AMERICAN BANKRUPTCY INSTITUTE

2019 Winter Leadership Conference

Recent Trends in the Credit Bidding of Assets and Cross-Border Issues

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CONCURRENT SESSION

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RECENT TRENDS IN THE CREDIT BIDDING OF ASSETS AND CROSS-BORDER ISSUES

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What is credit bidding?

- A secured creditor places a bid at a sale of the collateral to which its lien is attached, using the debt owed to it to offset the purchase price.
- Non-cash.
- Prevents an undervalued sale of collateral.

RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 566 U.S. 639, 644 n.2 (2012)

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Credit Bidding Under US Law

- Section 363(k) of the Bankruptcy Code allows secured creditors to credit bid when a debtor conducts a sale of assets outside the ordinary course of business. See 11 U.S.C. § 363.
- Secured creditors are also afforded, under section 1129, the right to credit bid in situations where there is a sale of a debtor's assets, including the collateral securing the creditor's claim, pursuant to a chapter 11 plan of reorganization. See 11 U.S.C. § 1129.
- Real property.
- Uniform Commercial Code.

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Credit Bidding in Canada

- No Statutory Source
- By Agreement/Contract, but subject to Judicial Discretion
- Must meet Statutory and Case Law Provisions regarding Insolvency Sales

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Other Jurisdictions

- EU
- EU Member States
- Offshore Jurisdictions

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Valuation

- A secured creditor may credit bid the amount of its entire claim, notwithstanding any valuation of the collateral pursuant to section 506(a) of the Bankruptcy Code.
- The general logic in this approach is that a secured creditor's bid of its debt sets the value of the company, because a secured lender will not bid more than what it believes will provide a fair return for its collateral.

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SubMicron Systems

Assume that Debtor has a single asset: a truck, T. Lender is a secured creditor that has loaned Debtor $15, taking a security interest in T. Debtor is in Chapter 11 bankruptcy and has filed a 363 motion to sell T to Bidder for $10. Debtor argues that Lender can only credit bid $10 for T and must bid any excess in cash if it wishes to outbid B.

This hypothetical reveals the logical problem with an actual value bid cap. If Lender bids $12 for T, by definition $12 becomes the value of Lender's security interest in T. In this way, until Lender is paid in full, Lender can always overbid Bidder. (Naturally, Lender will not outbid Bidder unless Lender believes it could generate a greater return on T than the return for Lender represented by Bidder's offer.) As Lender holds a security interest in T, any amount bid for it up to the value of Lender's full claim becomes the secured portion of Lender's claim by definition. Given the weight of reason's demand that "it must be so," we see no reason to catalog the myriad other arguments that have been advanced to support this "interpretation."

In re SubMicron Systems Corp., 432 F.3d 448 (3d Cir. 2006) (footnotes omitted).

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Limits on Credit Bidding

- Bid relies on the collateral and is susceptible to errors in perfection of the security
- Use of Debtor in possession financing to cure deficiencies and expand scope of collateral in the US and Canada

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Canadian Financing Issues

- Creeping roll ups and extended security
- CCAA
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- Cross border recognition proceedings

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Review of Collateral

- The scope of the credit bid is directly tied to the validity of the lien on collateral.
- Lenders collateralized in the assets of a company will be subject to various rules regarding perfection of different types of collateral.

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Checklist

- Real Property
- Liquor Licenses
- Avoidance Actions
- Executory Contracts and Leases
- Intellectual Property
- Goodwill
- Unencumbered Assets

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Additional Security for Lenders

- DIP charge
- *Real Mex*

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Intellectual Property as a Credit Bid

- Industry Specific
- Security and Collateral
- Perfection
  - Local
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- Goodwill and Trademarks

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Goodwill in Credit Bids

- Valuation
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- Other aspects of law

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Bankruptcy Code section 363(k) provides that a secured creditor may credit bid in a sale of its collateral unless "the court for cause orders otherwise."

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What is "Cause"?

- Improper conduct
- Dispute over perfection or scope
- Violation of sale procedures
- Chilling investment banking process or bidding

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Disputes Between Secured Lenders

- U.S. Law
  - Determining the "Fulcrum Security"
  - Valuation
  - Cash versus non-cash bidding
- Canadian Law

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Pros and Cons of Credit Bidding

- Secured lender's interests versus the estate interests
- (Debtor and any statutory committees)
- Risks in Canada

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RECENT TRENDS IN THE CREDIT BIDDING OF ASSETS AND CROSS-BORDER ISSUES

I. WHAT IS CREDIT BIDDING?

A. Credit bidding is the process by which a secured creditor places a bid at a sale of the collateral to which its lien is attached, using the debt owed to it to offset the purchase price.

B. Credit bidding allows for a non-cash bid from a secured creditor for the amount of its debt.

C. Credit bidding also prevents a creditor's collateral from being sold at a price that is undervalued. *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 644 n.2 (2012) ("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."); *Beal Bank S.S.B. v. Waters Edge Ltd. P'ship*, 248 B.R. 668, 680 (D. Mass. 2000).

II. CREDIT BIDDING IN BANKRUPTCY

Section 363(k) of the Bankruptcy Code allows secured creditors to credit bid when a debtor conducts a sale of assets outside the ordinary course of business. *See* 11 U.S.C. § 363. Secured creditors are also afforded, under section 1129, the right to credit bid in situations where there is a sale of a debtor's assets, including the collateral securing the creditor's claim, pursuant to a chapter 11 plan of reorganization. *See* 11 U.S.C. § 1129.

A. **363(k):** Section 363(k) allows a secured creditor to credit bid in a § 363 sale of the collateral securing its claim. Credit bidding gives under secured creditors the ability to control their collateral when it is worth less than the face amount of their claims.

> 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.

11 U.S.C. § 363(k).

B. **1129 (b)(2)(A)(ii):** Section 1129 provides that a secured creditor must be allowed to credit bid when its collateral is sold free and clear of its liens in the context of a cramdown plan of reorganization.

> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> A. With respect to a class of secured claims, the plan provides –
>
> (i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and
>
> (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;
>
> (ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or
>
> (iii) for the realization by such holders of the indubitable equivalent of such claims.

11 U.S.C. § 1129(b)(2)(A)(ii).

III. CREDIT BIDDING UNDER STATE LAW

A secured creditor's credit-bid right is not limited to sales under section 363 of the Bankruptcy Code or under section 1129 through a plan. There are several alternatives for creditors to take ownership of a defaulting borrower's business or assets.

A. **Real Property**: Either by statute or case law, secured creditors may credit bid their secured debt in connection with the foreclosure of real property collateral. *See* Cal. Civ. Code § 2924h(b) ("The present beneficiary of the deed of trust under foreclosure shall have the right to offset his or her bid or bids . . . to the extent of the total amount due the beneficiary including the trustee's fees and expenses."). *See also AgStar Fin. Servs. v. Northwest Sand & Gravel, Inc.*, 161 Idaho 801, 803, 391 P.3d 1271, 1273 (2017) ("Where a secured creditor who holds more than one source of security for the same debt seeks a deficiency

judgment after having foreclosed on mortgaged real property and obtained title to such real property by credit bid in the foreclosure sale, a court should utilize its equity powers to consider the debt satisfied where the reasonable value of the real property is litigated and determined to be substantially greater than the debt. It must be remembered that where the creditor acquires the property through a credit bid, the creditor has absolutely no incentive to offer anywhere near a market value price. A credit bid in these circumstances is an artificial price that is often designed to allow the creditor to then pursue additional value through other sources, such as guarantees and security interests in personal property.) (footnotes omitted); *Dreyfuss v. Union Bank of Cal.*, 24 Cal. 4th 400, 403, 101 Cal. Rptr. 2d 29, 31, 11 P.3d 383, 384 (2000) ("Anyone, including the creditor, can bid at a foreclosure sale. The creditor is entitled to make a credit bid up to the amount of the indebtedness without payment of additional cash. Such a credit bid can be made in an amount up to the sum of the total amount due, including the fees and expenses of the trustee. 'The mortgagee is not required to open the bidding with a full credit bid, but may bid whatever amount he thinks the property worth. Indeed, many creditors continually enter low credit bids . . . to provide access to additional security or additional funds.'") (citations omitted; quoting *Cornelison v. Kornbluth*, 15 Cal. 3d 590, 607)). In the event a secured lender asserts a deficiency claim against the borrower or a guarantor, the court may then be required to determine the fair and reasonable market value of the mortgaged premises, thus limiting any deficiency judgment by a "fair market value" credit. *See, e.g.,* N.Y. Real Prop. Acts. Law § 1371; N.J. Stat. Ann. § 2A:50-3.

B. UCC Article 9 Remedies:

1. Enforcement Through a Judicial Process: A secured creditor may commence a judicial action generally in the form of filing a complaint and availing itself of prejudgment and postjudgment remedies.

2. UCC Article 9 further provides several options for a secured creditor to take ownership of collateral.

a. Public or Private Sale: UCC § 9-610 authorizes a secured creditor to complete a sale of collateral of a defaulting borrower, and to credit bid at such sale. Except when dealing with assets "of a kind that are customarily sold on a recognized market or the subject of widely distributed standard price quotations," the sale must be completed through a "public disposition." *See* U.C.C. § 9-610. Every aspect of the sale must be commercially reasonable.

b. Acceptance in Full or Partial Satisfaction: UCC § 9-620 authorizes a secured creditor to take title to its collateral in full or partial satisfaction of its secured claim. This can be a cheap and efficient way to obtain title to collateral if consensual. This remedy is not available if parties entitled to notice of the disposition object, including other parties asserting an interest in the collateral and, with respect to acceptance in partial satisfaction, guarantors of the secured debt.

IV. CREDIT BIDDING THE FULL FACE VALUE OF DEBT

A. A secured creditor may credit bid the amount of its entire claim, notwithstanding any valuation of the collateral pursuant to section 506(a) of the Bankruptcy Code. It is generally accepted that a secured creditor *can credit bid the full face amount of its debt*, not only the secured portion under § 506(a). *See Cohen v. KB Mezzanine Fund II, LP* (*In re SubMicron Systems Corp.*), 432 F.3d 448 (3d Cir. 2006); *John Hancock Mut. Life Ins. Co. v. California Hancock, Inc.* (*In re California Hancock, Inc.)*, 88 B.R. 226 (B.A.P. 9th Cir. 1988); *In re Realty Invs., Ltd. V*, 72 B.R. 143 (Bankr. C.D. Cal. 1987).

B. Whether a claim is secured or unsecured is determined pursuant to section 506(a) of the Bankruptcy Code and a secured creditor's claims can be split into a secured and an unsecured claim. Section 506(a)(1) provides that a secured creditor's claim is: "a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim." The provision goes on to mandate that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property." 11 U.S.C. § 506.

C. The general logic in this approach is that a secured creditor's bid of its debt sets the value of the company, because a secured lender will not bid more than what it believes will provide a fair return for its collateral.

> Assume that Debtor has a single asset: a truck, T. Lender is a secured creditor that has loaned Debtor $15, taking a security interest in T. Debtor is in Chapter 11 bankruptcy and has filed a 363 motion to sell T to Bidder for $10. Debtor argues that Lender can only credit bid $10 for T and must bid any excess in cash if it wishes to outbid B.
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> This hypothetical reveals the logical problem with an actual value bid cap. If Lender bids $12 for T, by definition $12 *becomes* the value of Lender's security interest in T. In this way, until Lender is paid in full, Lender can always overbid Bidder. (Naturally, Lender will not outbid Bidder unless Lender believes it could generate a greater return on T than the return for Lender represented by Bidder's offer.) As Lender holds a security interest in T, any amount bid for it up to the value of Lender's full claim becomes the secured portion of Lender's claim by definition. Given the weight of reason's demand that "it must be so," we see no reason to catalog the myriad other arguments that have been advanced to support this "interpretation."

SubMicron Systems, 432 F.3d at 448 (footnotes omitted).

V. CREDIT BID FOR COLLATERAL ONLY

Secured creditors may only credit bid on property over which they have a valid lien. If the secured creditor intends to acquire other unencumbered property, the creditor must generally pay cash or provide some other consideration.

A. *RealMex* – The DIP Order provided that if certain second lien noteholders acquired the DIP Lenders' interests in the "DIP Obligations," they could only use those DIP Obligations to credit bid on assets that were their prepetition collateral. *In re Real Mex Restaurants Inc.*, No. 11-13122, (Bankr. D. Del. Nov. 9, 2011), ECF No. 392 (order).

In the event a secured creditor is not properly collateralized in the subject collateral, it may attempt to fill those holes by providing a DIP loan secured by all of the debtor's assets, including any postpetition property.

DIP lenders/credit bidders may attempt to roll up their prepetition debt to obtain full DIP liens on all outstanding debt to strengthen a credit bid right. *See Keybank N.A. v. Franklin Advisers, Inc.*, 600 B.R. 214, 221-223 (S.D.N.Y. 2019).

B. *In re TPP Acquisition, Inc.* – The DIP order authorized a full rollup of prepetition debt, but the committee reserved the right, through a challenge proceeding, to unwind the rollup, including to carve back any rollup to the extent it covered any prepetition unencumbered assets. *TPP Acquisition Inc. dba The Picture People*, No. 16-33437 (Bankr. N.D. Tex. Oct. 7, 2016), ECF No. 230 (order).

DIP lenders may further insist on limitations on marshalling or similar doctrines in the DIP order that might limit a court's ability to require DIP collateral to be first used to satisfy new DIP funds. *See In re Gen. Wireless Operations Inc.,* No. 17-10506*,* 2017 Bankr LEXIS 3990 (Bankr. D. Del. Aug. 16, 2017).

VI. UNENCUMBERED ASSETS

A. *Real Mex Restaurants, Inc.*

1. In *Real Mex,* a Delaware bankruptcy court approved a sale of substantially all of the debtors' assets to a group of second lien noteholders. The consideration consisted of (i) an $80 million credit bid, (ii) $45 million cash (the amount necessary to pay the DIP), and (iii) assumed liabilities of approximately $38 million (although the value of this was in dispute). *See In re Real Mex Restaurants, Inc.,* No. 11-13122 (Bankr. D. Del. Dec. 30, 2011), ECF No. 685 (sale motion).

2. The committee argued that there was at least $25 million in unencumbered assets on the petition date, which only would have been encumbered pursuant to the DIP that rolled up the debtors' first lien notes. The court approved the sale, principally on the ground that there was no alternative and that, in the absence of the sale, the business would likely liquidate,

risking 11,000 jobs. *See id.* (Feb. 8, 2012), ECF No. 875 (committee sale objection).

3. The court approved the sale over the committee's objection. The court recognized that the non-credit bid consideration under the sale "was potentially attributable to unliened assets beyond the credit bid that applies to their collateral." *See id.* (Feb. 22, 2012), ECF No. 923 (sale order).

B. **Real Property Leases** – Real property leases generally constitute real property, and a secured lender must therefore record a lien in the real property lease by recording in the local jurisdiction. A UCC-1 financing statement is not sufficient.

C. **Assignment of Executory Contracts or Leases** – With certain exceptions, Bankruptcy Code section 365(f) restricts the enforceability of anti-assignment provisions in an executory contract or unexpired lease. In a case where such contracts or leases provide meaningful value to the debtor, one could argue that the increased value to the leases resulting from section 365(f) is not subject to any prepetition lien, and is "after-acquired" property or value. *See In re Tek-Aids Indus.,* 145 B.R. 253, 256 (Bankr. N.D. Ill. 1992) (holding a lender should not have a prepetition lien on rights that only arise as a result of debtor's bankruptcy).

D. **Avoidance Actions** – With limited exceptions, the majority of courts hold that avoidance actions are not subject to prepetition liens. *See*, *e.g.*, *Tek-Aids Indus.,* 145 B.R. at 256 ("Allowing a prepetition blanket security interest to reach preference actions would be tantamount to giving a creditor additional collateral it would not have had if the debtor had not filed a bankruptcy petition or had a petition filed against it. Such a windfall contradicts any notion of fair and equal treatment among creditors."). Purchasers will generally want to acquire the estate's preference actions with respect to vendors or lessors of assigned contracts or leases. Unless subject to a postpetition lien, such claims should be unencumbered assets that can only be acquired with a cash bid.

E. **Foreign Intellectual Property** – Perfection of foreign intellectual property generally requires action in the foreign jurisdiction, which is rarely undertaken.

F. **E&P Reserves (15% Reserves)** – There are often holes in a lender's perfected collateral package when the borrower is an E&P company. This is partially because credit documents often only require the lender to have perfected liens on 85% of proven reserves. This may be why three relatively recent E&P credit-bid sales involved meaningful cash payments or assumption of liabilities. *See Emerald Oil,* No. 16-10704 (Bankr. D. Del. Nov. 1, 2016), ECF No. 874 (order) ($94.5M credit bid, $16M cash, plus assumption of obligations); *RAAM Global Energy,* No. 15-35615 (Bankr S.D. Tex. Jan. 20, 2016), ECF No. 384 (order) ($58.8M credit bid, $2.5M cash, plus assumption of obligations); *Endeavour International*, No. 14-12308 (Bankr. D. Del. Oct. 16, 2015), ECF No. 985 (order) ($398M credit bid plus commitment to pay administrative expenses and to wind down U.S. operations).

G. **Liquor Licenses** – State law often prohibits the granting of security interests in liquor licenses, and in some cases proceeds of liquor licenses.

H. **Goodwill** – "Goodwill is 'an intangible asset that represents the ability of a company to generate earnings over and above the operating value of the company's other tangible and intangible assets.'" *Official Committee v. UMB Bank* (*In re Residential Capital, LLC)*, 501 B.R. 54549, 610 (Bankr. S.D.N.Y. 2013) (quoting *In re Prince*, 85 F.3d 314 (7th Cir. 1996)). Goodwill may include "name recognition, consumer brand loyalty, or special relationships with suppliers or customers." *Id.*

1. To value goodwill, generally accepted accounting principles ("GAAP") look to "any excess of [a] purchase price over the fair value of the assets acquired and the liabilities assumed." *Id.*

2. A debtor's "goodwill" has been held to be an asset of the debtor's estate. *Ackerman v. Schultz* (*In re Schultz)*, 250 B.R. 22 (Bankr. E.D.N.Y. 2000).

3. Goodwill is generally considered to be a general intangible. *E.g.*, *First City Nat'l Bank v. Mid-West Motors, Inc.* (*In re Mid-West Motors, Inc.)*, 82 B.R. 439 (Bankr. N.D. Tex. 1988); *United States v. Petersen*, 172 F.3d 60 (9th Cir. 1999) (unpublished). The Official Comments for UCC § 9-106 specifically stated that a debtor's goodwill is a general intangible, but they no longer do so. At least one court has held that this omission is evidence that goodwill is not a general intangible, but is rather an account. *Jahn v. Cohutta Banking Co.* (*In re U.S. Ins. Grp.)*, 429 B.R. 903 (E.D. Tenn. 2010).

4. If a debtor seeks to sell its business as a going concern to a secured lender pursuant to a credit bid, then (to the extent value in the company is attributable to the debtor's postpetition efforts or rights only available in bankruptcy) such value may not be encumbered by the secured lender's prepetition security interests and therefore may need to be paid for with cash.

5. Case law recognizing a secured creditor's right to credit bid the face amount of its debt is based on the rationale that a secured creditor's credit bid sets the value of the business. If a portion of that value is attributable to postpetition goodwill, a court may hold that the secured creditor must pay cash equivalent to the goodwill generated by the debtor after the petition date. *See, e.g., In re Suncruz Casinos, LLC*, 298 B.R. 833, 839 (Bankr. S.D. Fla. 2003).

VII. LIMITING A CREDIT BID FOR CAUSE

A. Bankruptcy Code section 363(k) provides that a secured creditor may credit bid in a sale of its collateral unless "*the court for cause orders otherwise*."

B. What Is Cause?

1. Improper conduct by the buyer. *See In re Aloha Airlines, Inc.*, No. 08-00337, 2009 Bankr. LEXIS 1085, at *2 (Bankr. D. Haw. Mar. 5, 2009).

2. Secured debt is in dispute. *See In re Merit Grp, Inc.*, 464 B.R. 240, 252 (Bankr. D.S.C. 2011) (collecting cases).

3. Failure to comply with procedural requirements established by the court for the sale of collateral. *See Greenblatt v. Steinberg,* 339 B.R. 458, 463 (N.D. Ill. 2006).

4. To avoid chilling the auction process.

a. *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 316 n.14 (3d Cir. 2010) ("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 Fisker Auto. Holdings*, 510 B.R. 55 (Bankr. D. Del. 2014); *In re Free Lance-Star Publ'g Co.*, 512 B.R. 798 (Bankr. E.D. Va. 2014).

b. A Delaware bankruptcy court limited a credit bid in connection with the sale of a hybrid car manufacturer's assets. Although the court limited the amount of the credit bid to the distressed purchase price actually paid for the debt, the court's focus was on the prospect that the credit-bid would chill bidding and that the full scope of the underlying lien was as yet undetermined. The court also expressed concern as to the expedited nature of the sale. *See Fisker Auto. Holdings,* 510 B.R. 55.

c. As noted by the American Bankruptcy Institute Commission to Study the Reform of Chapter 11, "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." 2012-2014 Final Report and Recommendations 147 (2014).

5. "Cause" is generally assessed on a case-by-case basis.

C. Companies are often financed with more than one tranche of debt and have first-lien securities, second-lien securities and sometimes even third-lien securities. When more than one tranche of debt exists and one or more tranche or holder wants to credit bid, it may create issues for the debtor and other constituents to negotiate or litigate:

1. **Determining the fulcrum security** – Courts have held that wholly underwater junior secured creditors cannot credit bid their debt. *See, e.g.*, *In re Battershell*, 603 B.R. 86, 90 (Bankr. D.N.M. 2019); *see also* ***In re***

Valley Bldg. Supply, 39 B.R. 131 (Bankr. D. Vt. 1984); *In re Lahaina Venturers*, 41 B.R. 357 (Bankr. D. Haw. 1984). The debtor may need to determine which is the fulcrum security or the place in the capital structure where value is insufficient to pay the security in full. *See BOKF, NA v. Wilmington Sav. Fund Soc'y, FSB (In re MPM Silicones, L.L.C.)*, 596 B.R. 416, 422 (S.D.N.Y. 2018). There are cases in which loan-to-own hedge funds have purchased the wrong security which is out of the money. Distressed valuation is only fully tested in an arm's length open-sale process, which may not be achievable in a credit bidding scenario. *See*, *e.g.*, Christie Smythe, *Fulcrum Deals Rising to Prominence, Experts Say*, Law360.com (Oct. 9, 2009), http://www.law360.com/securities/articles/122360/-fulcrum-deals-rising-to-prominence-experts-say ("As companies mired in debt continue to seek refuge in bankruptcy court, popularity is growing in so-called fulcrum investing, a risky bet placed on debt securities bought on the cheap and expected to be converted into equity holdings through the restructuring process . . . .").

2. **Cash versus non-cash bidding** – When a tranche of debt has more than one holder, the debt holders do not always agree on a path forward. Some may want to own the company going forward while others are more inclined to take as much cash as possible. Again, valuation may come into play as the debt holders negotiate how much of each bid must be in cash to satisfy those non-credit bidding debt holders. *See* David W. Marston, *Distressed Debt: Forget the Vultures, Your Lenders May be Circling* (Sept. 8, 2009), http://www.gibbonslaw.com/news_publications/articles.php?action=display_publication&publication_id=2879 ("The fulcrum security is the security most likely to be converted into equity in a reorganized company.").

VIII. RECENT TRENDS IN CREDIT BIDDING OF ASSETS AND CROSS-BORDER ISSUES

A. CREDIT BIDDING IN CANADA

1. Credit bidding has no statutory basis in Canada and is subject to judicial discretion of courts. *See Century Services Inc. v. Canada,* 2010 SCC 60.

a. Whereas credit bidding is a right found in the US Bankruptcy Code, in the Canadian context the ability to credit bid is established through credit agreements and security documents. *See Canwest Publishing,* 2010 ONSC 222; *White Birch Holding Co.,* 2010 QCCS 4915.

b. Rise in popularity in connection with increasing use of sale of all or substantially all of debtor's assets.

i. Sale processes are often procedure of choice for large-scale assets.

c. Risks

i. **Governance disputes**: Interlender disputes are not entertained by CCAA court (In *White Birch*, e.g., all minority lenders were bound to the instruction from majority lenders by terms of first-lien credit agreement directing agents to credit bid on authorization from majority lenders; minority would be "dragged along" with results of instruction and were bound to it.).

ii. Potential to "chill" market: A senior secured creditor influencing a sale process could yield weakened confidence in the fairness and transparency of the process which in turn could lead to fewer third party bids.

iii. Appeals to court: Once a sale process has been sanctioned by the court, appeals are often no longer entertained and therefore outcome of bid cannot be changed.

d. What does the CCAA say?

i. The CCAA does not expressly provide secured creditors the right to credit bid their debt in this manner, but the practice has been widely accepted in Canadian insolvency proceedings.

ii. Credit bid must be put forward in a process that is fair and transparent, and demonstrates the appropriate value that has been given for the business and that demonstrates that the credit bidder did not assert any undue influence or control over a process through which it seeks to benefit.

iii. Section 36 of the CCAA:

> **36 (1)** A debtor company in respect of which an order has been made under this Act may not sell or otherwise dispose of assets outside the ordinary course of business unless authorized to do so by a court. Despite any requirement for shareholder approval, including one under federal or provincial law, the court may authorize the sale or disposition even if shareholder approval was not obtained.
>
> **36 (3)** In deciding whether to grant the authorization, the court is to consider, among other things,

(a) whether the process leading to the proposed sale or disposition was reasonable in the circumstances;

(b) whether the monitor approved the process leading to the proposed sale or disposition;

(c) whether the monitor filed with the court a report stating that in their opinion the sale or disposition would be more beneficial to the creditors than a sale or disposition under a bankruptcy;

(d) the extent to which the creditors were consulted;

(e) the effects of the proposed sale or disposition on the creditors and other interested parties; and

(f) whether the consideration to be received for the assets is reasonable and fair, taking into account their market value.

36 (4) If the proposed sale or disposition is to a person who is related to the company, the court may, after considering the factors referred to in subsection (3), grant the authorization only if it is satisfied that

(a) good faith efforts were made to sell or otherwise dispose of the assets to persons who are not related to the company; and

(b) the consideration to be received is superior to the consideration that would be received under any other offer made in accordance with the process leading to the proposed sale or disposition.

36 (6) The court may authorize a sale or disposition free and clear of any security, charge or other restriction and, if it does, it shall also order that other assets of the company or the proceeds of the sale or disposition be subject to a security, charge or other restriction in favour of the creditor whose security, charge or other restriction is to be affected by the order.

iv. If sale is to a related party, standard is higher (CCAA section 36(4).

v. Voting requirements under section 6 (simple majority in number representing 2/3 in value of creditors or creditor class) still required.

e. What does CCAA case law say?

i. Credit bidding has no statutory basis in Canada; subject to judicial discretion.

ii. *Royal Bankr v. Soundair Corp.* principles (1991 CarswllOnt 205) for sale approval (focus on process rather than higher price):

1. Whether sufficient effort has been made by the debtor to get the best price for the assets

2. The interests of all parties

3. Efficacy and integrity of the process by which offers were obtained by the debtor

4. Whether the process was unfair

iii. *Maax Corp,* 2008 CarswellQue 15021.

1. Quebec Superior Court approved bidding procedures that encompassed credit bidding – stands for argument that right to credit bid is "not inconsistent" with the terms of the CCAA.

2. Credit bidding acceptable under CCAA and under Quebec provincial law (Code of Civil Procedure).

3. Cited in *White Birch*, 2010 QCSC 4915.

iv. *Eddie Bauer,* 2009 CarswellOnt 5450.

1. Chapter 11 proceedings and CCAA proceedings – joint hearing on approval of sale and vesting order.

2. Court-approved bidding procedures that encompassed credit bidding – stands for argument that right to credit bid is allowed within the terms of the CCAA (same as above).

3. Under SISP (Sale and Investor Solicitation Process), the credit bid had to include a cash amount for any assets upon which the DIP lenders, prepetition revolving lenders, prepetition term

lenders or other participants (if joint credit bid) did not have a valid and perfected first priority prepetition security interest and such assets were sought to be obtained through the credit bid.

4. Joint credit bidding was allowed: DIP lender/prepetition revolving lender/prepetition term lender submits bid directly or indirectly by way of equity investment, contract, or other type of arrangement with any partner, investors, joint ventures, other co-bidder or any person that is not the DIP lender/prepetition revolving lender/pre-petition term lender.

v. *Brainhunter Inc,* 2009 CarswellOnt 8207 (Ont SCJ).

1. Approved in form but not in explicitly labelled as "credit bidding."

2. The court approved the use of secured notes held by creditors as "additional consideration in the auction if it were necessary to increase its bid."

3. The credit bid was ultimately not employed because it was merely an additional resource to outbid other interested parties – seems to stand for proposition that credit bidding is allowable but not guaranteed by the court in the circumstances.

4. If there is no specific legislation stating otherwise (i.e. the CCAA), a secured creditor cannot be guaranteed that it can use credit bidding with respect to an auction/sales process unless court approval is sought.

vi. *Canwest Publishing,* 2010 ONSC 222: Implicit acceptance of credit bidding in Canadian restructuring law

1. The debtors asked for a SISP approval backstopped by a credit acquisition put forward by the secured lenders.

vii. *White Birch Paper,* 2010 QCCS 4915: Also permitting credit bidding (stalking horse and winning bidder acquired the assets in part by way of credit bid through CCAA auction process).

1. Relied heavily on the fact that bidding procedures had made mention of the lenders' option to credit bid, in addition to the security agreements, as

support in their decision to approve the lenders as the winning bidder.

viii. *PCAS Patient Care Automation Servs.,* 2012 ONSC 2840.

1. Stalking horse credit bid by DIP lender – looked to *Soundair* principles.

2. Cites *CCM Master* (referenced below): "the use of stalking horse bids to set a baseline for the bidding process, including credit bid stalking horses, has been recognized by Canadian courts as a reasonable and useful element of a sales process. Stalking horse bids have been approved for use in other receivership proceedings, BIA proposals, and CCAA proceedings."

3. Credit bid was put forth in a way that allowed sufficient opportunity for interested parties to come forward with superior offers while recognizing the Company's urgent need to effect a transaction (cites *Canwest*)

f. What does Bankruptcy and Insolvency Act (BIA) say?

i. Proposal Proceedings

1. Section 65.13 of the BIA: restriction on disposition of assets – similar language to section 36 of the CCAA.

ii. In a Receivership

2. Section 248(1) of the BIA.

g. What does Receivership case law say?

i. *Montrose Mortgage Corp. v Kingsway Arms Ottawa,* 2013 ONSC 6905: court authorized immediate completion of a credit bid transaction in respect of a retirement residence ("quick flip" involving appointment of receiver and immediately seeking court approval of a "pre-pack" sale transaction may represent best/only alternative to liquidation).

ii. *CCM Master,* 2012 ONSC 1750; *Canrock Ventures LLC,* 2011 ONSC 2308 – both involve receiverships.

iii. *Parlay Entertainment,* 2011 ONSC 3492.

B. RECENT INTERNATIONAL ISSUES IN CROSS-BORDER PROCEEDINGS

1. Update on DIP Financing (Rollup and Extending Security Over Canadian Assets)

a. Statutory objective to allow the debtor time and breathing space to facilitate a going concern solution which ultimately maximizes value and benefits.

2. No judicial consensus yet or fully reasoned analysis as the permissibility of rollups or creeping rollups based on varying case law (largely a result of varying interpretations of section 11.2, which provides that a DIP charge may not secure an obligation that exists before the order approving the DIP financing is made).

a. What does CCAA say?

i. **Section 11.2**: On plain reading, a DIP charge cannot secure prefiling obligation but payment of prefiling indebtedness is not the same as securing prefiling indebtedness.

[Note: This language comes into force on November 1, 2019, i.e., limit relief provided under section 11 to what is reasonably necessary]

11.001

An order made under section 11 at the same time as an order made under subsection 11.02(1) or during the period referred to in an order made under that subsection with respect to an initial application shall be limited to relief that is reasonably necessary for the continued operations of the debtor company in the ordinary course of business during that period.

11.2(1) Interim financing

On application by a debtor company and on notice to the secured creditors who are likely to be affected by the security or charge, a court may make an order declaring that all or part of the company's property is subject to a security or charge—in an amount that the court considers appropriate—in favour of a person specified in the order who agrees to lend to the company an amount approved by

the court as being required by the company, having regard to its cash-flow statement. The security or charge may not secure an obligation that exists before the order is made

[Note: This language comes into force on November 1, 2019, i.e., limit relief provided under section 11 to what is reasonably necessary] Additional factor — initial application

11.2 (5)

When an application is made under subsection (1) at the same time as an initial application referred to in subsection 11.02(1) or during the period referred to in an order made under that subsection, no order shall be made under subsection (1) unless the court is also satisfied that the terms of the loan are limited to what is reasonably necessary for the continued operations of the debtor company in the ordinary course of business during that period.

b. What does case law say?

Must demonstrate that there will be appropriate benefits as well as no prejudice to stakeholders as a result of the court authorization (monitor can provide opinion re: prefiling lender's security, no alteration of status quo re relative priorities of other creditors, DIP lender not obtaining undue advantage, stakeholders given adequate notice of DIP approval motion, availability of mechanic to reverse roll up if challenged).

i. ***White Birch*, 2010 QCCS 4915:** Quebec court approved DIP financing and corresponding superpriority charge, notwithstanding the $50M of the $140M DIP proceeds would directly repay and discharge the prefiling asset-based revolving credit facility extended by the DIP lender.

1. Minority lenders' leave to appeal at QCCA denied.

2. Terms of underlying credit and security documentation are highly relevant to secured party's right to credit bid/its agent's right to credit bid on its behalf.

ii. ***Hartford Computer Hardware Inc.*, 2012 ONSC 964:** Court expressly held that the roll-up provision would not otherwise be permissible under section 11.2 of the CCAA

1. In *White Birch*, priming DIP charge did not secure any obligations that were owing prefiling

2. After *Hartford*, creeping rollups were apparently permissible under section 11.2 on the basis of maintaining the existing cash management system of the debtor in connection with an ABL facility.

iii. ***Comark, Inc.,* 2015 ONSC 2010:** Court approved DIP financing facility that in essence provided a creeping rollup on basis of approval of existing cash management system being used in connection with the company's ABL facility.

1. Also the basis of the court's approval of a creeping rollup in *Golftown Canada Inc.,* No. 16-11527-00CL (OSCJ [Commercial List]) (dual plenary CCAA and Ch. 11 proceedings).

iv. ***Xinergy, Ltd.,* 2015 ONSC 2692.**

1. US court authorized use of proceeds of DIP facility to pay out first-lien loans (rollup provision)

2. CCAA court held that this could not be ordered in a CCAA proceeding because of section 11.2(1) of the CCAA (can't secure an obligation that existed prior to the Initial Order), but CCAA court determined that the issue was whether it should recognize the US order under the principles of comity (section 44, Part IV of CCAA).

3. Cited *Hartford Computer* (above), which recognized rollup provision.

4. Court must be satisfied that it is necessary to protect the debtor's property or is in the interests of its creditors.

5. CCAA court and proposed information officer did not think there would be any material prejudice to Canadian creditors if the DIP facility were to be recognized.

v. ***Performance Sports Group,* 2016 ONSC 6800:** Court approved creeping rollup explicitly (rather than on basis of cash management in connection with an ABL Facility), but distinguished creeping rollup from rollup; the former, the court held, is permitted under the CCAA.

vi. ***Toys R Us,*** **2017 ONSC 5571:** Less than a year after *Performance Sports Group,* the court approved full rollup (also dual plenary proceedings).

1. Can prepetition secured lenders get additional security over Canadian assets through DIP charge?

vii. ***Colt Holding Co,*** **2015 ONSC 3928**

1. Cross-border recognition proceedings and section 363 sales process ensured continuation of business as going concern.

2. As in *Xinergy,* CCAA court recognized the need for cross-border cooperation, notwithstanding the prohibition under section 11.2 of the CCAA.

3. Two DIP facilities from the existing secured lenders

4. In best interests of Colt Canada as "borrower and guarantor" under the DIP facilities and such obligations will not result in any material prejudice to Colt Canada's stakeholders

5. Superpriority charges granted on the chapter 11 debtors' property in Canada

6. Appropriate under part IV of the CCAA and necessary to protect the debtor's property.

viii. **Zochem (*Horsehead Holdings*, 2016 ONSC 958)**

1. Cross-border recognition proceedings

2. Debtors reached agreement for senior secured superpriority DIP credit facility to allow Zochem to pay off obligations to U.S. bank and to finance debtors' operations and chapter 11 proceedings.

3. Condition of advance under DIP facility was granting of superpriority charge over assets of debtors in Canada in favour of DIP lender.

4. Decision cited *Xinergy*, 2015 ONSC 2692: When recognizing a financing order granted by a foreign court, consideration should be given as to whether there would be any material adverse interest to any Canadian interests.

ix. ***Payless Holdings,*** **2017 ONSC 2321**

1. Court refused to recognize an interim DIP order approved under chapter 11 on basis that it would be detrimental to Canadian landlord creditors as a result of cross-collateralization of the DIP (under that DIP, the Payless Canada Group would effectively become jointly liable with the US debtors under ABL credit facility prior to filing date, AND Payless Canada Group would become liable for new obligations of US debtors in connection with DIP ABL credit facility).

2. The debtors attempted to structure DIP so priorities were not altered: major supplier got critical vendor charge, unsecured trade creditors got unsecured creditors' charge, employees were paid in the ordinary course and protected by prepetition wages and benefits order BUT landlords had no comparable protection from impact of rollup.

x. ***Jack Cooper***

1. Also cross-border recognition proceedings

2. CCAA court approved DIP ABL facility with full rollup provision such that upon the entry of the interim DIP order, the borrowers shall borrow loans in an amount sufficient to repay all outstanding principal, accrued interest, accrued fees and expenses, and any other indebtedness and amounts owing the ABL facility.

3. No impediment to granting approval of interim DIP financing including a full rollup provision in foreign recognition proceedings under Part IV of the CCAA.

4. Consistent with the findings of the U.S. court that relief requested necessary for the protection of the Jack Cooper Group's property and for the interests of creditors in Canada and the U.S.