting results of empirical survey on, among other issues, investors' loan-to-own strategies in bankruptcy). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies). *See also* Jonathan M. Landers, *Reflections on Loan-to-Own Trends,* Am. Bankr. Inst. J., Oct. 2007, at 44–46 (explaining loan-to-own transactions); Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. Legal Analysis 511, 513 (2009) (discussing, among other things, impact of creditor control on the decision to sell assets in bankruptcy); Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, *supra* note 115 ("Controlling secured lenders often use chapter 11 as a vehicle to foreclose on their assets. Traditional corporate reorganizations are becoming a *rara avis*; the strongly emerging norm is for debtors to be liquidated in speedy '§ 363 sales,' the reference being to the Bankruptcy Code section authorizing sales. This practice has become so prevalent that a coauthor and I have spoken of the 'new 'Chapter 3' reorganization.'"); Brubaker, *Credit Bidding and the Secured Creditor's Baseline Distributional Entitlement in Chapter 11*, *supra* note 542, at 10 ("'The 'loan to own' phenomenon has caused some to question the advisability of credit bidding. The basic concern seems to be that a 'loan to own' lender's primary incentive is, unlike a traditional lender, acquiring the debtor's assets as cheaply as possible, rather than maximizing the recovery on its secured loan. A traditional lender has every incentive to maximize the sale price of its collateral through vigorous competitive bidding, sincerely hoping that bid prices will exceed the amount it could credit bid with its existing secured loan, as this would mean a full recovery on that loan. A 'loan to own' lender, though, has every incentive to inhibit competitive bidding in order to ensure that bid prices will not exceed the amount it can credit bid with its existing secured loan, as this would mean that the 'loan to own' lender can acquire the debtor's assets solely through a credit bid of its existing secured loan and with no additional investment."); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 Tex. L. Rev. 795, 846 (2004) ("In both judicial and private auction sales, there are often strict requirements for a bidder other than the secured party. In particular, the bidder may have to bring sufficient cash to cover its bid or to provide cash payment very shortly after the bidding. For this and other reasons, it is often the case that few other bidders appear at foreclosure and repossession sales. This fact combines with the bidding-in rules to make it possible for secured parties to buy at their own sales at a price well below market value while avoiding sanctions for violating Article 9's notice and sale procedures.").

The limited empirical data on section 363x sales are mixed in results and difficult to interpret because the coding of the debtor's exit strategy as a liquidation, going concern sale (*i.e.*, section 363x sale), or confirmed plan often is very subjective, and the data are "noisy" in this respect.[748] It also is challenging for empiricists to collect and code creditors' recoveries, particularly in cases that do not have publicly traded securities. In fact, much of the data on chapter 11 cases speak only to the large chapter 11 cases.[749] For example, the chart shown below demonstrates a positive linear trend (illustrated by the dotted line) in the number of section 363 sales in chapter 11 cases, but it also is limited to large public companies.[750]



748 *See, e.g.,* Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 Mich. L. Rev. 1 (2007) (study analyzing large public company bankruptcy cases and finding that recoveries in reorganization cases are more than double recoveries from going concern sales); James J. White, *Bankruptcy Noir*, 106 Mich. L. Rev. 691 (2007) (critiquing the LoPucki & Doherty study and finding no statistical difference between sale prices and reorganization prices); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Verite*, 106 Mich. L. Rev. 721 (2008) (responding to the White study). *See also, e.g.,* Jenkins & Smith, *Creditor Conflict and the Efficiency of Corporate Reorganization*, *supra* note 42 (developing model to assess efficient and inefficient liquidations in bankruptcy and concluding that about 8 percent of firms are inefficiently liquidated — *i.e.,* they were liquidated when it would have been more efficient to reorganize); Edith S. Hotchkiss & Robert M. Mooradian, *Acquisitions as a Means of Restructuring Firms in Chapter 11*, 7 J. Fin. Intermediation, 240–262 (1998) (providing "empirical evidence that takeovers can facilitate the efficient redeployment of assets of bankruptcy firms"). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

749 For example, many chapter 11 empirical studies use the UCLA-LoPucki Bankruptcy Research Database or a similarly restricted database. The UCLA-LoPucki Bankruptcy Research Database includes all bankruptcy cases filed between 1980 and 2012 by or against a business debtor or group of affiliated debtors that had assets worth $100 million or more, measured in 1980 dollars.

750 Mr. Shrestha prepared this chart for the Commission based on data from the UCLA-LoPucki Bankruptcy Research Database. Accordingly, it was limited to large public companies. The chart analyzes all Section 363 Sales in the UCLA-LoPucki Bankruptcy Research Database (including confirmed, pending, converted, and dismissed cases). Because certain of the cases included in this analysis did not include data for the date of the sale order, some of these data are not included in the chart describing the median duration between the petition date and sale order date in bankruptcy cases. *See* Section IV.C.2, *Timing of Section 363x Sales*. *But see* Jay Lawrence Westbrook, *The Role of Secured Credit in Chapter 11 Cases: An Empirical Review*, 2015 Ill. L. Rev.__, at *6 (forthcoming 2015) (finding, in an empirical study of 424 cases covering a broad cross section of chapter 11 debtors in nine districts, that only about 25 percent of cases and any sales out of the ordinary course, suggesting that section 363 sales are less common that previously thought) (draft on file with Commission). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

Moreover, chapter 11 cases — unlike consumer bankruptcy cases — often present unique facts and involve dynamics not reflected on the court docket. Accordingly, although the data are extremely informative, they should be read with caution, and any claims of causality should be critically analyzed given the foregoing factors and related research limitations (*e.g.*, endogeneity bias, sample selection bias) that may impact research issues in this area.[751]

As suggested above, a section 363x basically determines the maximum recovery any particular creditor will receive in the case. In a case where the debtor's assets are sold for less than the value of the secured claims asserted against the estate, junior creditors — including those holding prepetition unsecured claims and, potentially, postpetition administrative claims relating to the administration of the case following the sale — may not receive any distributions. Although a debtor that liquidates in chapter 11 does not receive a discharge, for all practical purposes, a section 363x essentially discharges the primary source of recovery in business cases (*i.e.*, the debtor's assets).

Accordingly, many courts raise concerns regarding section 363x sales in chapter 11 cases. Among other things, courts and commentators note that these sales skirt the notice and due process protections of the plan process, are often pursued before parties in interest have adequate information to assess the sale and a debtor's restructuring alternatives, and may determine ultimate distributions to creditors without creditors having a vote or the protections of the "fair and equitable" standard of section 1129(b).[752] Nevertheless, as many of these courts recognize, a debtor in possession may have no viable restructuring alternatives, and the section 363x sale may in fact represent its best opportunity for providing recoveries to at least some stakeholders. In these circumstances, many courts strive to make a going concern sale work under the current Bankruptcy Code, but it was not an intended, and thus is not a perfect, fit.[753]

Approval of Section 363x Sales: Recommendations and Findings

Some commentators argue that a sale of all or substantially all of a debtor's assets is akin to a traditional reorganization in that it is a change-of-control event that facilitates distributions of value to creditors and frequently continues the business of the debtor in some form. The Commissioners debated this general proposition at length. Although the Commissioners held differing views on what qualifies as "reorganization" under chapter 11, many of the Commissioners believed that sales of all or substantially all of a debtor's assets have become part of the restructuring landscape. As such, the Commission agreed that the most constructive approach to the issue was to analyze critically the sale process, recognizing the potential utility of the process in achieving certain policy goals, including maximizing value for creditors and preserving jobs for at least part of the debtor's workforce.

751 *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

752 *See, e.g., In re* Gen. Motors Corp., 407 B.R. 463, 491 (Bankr. S.D.N.Y. 2009), *aff'd*, *In re* Motors Liquidation Co., 430 B.R. 65 (S.D.N.Y. 2010) ("[A] debtor cannot enter into a transaction that 'would amount to a *sub rosa* plan of reorganization' or an attempt to circumvent the chapter 11 requirements for confirmation of a plan of reorganization."). *But see* Comm. of Equity Sec. Holders v. Lionel Corp.(*In re* Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983) ("Every sale under § 363(b) does not automatically short-circuit or side-step Chapter 11; nor are these two statutory provisions to be read as mutually exclusive. Instead, if a bankruptcy judge is to administer a business reorganization successfully under the Code, then . . . some play for the operation of both § 363(b) and Chapter 11 must be allowed for.").

753 *See, e.g., In re* Chrysler LLC, 405 B.R. 84, 96 (Bankr. S.D.N.Y. 2009), *appeal dismissed*, 592 F.3d 370 (2d Cir. 2010) ("A debtor may sell substantially all of its assets as a going concern and later submit a plan of liquidation providing for the distribution of the proceeds of the sale. This strategy is employed, for example, when there is a need to preserve the going concern value because revenues are not sufficient to support the continued operation of the business and there are no viable sources for financing.").

As discussed above, a key concern among the Commissioners was the timing of section 363x sales, which they believed should be conducted in a methodical manner and on a reasonable timeline so that the debtor can identify, and creditors can confirm, that the sale not only provides the best and highest offer for the assets, but also the best restructuring alternative for the debtor and all of its stakeholders. The Commission recommended a 60-day moratorium on section 363x sales to promote these objectives.[754]

The Commissioners reflected on the meaningful differences between a section 363x sale process and the chapter 11 plan process. They considered both substantive and procedural aspects of the process. For example, courts use slightly different standards of review in approving sales of substantially all of a debtor's assets under section 363 of the Bankruptcy Code.[755] Most courts employ some form of heightened scrutiny, but that review may simply turn on whether the debtor in possession has a "good reason" for the proposed sale under the circumstances of the particular case.[756] Such a standard is a much different and arguably lower standard than that applied to confirmation of a chapter 11 plan in the cramdown context.[757] The Commissioners observed that a cramdown analysis generally is applicable because most classes of creditors will be impaired by the sale and receive nominal, if any, distributions from the sale proceeds. Moreover, creditors do not get a "vote" on the sale. To confirm a plan under the section 1129 cramdown standard, a debtor must establish that the plan (i) satisfies

754 *See* Section IV.C.2, *Timing of Section 363x Sales*.

755 *See* Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1072 (2d Cir. 1983) (reviewing historical standard applicable to bankruptcy sales and finding more flexibility under section 363(b), noting that "[i]n 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"). *See also In re* Whitehall Jewelers Holdings, Inc., 2008 WL 2951974, at *6 (Bankr. D. Del. July 28, 2008) ("[W]hen a preconfirmation [section] 363(b) sale is of all, or substantially all, of the Debtor's property, and is proposed during the beginning stages of the case, the sale transaction should be 'closely scrutinized, and the proponent bears a heightened burden of proving the elements necessary for authorization'") (citation omitted); *In re* George Walsh Chevrolet, Inc., 118 B.R. 99, 101 (Bankr. E.D. Mo. 1990) ("A sale of substantially all of the Debtor's assets other than in the ordinary course of business and without the structure of a Chapter 11 Disclosure Statement and Plan . . . must be closely scrutinized and the proponent bears a heightened burden of proving the elements necessary for authorization."); *In re* Indus. Valley Refrigeration & Air Conditioning Supplies, Inc., 77 B.R. 15, 17 (Bankr. E.D. Pa. 1987) (holding that a sale of virtually all of the debtor's assets "can be permitted only when a good business reason for conducting a preconfirmation sale is established and . . . the burden of proving the elements for approval of any sale out of the ordinary course of business — including provision of proper notice, adequacy of price, and 'good faith' — is heightened").

756 *See* Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983) ("The rule we adopt requires that a judge determining a § 363(b) application expressly find from the evidence presented before him at the hearing a good business reason to grant such an application."). *See also In re* Boston Generating, LLC, 440 B.R. 302, 321 (Bankr. S.D.N.Y. 2010) ("[A] court rendering a section 363(b) determination must 'expressly find from the evidence presented . . . a good business reason to grant such application.'") (citations omitted); *In re* Daufuskie Island Props., LLC, 431 B.R. 626, 637 (Bankr. D.S.C. 2010) ("(Because the sale is one of substantially all assets of the Estate prior to confirmation of a Chapter 11 plan in this case, authorization for the sale under § 363(b)(1) requires that the Trustee satisfy the 'sound business purpose' test for pre-confirmation sales."); *In re* Gen. Motors Corp., 407 B.R. 463, 489 (Bankr. S.D.N.Y. 2009), *aff'd*, *In re* Motors Liquidation Co., 430 B.R. 65 (S.D.N.Y. 2010) ("[I]t is plain that in the Second Circuit, as elsewhere, even the entirety of a debtor's business may be sold without waiting for confirmation when there is a good business reason for doing so."); *In re* Nicole Energy Servs., Inc., 385 B.R. 201, 10 (Bankr. S.D. Ohio 2008) ("[T]he Court may approve a sale of all of a debtor's assets under § 363(b) 'when a sound business purpose dictates such action.'").

757 *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 16–17 (Nov. 15, 2012) ("Chapter 11 plans of liquidation continue to grow in popularity as a 'reorganization' option but offer less protection to creditors, including secured creditors, than a liquidation under Chapter 7. In almost all cases, once the Chapter 11 plan of liquidation has been confirmed, it is the debtor or liquidating trustee who conducts the liquidation without further input from creditors and often with limited (if any) judicial oversight. As a result, creditors have little or no input into the liquidation decisions made by the liquidating trustee/debtor beyond the information contained in the disclosure statement, and there is no real ability on the part of creditors to oversee the liquidation that is being accomplished — allegedly for their benefit. . . . It is becoming commonplace that courts will not condone a §363 sale which disposes of substantially all of the estate's assets without the court and the creditors being advised as to the terms of 'wind-down' or a plan of liquidation. Similarly, many courts allow for what are referred to as "structured dismissals" in lieu of either a Chapter 11 plan of liquidation or a conversion to Chapter 7, without any specific statutory underpinning. Without giving any real guidance as to when a Chapter 11 liquidation is appropriate and the level of interaction available to creditors if the Debtor has not complied with the plan or refuses to cooperate, the secured lender is left only with the option of reclaiming its collateral."), *available at* Commission website, *supra* note 55; *See Written Statement of Maureen Leary: SABA/NAAG Annual Seminar Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 8, 2013) (suggesting higher standard of review for sales under section 363(b) and (f)), *available at* Commission website, *supra* note 55.

all of the requirements of section 1129(a) (including good faith, the best interests of creditors test, and payment of all administrative claims and certain priority claims), except section 1129(a)(8); and (ii) does not discriminate unfairly and is fair and equitable with respect to each dissenting impaired class under section 1129(b).[758]

In general, a plan discriminates unfairly against an impaired dissenting class if it provides greater value to a class of claims or interests with equal priority. "In a nutshell, if the plan protects the legal rights of a dissenting class in a manner consistent with the treatment of other classes whose legal rights are intertwined with those of the dissenting class, then the plan does not discriminate unfairly with respect to the dissenting class."[759] Section 1129(b)(2) sets forth certain standards that must be met for the plan to be considered fair and equitable as to dissenting impaired classes of secured and unsecured claims and equity interests. The legislative history, however, also makes clear that certain factors that are relevant to the fair and equitable determination are not specified in section 1129.[760] The most common factor considered in this context is a prohibition on a senior class receiving more than 100 percent of its claim in a cramdown scenario.

In addition to substantive distinctions, the Commissioners observed that, particularly in an expedited sale process, many creditors do not receive notice of the sale or sufficient information to evaluate the sale. Yet the sale may eviscerate any recoveries for unsecured creditors in the case, and could subject some or all of the creditors to third-party releases or discharges that impact the parties and property potentially available to satisfy their claims. The Commissioners believed that more meaningful notice to a broader audience is necessary and appropriate in many cases.

Overall, the Commissioners found little difference in the consequences to creditors' rights and claims under an order approving a section 363x sale or an order confirming a chapter 11 plan. They did find, however, significant differences in the creditor protections available under the two processes. Considering the potentially greater exposure to loss of value in the sale context where the assets are being removed from the estate, the Commission ultimately determined that creditors should be afforded at least the same level of protection in the section 363x sale process and in the chapter 11 plan process. The proposed procedural principles for section 363x incorporate these recommendations.

758 11 U.S.C. § 1129(a), (b).
759 Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 Am. Bankr. L. J. 133, 142 (1979).
760 *Id.*