AMERICAN
BANKRUPTCY
INSTITUTE

2017 Northeast Bankruptcy Conference

Loans-to-Own: How Do You Do It? Should You Do It?

Hon. Christopher J. Panos, Moderator
U.S. Bankruptcy Court (D. Mass.); Boston

Barry S. Feigenbaum
Rogin Nassau LLC; Hartford, Conn.

Jeffrey B. Gaynor
TrueNorth Capital Partners LLC; Stamford, Conn.

Donald E. Rothman
Riemer & Braunstein LLP; Boston

An Investment Bankers View on Optimal Path to Value Creation for a Distressed Business (including when, if ever, it makes sense to pursue a "Loan to Own" strategy)

Introduction

As an investment banker ("IB"), I have been representing companies in the purchase and sale of distressed businesses in the middle market for more than twenty-five years. I need to ask the reader to (1) provide me a bit of latitude on use of legal terms and concepts (I am not an attorney), and (2) presume I am addressing predominantly, privately-owned businesses in the bottom half of the middle market (capital structures typically no more complex than equity, senior secured and junior capital).

Overview

I have come to believe that the term "sale" may be a misnomer in a distressed situation. As you read on, presume that I am referencing businesses that are overleveraged and/or require new capital in support of a turnaround plan. This rescue capital will require substantial targeted returns (equity returns) for the risk undertaken to right the business. What is really happening is less a "sale" and more a creation of value (where little or none existed for the equity). In a conventional sale process, one presumes the goal is highest and best value. Highest and best value does not ensure potential value creation, at least not for the prospective investor (new capital).

Value creation may be enhanced in "Loan to Own" transactions. Loan to Own transactions are characterized as the purchase of the secured debt position with the goal of either being paid at par or using par value to acquire the company. The debt is usually purchased at a discount and then credit bid in a 363 sale or foreclosed "peacefully" pursuant to Article 9. The discount dictates the extent to which value is created for the rescue capital, even before greater value may be realized through a turnaround plan.

There are risks involved with this strategy—liquidation risk, i.e., the company fails and liquidation value is less than what was paid for the debt; litigation risk, i.e., the debt purchaser becomes the target of subordination, re-characterization, breach of fiduciary duty, or fraudulent conveyance claims; and "value" risk, i.e., the risk that other investors believe that the company is worth more than the debt acquirer, although in this situation the debt acquirer's downside is payment at par, the risk is that the debt acquirer ends up not owning.

So why use this strategy, what is the financial advantage for the investor, as it is usually the investor calling the shots? How does using the Loan to Own strategy create value that other strategies do not, and, enough that an investor would decide to use this strategy given the risks? The short answer is control.

The Distressed Sale Process vs. the Conventional Sale Process

I do believe that there is a methodology and calculus that should be employed when evaluating a strategy for a "sale" or purchase of (or attracting capital to/investing capital in) a

	CONVENTIONAL TIMELINE					
	Action Item	Month 1	Month 2	Month 3	Month 4	Post Close
Preparation						
1	Valuation (DCF, Comps, Transactions, liquidation)					
2	Article 9, 363, Plan, Composition Agreements					
3	Cash flow Projection					
4	Aggregate Data Necessary for Marketing Marterials					
5	Prepare and Agree Teaser					
6	Prepare/Agree NDA Form					
7	Prepare and Agree Potential Buyer List					
8	Consider strategy for employ/tax/regulatory, etc. (NOL and/or debt forgiveness)					
9	Draft Confidential Info Memorandum (CIM)					
10	Contract and Populate Online Data Room					
11	Prepare Management Presentation and Rehersal					
Marketing						
10	Contact Potential Buyers, Exchange NDAs					
11	Deliver CIM					
12	Solicit Initial Bids - EOI					
13	Coordinate Site Visit / Management Meetings					
14	Open Data Room					
15	Request Letter of Intent (LOI)					
16	Negotiate and Execute LOI					
Due Diligence and Documentation						
17	Buyer's Confirmatory Due Diligence					
18	Onsite Due Diligence					
19	Receive/Deliver Definitive Agreements					
20	Review and Negotiate Definitive Agreements					
21	Execute Difinitive Agreement					
Closing and Post-close						
22	Closing Preparation (Regulatory Filing, Consents, etc)					
23	Post-close Integration					
24	Closing					
25	Post-closing Adjustment					

distressed business, and in particular by a potential new owner/provider of rescue capital. Critical to understand the unique aspects of distressed sale vs. conventional sale and the varying interests of the parties.

The above timeline summarizes typical steps in a sale process and highlights in red the steps that are different for a distressed vs. a conventional sale (for a conventional sale this process would likely be depicted as six to nine months):

In the simplest sense, for a going concern, value is represented by the present value of annual future free cash flow. For a distressed business, where positive cash flow, if any, discounts to less than the sum of liabilities, and the ability to operate absent capital infusion is in question, the liquidation value of the hard assets will drive value. Additionally, the time frame shortens from annual to monthly, and even weekly, projections. As IBs, we know that potential investors or buyers will seek to pay **no** more than a modest premium to liquidation value and many will discount further for anticipated future capital requirements to underwrite the turnaround plan.

In a conventional "sale" process, the seller is typically seeking their personal optimal intersection of: highest value, optimal structure, certainty of close, time to close and post close disposition of the business and the employees. Most importantly, in a conventional sale of a healthy business, the seller has the luxury of time to seek their optimal outcome. In a distressed "sale" process, the seller is typically seeking optimal structure, certainty of close, time to close, reduction of personal exposure and post close disposition of the business and the employees. The seller does not have the luxury of time, and, most importantly, highest value takes on a very different meaning (and is explained further below).

The current equity interests' protection is to try to control the sale/investor process for as long as possible. It is atypical to request a non-circumvent provision in a non-disclosure agreement in a conventional sale process and paramount to request one in a distressed process. Sophisticated investors will attempt to negotiate directly with secured creditors. The equity interests' ability to inject itself between creditor and investor often represents their only leverage.

Investors (rescue capital) will weigh optimal financial outcome, transactional control and perceived (litigation) risks in determining whether they proceed with an investment and then, how they may structure such investment.

The creditors will weigh these offers against liquidation value, less legal and collection costs, time, and the cost of internal resource (devotion of manpower to a slow process). Because the equity owner is out of the money, despite fiduciary duties and possible personal exposure, the interest of the equity often becomes adversarial to those of the creditors. Private owners, particularly those with personal guarantees, will become natural competing bidders if they cannot align their interest with that of the investor.

Other differences between a conventional and distressed process include:

(1) Cash flow – in a distressed sale the ability to identify how the business will fund operations through a closing is top of the list for obvious reasons. Call this step one;

(2) Tax Implications - consideration of tax implications for debt forgiveness is not an issue in a conventional sale but can have dramatic implications in a distressed process and can force a legal mechanism if NOLs are not available as a shelter;

(3) Timing – because there is no luxury of time (time is of the essence), there is typically a more relaxed approach to confidentiality concerns. I am not suggesting protections, such as non-disclosure agreements ("NDA"), are any less important. However, the latitude to negotiate NDAs, the early opening of data rooms, and the earlier disclosure of more data, all in the interest of moving quickly, tends to be the norm;

(4) Purchase and sale ("P&S") agreements – both buyer/investor and seller need to recognize that P&S agreements will be abbreviated. Specifically, representations and warranties are less significant as there is often no solvent individual or entity to stand behind them. Representation and warranty insurance is usually cost prohibitive in these situations;

Finally, in the middle market, and particularly with privately-owned businesses that are in financial distress, business viability and capital requirements to achieve business viability are of critical importance. A credible pro forma is what is being "sold" by the IB. "Credible" cannot be over-emphasized. The IB that understands the distressed market knows that there are investors that focus specifically on "special situations". The IB gets a few minutes on the phone to capture the investors interest. The plan had better be simple and, ideally, it will not hinge on revenue growth (deemed the riskiest proposition by investors) only.

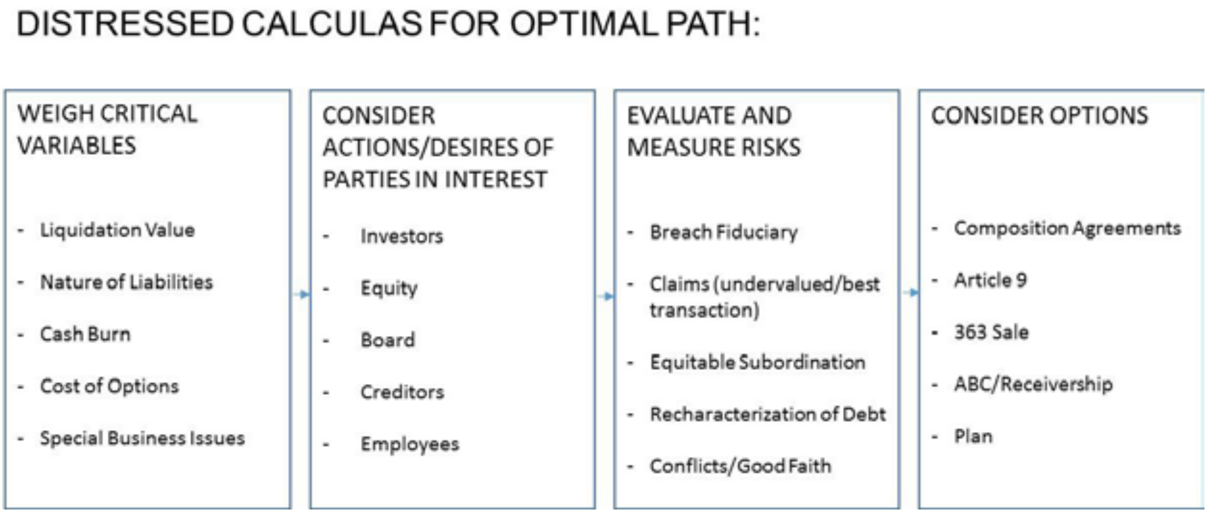
Given the above, when should the investor choose/consider the loan to own strategy? In the distressed sale, where the business is over leveraged and underperforming, a legal mechanism should be employed to reduce the leverage (and create value): sale of assets pursuant section 363 of the Bankruptcy Code, friendly foreclosure of assets pursuant to Article 9, composition agreements outside of a formal bankruptcy proceeding, receivership, assignment for the benefit of creditors or a plan of reorganization pursuant to a bankruptcy filing.

Assimilation of Data and Analysis of Optimal Path

Loan to Own and a 363 sale or Article 9 friendly foreclosure are not mutually exclusive. Owning the debt can improve an investors position regardless of legal strategy employed to deleverage. There is not an absolute clear optimal path at the outset. There are likely best paths, however, the fluidity of the situation dictates a possible need to pivot for changing circumstance at any moment. Some of the obvious variables that will influence direction include: (1) Business performance during the process, (2) Outside influences on the Business i.e. customer, supplies key employees etc., (3) changes in the market and economic climate during the process, and, perhaps most importantly, (4) the rescue capital's appetite for risk (nature of the winner).

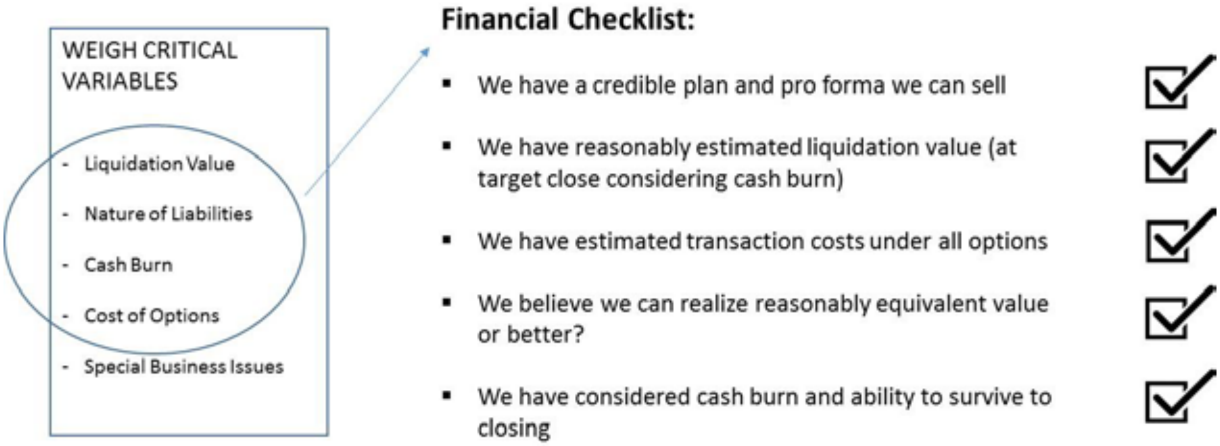
Specific advantages of Loan to Own include speed and control. The purchase of debt of target may reduce time to transaction by months due to ability to force the process. Owning the debt may provide an ability to limit or cut off equity's control/leverage mentioned above. An investor can enhance its ability to dictate (to a degree) terms to other creditors, vs. taking terms as negotiated by others if a stalking horse. Control is further realized through an ability to limit competition. Particularly where an investor provides working capital and other financial accommodations, will a competing buyer want to step in?

Despite possible advantages for the investor, Loan to Own is not a default position. If composition agreements can achieve the desired result, this path may be favored as it is likely more favorable to the business owner, the least costly path, minimizes litigation risk and maximizes transactional control. However, with composition agreements, it can be difficult to achieve the optimal financial outcome due to creditor holdouts. You cannot compel a creditor to take a discount or long-term payment plan without employing one of the other legal mechanisms mentioned above. Article 9 will most often be the second choice (363 third) for "sophisticated" investors (transactional control with same financial outcome with lower transaction costs if risks can be quantified and are deemed manageable).



The diagram above ("Distressed Calculus for Optimal Path") lists outcomes in preferred order for the investor based upon transactional and cost control, assuming reasonably similar financial outcomes can be realized. Investors are not really identifying the best option so much as eliminating options that do not achieve the desired capital structure with legal and operating risk acceptable to them. In other words, why go to the time, expense and possible risk of a 363 sale if composition agreements or an Article 9 friendly foreclosure can deliver the investor a reasonably similar outcome (without transactional control risk – overbid risk)? And, of course, if any option provides limited chance to create value, why make any investment?

The below "Financial Checklist" reflects the initial steps in evaluation of "Optimal Path". The steps are employed to evaluate the overriding question: will any party in interest, **in the money**, be disadvantaged by the restructure and have a legitimate claim?



When the IB has completed his review of financial considerations, the question of "Special Business Issues" and legal risk remains. This will highlight the need for a team comprised of IB and attorney to plan from the outset. There are any number of issues that might preclude use of one or more of the legal mechanisms to deleverage. Examples would include regulated industries such as banking, shipping, government contractors and utilities where formal proceedings can have implications for day to day operations. Furthermore, special circumstances such as multi-employer collective bargaining agreements (withdrawal liabilities) or significant environmental or other successor liabilities (warranty or product liability for example) can impact decision making.

Finally, the questions remains' whether will legal risk/cost will be a show stopper? This depends on the buyer's appetite for risk/reward? It can be very difficult to quantify risk and cost given the relatively unsettled areas of law and varying positions of judge. If an investor goes the Loan to Own route, they have to go in estimating litigation cost and their appetite for risk.

It bears repeating that he evaluation process requires careful coordination and collaboration of the company's counsel and IB. Identifying optimal path is an iterative process and not the same for all parties. In summary, the IB considers/addresses value, likely nature of interest and optimal structure. Counsel outlines the risks associated with a path. IB works with counsel to quantify the risks. Path is adjusted based upon the investor appetite for risk (as weighed against cost, control and timing). Change a variable, reconsider the path.

Overview of Credit Bidding and Section 363(k)

Barry S. Feigenbaum
Rogin Nassau LLC
Hartford, Connecticut
bfeigenbaum@roginlaw.com

2017 ABI Northeast Bankruptcy Conference

I. The Basis for Credit Bidding under State Law and the Bankruptcy Code

In a typical loan-to-own scenario, an investor purchases an existing loan from a lender and the purchaser uses its newly acquired position as a secured creditor to effectuate the purchase of the underlying assets. In the real estate context we have often seen banks and special servicers of CMBS loans sell distressed debt to investors who then use their rights as the foreclosing party to acquire the underlying realty. In Connecticut, this is either by a "strict foreclosure," whereby the title passes to the foreclosing creditor if the holders of subsequent encumbrances or the owner of the "equity of redemption" do not redeem the property by satisfying the unpaid debt on or before the dates set by the court, or credit bidding by the secured creditor at a public auction held under court direction. Real property foreclosure rules generally permit the secured party to credit bid at foreclosure sales. See, e.g., Conn. Gen. Stat. § 49-27.

Similarly, in sales under Article 9 of the Uniform Commercial Code, purchases by the secured creditor are specifically permitted under Section 9-610(c), which states that "a secured party may purchase collateral: (1) at a public disposition; or (2) at a private disposition only if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations." As one court stated in ruling that under the Indiana UCC credit bidding at a public UCC sale is appropriate, "[a]s the proceeds of a sale under Section 9-504 are used to pay the debt owed to the secured creditor, it is ultimately inconsequential whether a secured creditor pays with cash or with the reduction of debt. The end result is the same." In re Finova Capital Corp., 356 B.R. 609, 625 (Bankr. D. Del. 2006).

In the bankruptcy context, Bankruptcy Code Section 363(k) provides that:

> 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.

As outlined below, this seemingly simple provision of the Bankruptcy Code has generated many hotly contested cases. To start, Section 363(k) requires that the holder of the claim be secured on the collateral being sold, that the claim be "allowed" and that the court not find "cause." Id.

The Supreme Court in RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 132 S. Ct. 2065, 2070 (2012), held that a secured creditor has the right to credit bid under Section 363(k) in a cramdown plan which provided for a sale of assets under Section 1129(b)(2)(A). Significantly, the RadLAX Court stated that "[t]he pros and cons of credit-bidding are for the consideration of Congress, not the courts." Id. at 2073. The court further noted that:

> The ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price. It enables the creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to protect the loan. That right is particularly important for the Federal Government, which is frequently a secured creditor in bankruptcy and which often lacks appropriations authority to throw good money after bad in a cash-only bankruptcy auction.

Id. at 2070, n.2.

The Supreme Court's recognition of the right of secured creditors to credit bid in RadLAX was not new. In fact, in the case of Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 580 (1935), the court recognized that the

> right of the mortgagee to insist upon full payment before giving up his security has been deemed of the essence of a mortgage. His position in this respect was not changed when foreclosure by public sale superseded strict foreclosure or when the Legislatures of many states created a right of redemption at the sale price. To protect his right to full payment or the mortgaged property, the mortgagee was allowed to bid at the judicial sale on foreclosure.

II. Limitations under Section 363(k)

Given the strong legislative intent that credit bidding be respected and the Supreme Court's statement in RadLAX that the policy of permitting credit bidding is within the purview of Congress and not the Courts, some recent bankruptcy cases have attempted to limit credit bidding using the "for cause" exception to Section 363(k). These cases created significant concern for the use of credit bidding in bankruptcy. However, a close review of these cases and subsequent case law has eased those fears.

In the case of In re Fisker Automotive Holdings, Inc., 510 B.R. 55 (Bankr. D. Del. 2014), the court limited the right of the secured creditor to bid in a Section 363 sale citing several factors it considered "cause." The secured creditor, Hybrid Tech Holdings ("Hybrid") did what many prospective purchasers do; it purchased the secured debt at a substantial discount and utilized its rights as a secured lender. Id. at 57. In this case, the outstanding principal was $168.5 Million and the purchase price paid for the debt was $25 Million. Id. The Debtor and Hybrid sought to approve a $75 Million credit bid on an expedited basis. Id.

Unfortunately for Hybrid, the collateral securing the loan did not appear to cover all of the assets necessary to operate the business. Id. The court stated that there was some amount of unencumbered assets, some assets which were in dispute regarding perfection and other assets where there was no dispute as of coverage. Id. at 58. It is unclear from the decision the value attributed to the value of the collateral covered by the pre-petition liens or what disputes there might be concerning the collateral. Significantly, the court noted that the parties stipulated that this dispute "is not likely subject to a quick or easy resolution. We may not agree on exactly where those lines are drawn between those three groups in certain respects. And we may not agree as to the allocation of value between these groups in all respects. But we agree that there are material assets in each category." Id.

In addition to the uncertainty with respect to collateral coverage of the Hybrid loan, the court noted two other factors it considered. The court was clearly disturbed that Hybrid sought to have the sale to it approved on a speedy basis. The case was filed three days before Thanksgiving and the Sale Motion and confirmation hearing was scheduled for January 3, leaving only 24 business days during the holiday season. Id. at 60. On top of that, the Committee was appointed on December 5. Id. Based on the insistence of this schedule, "[i]t is the Court's view that 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." Id. at 60-61.

Finally, the Fisker court found that there would be no bidding if Hybrid was permitted to credit bid over $25 Million. Id. at 61. This is based on the Committee presentation of a third party bidder which stated that it would not participate in an auction if the credit bid was not capped at $25 Million. The court stated that "the 'for cause' basis upon which the Court is limiting Hybrid credit bid is that bidding will not only be chilled without the cap; bidding will be frozen." Id. at 60.

It is important to note that the Fisker court extensively cited In re Philadelphia Newspapers, LLC, 599 F.3d 298 (3d Cir. 2010) for the proposition that cause can be found solely in the chilling of bidding. Id. at 59-60. However, this ignores that the holding of Philadelphia Newspapers was overruled by RadLAX. Further, Fisker does not address the statement by Justice Scalia in the RadLAX court's opinion that it is up to Congress, not the courts to determine the pros and cons of credit bidding. Every credit bid chills bidding since it creates a floor to protect secured lenders. Therefore, chilling alone should not constitute cause.

In the case of In re: The Free Lance-Star Publishing Co. of Fredericksburg, VA, 512 B.R. 798, 808 (Bank. E.D. Va. 2014), the Bankruptcy Court for the Eastern District of Virginia limited a secured creditors ability to credit bid based on its "inequitable conduct" and the fact that the creditor did not have a security interest in all of the assets being sold. The Debtor was involved in the newspaper, printing and broadcast businesses. In 2006, Branch Banking and Trust ("BB&T") loaned the Debtor $50.8 Million to construct a printing facility. Id. at 802. The BB&T loan was secured by most, but not all of the Debtor's assets. Id. The assets not encumbered by the BB&T loan included real estate on which broadcast towers were located (the "Tower Properties") and certain other property including motor vehicles, the FCC licenses, insurance policies and bank accounts. Id. at 802, 806.

In 2009, the Debtor was out of compliance with the BB&T Loan. Id. at 802. A forbearance agreement followed in 2011. Id. Conditions did not improve for the Debtor and it could not refinance the debt. Id. In June 2013, an affiliate of Standton Capital Partners, DSP Acquisition, LLC ("DSP") purchased the loan from BB&T and began its quest to acquire the Debtor's assets. Id. DSP wasted no time in telling the Debtor that it needed to file a Chapter 11 proceeding and sell substantially all of its assets to DSP pursuant to a Section 363 sale. Id. DSP made promises that it would operate the business and keep management in place. Id.

Shortly thereafter, DSP tried to get the Debtor to execute mortgages for the Tower Properties. Id. The Debtor refused and took the high road. Without notice to the Debtor, DSP thereupon filed UCC Fixture Filings on the land records in an attempt in encumber the fixtures on the Tower Properties. Id. at 803. Thereafter, DSP and the Debtor were unable to agree on release language in a forbearance agreement proposed by DSP. Id. After ninety days passed from the filing of the Fixture Filings, DSP resumed its pressure on the Debtor to file a Chapter 11 case. Id. This included a discussion in which DSP told the Debtor that there was no reason to market its assets and the time between filing and a sale should be no greater than six weeks. Id. DSP also objected to the Debtor's hiring of a financial consultant and insisted that any marketing material needed to indicate that DSP had the right to a $39 Million credit bid. Id. DSP and the Debtor also disagreed on the need for a DIP financing facility. Id. DSP insisted on one which included a lien on the Tower Properties. The Debtor said it did not even need a DIP facility and stopped negotiating with DSP. Id.

The Debtor filed its Chapter 11 case shortly thereafter. Id. at 804. At the first day hearings, DSP objected to the Debtor's use of cash collateral unless a lien was granted on the Tower Properties. The Debtor refused and the Court found that DSP was adequately protected without the supplemental liens. Id. At no time did DSP tell the court that it had filed the Fixture Filings. Id.

Based on its aggressive loan-to-own behavior and that it did not have a security interest in all of the Debtor's assets, the court limited DSP's credit bid to $1.2 Million on the broadcast business and $12.7 Million on the printing business. Id. at 808. The Free Lance-Star Publishing court did cite RadLAX for the validity and purpose behind credit bidding. Id. at 805. It also cited Fisker and Philadelphia Newspapers that the "for cause" exception gives the court authority to deny credit bidding, including "cause" based on chilling the bidding process. Id.

The Free Lance-Star Publishing court reiterated its finding that DSP did not have a lien on all of the assets being sold. Id. at 805-06. This finding was properly used to support its ruling that "DSP does not have a right to asset a credit bid on assets that do not secure DSP's allowed claim." Id. at 806. The court went on to find that DSP's conduct was inequitable since it improperly recorded the Fixture Filings and did not inform that Court of its filing, pressured the Debtor to shortened the marketing period, insisted on advertising its credit bid rights and "DSP's efforts to frustrate the competitive bidding process." Id.

Faced with DSP's actions, the court held that

> 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 enhance market value. Credit bidding can be employed to chill bidding prior to or during an auction process. DSP's motivation to own the Debtor's business rather than to have the Loan repaid has interfered with the sales process. DSP has tried to depress the sales price of the Debtor's assets, not to 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.

Id.

The unsavory conduct by DSP is also reflected in the court's observations that DSP did not put on any rebutting evidence or any alternative method for limiting its credit bid. Id. at 807. DSP also did not disclose at the court's invitation the price it paid for the BB&T loan. Id. Therein is the root cause of DSP's problems. It acted like a bull in a china shop in trying to force its will on the Debtor, fought the Debtor's attempts to act responsibly with respect to its creditors, filed liens it had no right to file and did not give full disclosure of its actions to the court. Faced with this bad behavior, the court acted.

III. A More Expansive View of Section 363(k)

Another case where a secured creditor's right to credit bid was limited by a bankruptcy court is In re RML Development, Inc., 528 B.R. 150 (Bankr. W.D. Tenn. 2014). This case is notable because of the court's discussion of what happens when there is a holder of a disputed secured claim that wants to credit bid. The court noted that under Section 363(k), only allowed claimants are entitled to credit bid and under Code Section 502(a), a claim is:

> deemed allowed, unless a party in interest … objects. Upon a timely objection, the claim is no longer deemed allowed and may only be allowed after notice, hearing, and the court's determination. 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. 11 U.S.C. §502(c)(1). Therefore, only an allowed claim under §502 is entitled to "credit bid" at a §363(b) sale.

Id. at 154.

In this case, the court fashioned a remedy which allowed the secured creditor to bid the undisputed portion of its claim and hold the balance of the proceeds in escrow pending determination of the dispute. Id. at 156-57. Alternatively, the secured creditor could post a bond, letter of credit or other security device in the amount of the credit bid. Id. at 157. By ordering this alternative, the court encouraged the parties to reach an agreement on the remaining disputes. Id.

The RML Development case reviews some of the "for cause" exception cases and concludes that "[t]he bankruptcy court should only modify or deny a §363(k) credit bid when equitable concerns give it cause. *This court believes such a modification or denial of credit bid rights should be the extraordinary exception and not the norm*." Id. at 155-56 (emphasis added). In so holding, the RML Development court implicitly is adopting the position that more than bid chilling is required for the court to find cause to exclude a secured creditor from the benefits of §363(k).

In the recent case of In re Aeropostale, Inc., 555 B.R. 369 (Bankr. S.D.N.Y. 2016), the court approved the right of the holders of secured debt to credit bid at an auction sale of the debtors' assets. The Debtors filed a motion to equitably subordinate the claims of the pre-petition lenders, prohibit the lenders from credit bidding and recharacterize the claims. Id. at 375. After an extensive evidentiary hearing, the court denied the motion and permitted the lenders to credit bid under Section 363(k). In this case, the pre-petition lenders to a clothing retailer consisted of affiliates (Aero Investors and MGF Sourcing Holdings Limited) of one of the Debtors' principal suppliers, MGF Sourcing US LLC ("MGF") and MGF's parent company, Sycamore Partners. Id. at 377. In 2013, another affiliate of Sycamore Partners, Lemur LLC, purchased an 8% percent interest in the Debtor on the open market. Id. at 376.

As of the petition date, the Debtors owed their secured creditors approximately $223 Million of which $151,250,000 was held by the MGF affiliates. The remaining secured debt was held by Bank of America on an asset based revolving facility. Id. at 377. The MGF related secured debt was in two tranches: (1) $100 Million in Tranche A funded by Aero Investors with interest only at 10% with a five year balloon; and (2) Tranche B funded by MGF Holdings with no interest and $5 Million in minimum annual principal payments. Id. at 378. The funding arrangement required the Debtors to enter into a sourcing arrangement with MGF. Id. at 379. The sourcing arrangement gave MGF the right to declare a "Credit Review Period" if the Debtors' liquidity dropped below $150 Million. Id. at 379-80. During a Credit Review Period MGF could alter the payment terms from 30 days after delivery to "such other shorter number of days or up-front terms as deemed prudent by [MGF] in the exercise of it [sic] reasonable credit judgment." Id. at 380. Prior to entering into the funding and sourcing arrangements, the Debtors sought and received funding proposals from other parties. Id. at 378. The MGF arrangements were made in May 2014. Id. at 378-79.

The Debtors' financial situation deteriorated throughout 2014 and 2015. Id. at 381. In January 2016, MGF determined that the Debtors would be in a Credit Review Period by April 2016. Id. at 384. The Debtors continued to deteriorate and in February 2016 Lemur sold its common stock position at a $53 Million loss. Id. After analyzing the

January 2016 statements, MGF determined that the Debtors were in a Credit Review Period. Id. Based on its rights under the sourcing arrangement, MGF altered the payment terms requiring a letter of credit for future orders due on placement of the orders. Id. at 385. The Debtors disagreed with MGF's position and an exchange of contentious letters followed. Id. The Debtors and MGF agreed to certain shipments prior to the May 4, 2016 bankruptcy filing. Id. at 386. Following the petition date, MGF and the Debtors settled the disputes regarding the supply agreement. Id. It turns out that the Debtors were in violation of the liquidity requirement in February 2016 and that the Debtors were unwittingly overstating liquidity. Id.

The court found that the pre-petition conduct of MGF was not inequitable. It found that Lemur's sale of stock did not harm creditors and that MGF acted within its rights under the supply arrangement. Id. at 411; 400. The court discounted testimony of the Debtors' expert that MGF's actions put the company into bankruptcy. Further, the court did not find any credible evidence that there was a secret conspiracy to force the Debtors into bankruptcy so that MGF could purchase the Debtors at a discount. Id. at 407-08. In summary, the "the totality of the credible evidence at trial demonstrates that the Sycamore Parties did not take actions beyond what was proper to protect their interests." Id. at 409.

As to the ability of MGF to credit bid, the court agreed that it has the authority under Section 363(k) to deny a secured creditor the right to credit bid based on inequitable conduct, disputes over the validity of the claimed lien or failure to follow procedural requirements. However, in this case, the court found that:

> there is no evidence of inappropriate behavior by the Term Lenders in the bankruptcy . . . . There are no allegations of collusion, undisclosed

> agreements, or any other actions designed to chill the bidding or unfairly distort the sale process. Consistent with the exercise of their own legal rights, the Term Lender have been relatively cooperative with the process by, among other things, agreeing to the payment of an expense to a potentially interested bidder and agreeing to a one-week extension of the sale process.

Id. at 416.

Having found no reason to limit credit bidding based on the conduct of the secured lenders or any issues with the validity of the lien or the amount of the debt, the court was faced with deciding whether the Debtors' claim that chilling bidding alone constitutes cause under Section 363(k). Id. The court analyzed the cases and determined that there is no support in the case law for chilling alone to be cause. The court analyzed both Fisker and Free Lance-Star Publishing and found that it was the secured creditor's conduct in each case, and not chilling credit bidding, that resulted in the limitation on credit bidding. Id. at 417-18. Further, in Fisker the court found that there would not just be chilling of bidding, but no bidding. The Aeropostale court also pointed out that even with inequitable conduct by the creditors in those cases limited credit bidding was permitted.

The Aeropostale court also cited the Final Report and Recommendations of the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 which "noted 'the fundamental role of credit bidding under state law and section 363(k)' and that 'all credit bidding chills an auction process to some extent…The Commission 'did not believe that the chilling effect of credit bids alone should suffice as cause under section 363(k)." Id. at 418.

The Aeropostale decision stands for the proposition that a secured creditor could exercise its rights to credit bid without a finding of cause under Section 363(k) so long as it acts in a responsible manner before the court and does not give the court any excuses to find inequitable conduct. Merely exercising contractual and legal rights, even if bidding is impaired, should not give rise to a successful challenge to credit bidding.

IV. Lessons From the Cases

The foregoing discussion highlights several important factors when considering embarking on a loan-to-own strategy using Section 363(k). First, do your due diligence. A loan-to-own situation requires diligence not only of the company or asset, but of the loan transaction itself. Make sure that the debt is valid, that the collateral is properly perfected and that there are no contractual prohibitions or impediments. These include a thorough review of the loan documents, history and any intercreditor relationships. Second, keep aggressive and overbearing conduct to a minimum. You should always act as though a creditors' committee and court may review your conduct. Obviously, filing financing statements without authority, and lack of candor to the court may result in an adverse ruling. A secured creditor should be prepared to be patient and allow exposure to the marketplace. Use any discounted purchase price for the debt as the buffer to such exposure. If possible, once in a proceeding show all available means of cooperation with the court and the U.S. Trustee. Do not give these parties any excuse to limit your rights. Only ask for an expedited sales process if it is truly necessary to preserve the assets. In summary, permit the debtor to run a fair process in accordance with the normal rules applicable to asset sales. The foregoing does not mean that you cannot exercise your rights. To the contrary, Aeropostale makes it clear that a secured creditor can exercise its right to protect itself; just use prudence in doing so.

Loan-to-own scenarios will always be with us. It is a function of the free alienability of debt and the preservation of creditor rights. It can also be an efficient mechanism to restructure business, preserve jobs and transfer ownership.