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Chapman Client Alert

August 31, 2016 Current Issues Relevant to Our Clients

Credit Bidding: Has the "Fisker" Threat Subsided?

A recent bankruptcy court decision in the Aéropostale bankruptcy case pending in the bankruptcy court for the Southern District of New York may provide some comfort to secured creditors seeking to credit bid (*i.e.*, to bid the amount of secured debt owed to a creditor rather than cash) in a sale process commenced by a debtor pursuant to Section 363 of the U.S. Bankruptcy Code (a *"Section 363 Sale"*). On August 26, 2016, after a week-long trial, Judge Sean Lane ruled that Sycamore Partners and its affiliates (*"Sycamore"*) could credit bid up to the full amount of its $150 million pre-petition secured loan at a Section 363 Sale of the assets of debtor Aéropostale, Inc. and its affiliates (the *"Debtors"*).[1]

The Debtors, relying on several 2014 bankruptcy court decisions that limited the ability of secured creditors to credit bid, argued that Sycamore should not be permitted to credit bid its loan because (i) permitting Sycamore to credit bid would chill other bidders from participating in the bidding process and (ii) Sycamore's debt should be equitably subordinated because its bad acts had pushed the Debtors into bankruptcy. The court overruled both claims and permitted Sycamore to credit bid up the full amount of its loan to the Debtors.

The *Aéropostale* decision provides some comfort that while a potential credit bid by a secured lender may chill other bidders from participating in an auction process, this fact, in and of itself, is insufficient to cause a court to limit a secured creditor's right to credit bid in such sale process. Nevertheless, secured creditors need to remain mindful of their actions and interactions with debtors both before and after a debtor has decided to commence a Section 363 Sale process, so as not to engage in conduct that could give rise to limiting their right to credit bid.

The Section 363 Sale Process and the 2014 Court Decisions

Section 363 of the Bankruptcy Code permits a debtor to sell all or substantially all of its assets free and clear of all liens. This provision, likewise, permits a holder of an allowed secured claim against a debtor to credit bid its loans in a Section 363 Sale, unless a court, for "cause," orders otherwise.[2] Prior to 2014, the bankruptcy courts had generally limited "cause" to situations in which a secured creditor had engaged in egregious misconduct (*i.e.*, such as collusion) and were largely unsympathetic to arguments that credit bidding should be precluded because it would chill the bidding process.

In two previous client alerts,[3] we discussed the potential implications of two 2014 bankruptcy court decisions from the District of Delaware and the Eastern District of Virginia — *In re Free Lance-Star Publishing Co. of Fredericksburg, Va.* and *In re Fisker Automotive Holdings, Inc.* — that had raised serious concerns for secured lenders and purchasers of secured loans in the secondary market.[4] In *Free Lance-Star* and *Fisker Automotive*, the respective bankruptcy courts severely limited the ability of the secured creditors in question to credit bid their secured claims.

Specifically, in *Free Lance-Star*, the secured creditor had purchased an existing $50.8 million loan to the debtor. The debtor commenced a Section 363 Sale process, and the secured creditor attempted to credit bid its $38 million secured claim against the debtor. Upon objection by the debtor and the unsecured creditors committee, the bankruptcy court entered an order limiting the secured creditor's right to credit bid to $13.9 million, and concluded that:

> [t]he confluence of (i) [the secured creditor's] less than fully secured lien status; (ii) [the secured creditor's] overly zealous loan to own strategy; and (iii) the negative impact of [the secured creditor's] misconduct has had on the auction process has created the perfect storm, requiring curtailment of [the secured creditor's] credit bid rights.

Similarly, in *Fisker Automotive*, the bankruptcy court limited a secured creditor's right to credit bid its $169 million secured claim to the $25 million that the secured creditor paid for its claim. The bankruptcy court found that cause existed to limit the secured creditor's rights due to (i) the desire not to chill bidding at the Section 363 Sale and (ii) concerns raised by

unsecured creditors regarding the extent and validity of the secured creditor's liens on certain assets being sold.

As discussed in our previous Client Alerts, the *Free Lance-Star* and *Fisker Automotive* cases broke new ground by expansively interpreting "cause" under Section 363(k) of the Bankruptcy Code to include situations where a court has determined that capping a credit bid would foster a "robust," "competitive" and "open" sale process and found a "loan to own" investment strategy by a secured creditor suspect. Courts had previously limited "cause" to clearly egregious conduct by a lender and not just the fact that credit bidding could chill bidding in the Section 363 sale process.

The *Aéropostale* opinion follows more closely with the traditional understanding of Section 363 to permit the secured creditor to fully credit bid its claim and may serve to limit the impact of *Free Lance-Star* and *Fisker Automotive*.

The Aéropostale Decision

In *Aéropostale*, the Debtors sought to sell substantially all of their assets pursuant to a chapter 11 plan of reorganization. The Debtors also sought to disqualify Sycamore from credit bidding at the proposed sale, and sought to equitability subordinate and recharacterize Sycamore's claims against the Debtors.

Sycamore and the Debtors were connected in multiple ways. First, two affiliates of Sycamore had made a $150 million prepetition secured term loan to the Debtors. As a condition to the term loan, Sycamore had required the Debtors to enter into a sourcing agreement with an entity owned by Sycamore, from which the Debtors would purchase approximately 30 percent of their merchandise. Additionally, Sycamore, through an affiliate, owned 8 percent of the common stock of the Debtors, and also owned preferred stock that represented 5 percent of Aéropostale common stock as of May 23, 2014. Finally, through an investor rights agreement, a Sycamore-related entity had the right to appoint up to two members to the Aéropostale board of directors.

Over the course of a five-day trial, the Debtors attempted to paint a picture of egregious conduct by Sycamore and its affiliates that ultimately led to the bankruptcy of the Debtors. The Debtors additionally asserted that permitting the Sycamore entities to credit bid their $150 million secured claim would have a chilling effect on the Debtors' sale process that should not be permitted. The bankruptcy court overruled both arguments.

In its decision, the bankruptcy court noted that although a court has discretion to deny credit bidding to the extent there is "cause," this "discretion does not give the bankruptcy court the authority to act arbitrarily or to be freewheeling. In other words, the standard is not standardless."[5] In reviewing the facts, the bankruptcy court found no inequitable conduct on the part of Sycamore that would limit its ability to credit bid, specifically finding that the Debtors made no allegations of collusion, undisclosed agreements, or any other action taken that was designed to chill bidding or unfairly distort the bidding process. In fact, the bankruptcy court found that the Sycamore entities had been "relatively cooperative" throughout the process, which was consistent with Sycamore exercising its own legal rights.[6]

Additionally, with respect to the Debtors' arguments that Sycamore's debt should be equitably subordinated and therefore Sycamore should not be permitted to credit bid such debt, the court noted that:

> the question is whether a party planning to exercise its rights as a creditor takes actions that step over the line into impermissible conduct to further its interests in a way that damages a debtor or the bankruptcy estate. The [c]ourt does not find such conduct here. Instead, the totality of the credible evidence at trial demonstrates that [Sycamore] did not take actions beyond what was proper to protect their interests.[7]

Therefore, contrary to the Debtors' assertions, based upon expert testimony and its review of the facts, the court determined that Sycamore's actions were not a part of a scheme to force the Debtors to file a chapter 11 bankruptcy petition. Also important to the court was that Sycamore's equity interests in Aéropostale were more valuable if Aéropostale survived.

The court then addressed the Debtors' arguments, relying on the *Free Lance-Star* and *Fisker Automotive* cases, that permitting Sycamore to credit bid would impermissibly chill bidding at the Section 363 Sale. With respect to the *Fisker Automotive* decision, the *Aéropostale* court noted that the chilling of bidding, alone, was not sufficient to justify prohibiting credit bidding and minimized *Fisker Automotive* by noting that the *Fisker Automotive* court had been concerned by "other problematic conduct" in that the secured creditor in *Fisker Automotive* had "insisted on an unfair process."[8] Additionally, the *Aéropostale* court limited the implications of *Free Lance-Star* by noting that although the case referenced a

concern about chilling bidding, the case also involved inequitable conduct wherein the creditor had attempted to "depress the sale price" of the debtor.[9] Finally, the bankruptcy court relied on the factual record of the case, in that several parties were interested in the sale process, and parties beyond Sycamore were expected to submit bids. Based on its findings, the court permitted Sycamore to credit bid the full amount of its claim.

Conclusion

The *Aéropostale* decision should provide secured creditors with some comfort that the bar to preclude or limit secured creditors' rights to credit bid has been raised. Importantly, the court was clear that the potential chilling effect of a credit bid, in and of itself, is not sufficient for a court to find cause to preclude or limit a credit bid under Section 363(k) of the Bankruptcy Code. Moreover, the court's careful analysis suggests that the pursuit of contractual remedies should not give rise to "cause" so long as such conduct does not "step over the line" into impermissible conduct.

Secured creditors, however, must continue to be mindful of their conduct in relation to a potential Section 363 Sale, especially given that the *Fisker Automotive* and *Free Lance-Star* cases remain valid cases that other bankruptcy courts may find persuasive. Moreover, the *Aéropostale* bankruptcy court also relied on the fact that multiple parties intended to bid at the Section 363 Sale and it is unclear how the court would have ruled had no other party expressed interest in the Debtors' assets.

As we have previously advised, secured lenders and purchasers of loans on the secondary market should continue to take steps to protect themselves in the event of a potential bankruptcy by (i) ensuring that their liens remain valid and perfected, (ii) being proactive in a Section 363 Sale process by offering non-credit bidding considerations (*i.e.*, cash or assumption of liabilities) to the extent it is seeking to acquire unencumbered assets and (iii) avoiding seeking overly aggressive timetables or constraints on the debtor's ability to fully and appropriately marketing the assets being sold.

Although *Aéropostale* offers comfort to the secured lender, the above-listed measures remain prudent and sensible to help a secured lender protect itself in the event of a Section 363 Sale.

For More Information

If you would like further information concerning the matters discussed in this article, please contact any of the following attorneys or the Chapman attorney with whom you regularly work:

Laura E. Appleby
New York
212.655.2512
appleby@chapman.com

Larry G. Halperin
New York
212.655.2517
halperin@chapman.com

Michael Friedman
New York
212.655.2508
friedman@chapman.com

1 Memorandum of Decision, *In re Aéropostale, Inc.*, Case No. 16-11275 (Bankr. S.D.N.Y. Aug. 26, 2016) [Docket No. 724] [hereinafter, Mem. Op.].

2 11 U.S.C. § 363(k).

3 *See* "New Challenge to Credit Bidding — Distressed Debt Purchasers Beware" (February 12, 2014), http://www.chapman.com/insights-publications-254.html; and "Recent Challenges to Credit Bidding — A New Trend?" (May 13, 2014), http://www.chapman.com/insights-publications-290.html.

4 *In re Free Lance-Star Publishing Co. of Fredericksburg, Va.*, 512 B.R. 798 (Bankr. E.D. Va. 2014); *In re Fisker Automotive Holdings, Inc. et al.*, 510 B.R. 55 (Bankr. D. Del. 2014).

5 *Mem. Op.* at 73 (internal citation omitted).

6 *Id*. at 75.

7 *Id*. at 63.

8 *Id*. at 76–77.

9 *Id*. at 77–78.

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