

Client Alert

Current Issues Relevant to Our Clients

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New Challenge to Credit Bidding - Distressed Debt Purchasers Beware

The right of a secured creditor to “credit bid” (i.e., to bid the amount of debt owed rather than cash) in a debtor’s sale of assets, once thought to be rock solid, is again under attack. A recent decision in the *Fisker Automotive* case¹ is very troubling in that it severely limited a secured creditor’s right to credit bid by capping the amount of the credit bid at the purchase price paid to acquire the secured claim. The Bankruptcy Court in *Fisker Automotive* held that “cause” existed under Section 363(k) of the Bankruptcy Code to limit the secured creditor’s credit bid because (i) doing so would promote an active auction and (ii) there were concerns regarding the extent and validity of the secured creditor’s liens on some of the assets that were to be sold. The secured creditor appealed the Bankruptcy Court’s decision, but the District Court declined to hear the appeal and, in its decision, lent support to the Bankruptcy Court’s ruling. As it stands, the *Fisker Automotive* decision presents a serious challenge to secured creditors and purchasers of distressed loans in the secondary market.

Right to Credit Bid

Section 363(k) of the Bankruptcy Code provides that a holder of an allowed secured claim may credit bid at a sale held by a debtor in a chapter 11 proceeding (a “363 Sale”) unless the court for cause orders otherwise.² Under the Bankruptcy Code, unless the debtor or another party in interest objects to a claim, a properly filed claim is deemed to be an allowed claim.³

The secured creditor’s right to credit bid in a 363 Sale has long been a bedrock bankruptcy principle. However, in the *Philadelphia Newspapers* case, the debtors attempted to circumvent this provision by selling their assets pursuant to a plan of reorganization rather than pursuant to

Section 363, arguing that a secured creditor’s right to credit bid did not apply to a sale under a plan of reorganization. The Bankruptcy Court in *Philadelphia Newspapers* confirmed the debtor’s plan and held that the secured creditor’s right to credit bid did not apply to a sale under a plan of reorganization. The Third Circuit upheld the confirmation of the chapter 11 plan that denied the secured creditor the right to credit bid.⁴

In May of 2012, the Supreme Court seemingly ended the controversy engendered by *Philadelphia Newspapers* when it upheld the right of secured creditors to credit bid their debt at a sale of the secured creditor’s collateral under a plan of reorganization.⁵ The *RadLAX* decision effectively overturned the Third Circuit’s decision in *Philadelphia Newspapers*.

However, the *Fisker Automotive* case has reignited this controversy by challenging certain bedrock principles: (i) that a secured creditor may credit bid its entire claim in a 363 Sale unless “cause” is shown so as to disallow such credit bid; and (ii) that the price paid by a purchaser of a loan or claim is irrelevant to the amount of the creditor’s claim and its right to enforce such claim.

Proposed Asset Sale and Committee’s Objection

The facts in *Fisker Automotive* are not complicated and are similar to many other cases in which secured creditors seek to credit bid their secured claims. The senior secured creditor purchased approximately \$169 million of secured debt from a third party for \$25 million. The debtor then filed its chapter 11 case and sought court approval for a private sale of substantially all of its assets to the secured creditor pursuant to a 363 Sale. The consideration for the purchase included \$75 million in the form of a credit bid, waiver of the remaining secured debt, assumption of certain liabilities and payment of additional cash.

¹ *In re Fisker Automotive Holdings, Inc., et al.*, Case No. 13-13087 (KG) (Bankr. D. Del. Jan. 17, 2014) [Docket No. 483].

² See 11 U.S.C. § 363(k).

³ See 11 U.S.C. § 502(a).

⁴ *In re Philadelphia Newspapers, LLC*, 559 F.3d 298 (3d Cir. 2010).

⁵ *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012).

The creditors' committee opposed the proposed sale and, in particular, the secured creditor's right to credit bid. The committee instead proposed a public auction with another party serving as the stalking-horse bidder. The committee argued that no credit bid should be allowed because it would chill bidding; in fact, the committee stated that there would be no auction at all if the secured creditor's ability to credit bid were not curtailed or capped, as the other interested bidder would not bid more than the amount of the secured party's secured claim.

The committee also raised concerns regarding the extent and validity of the secured creditor's liens and argued that no credit bid right existed where assets being sold included a mix of secured collateral, disputed collateral and unencumbered collateral.⁶ As a fallback position, the committee suggested that any credit bid be capped at \$25 million, the price the secured creditor paid to purchase the secured claim, because that amount was the best evidence of the value of the collateral securing the secured claim.

Limitation on the Right to Credit Bid

The Bankruptcy Court held that "cause" existed under Section 363(k) of the Bankruptcy Code to limit the secured creditor's right to credit bid for two reasons: (i) the desire to foster a competitive bidding process; and (ii) concerns raised by the committee regarding the extent and validity of the secured party's liens on some of the assets that were being sold. The Bankruptcy Court then capped the secured creditor's credit bid at \$25 million, the purchase price for the secured claim.

The Bankruptcy Court appeared to be deeply concerned with the speed at which the proposed sale was proceeding and believed that the "drop-dead" date initially proposed by the secured creditor was fabricated and designed to put pressure on other creditors and the Court. In the Bankruptcy Court's view, the rush to sell the assets was "inconsistent with the notions of fairness in the bankruptcy process."⁷

Denial of Appeal

The secured creditor immediately appealed the Bankruptcy Court's decision to the District Court and requested an expedited hearing on the appeal. On February 7, 2014, the District Court refused to hear the

appeal, finding that the decision was not ripe for appeal because the Bankruptcy Court had not yet fully resolved the issue of the validity of the secured creditor's liens or how the proceeds of the auction would be distributed.⁸

In its February 7 ruling, the District Court confirmed the power of Bankruptcy Courts under the plain language of Section 363(k) to deny or limit a secured creditor's right to credit bid and stated that the desire to foster a competitive bidding environment was an appropriate reason for denying this right. In addition, the fact that the secured creditor could be reimbursed out of the proceeds of the auction, if it was ultimately determined that its credit bid should not have been capped, was sufficient reason for the District Court to deny hearing the appeal.

Issues and Concerns

The *Fisker Automotive* case is extremely troubling to secured creditors and purchasers of secured claims in the secondary market. Although only a small number of cases have directly addressed the issue of what constitutes "cause" under Section 363(k) of the Bankruptcy Code to limit or deny a secured creditor's right to credit bid, until now, courts that have denied this right have generally done so only in cases where secured creditors have engaged in misconduct or wrongdoing, or in instances where there have been bona fide disputes regarding the perfection of a secured creditor's liens.⁹

In almost any bankruptcy auction, the ability of a secured creditor to credit bid will, to a certain extent, chill bidding and in some instances may even obviate an auction if the secured claim greatly exceeds the perceived value of the assets. It is equally true that in many asset sales, there is a mix of secured collateral, disputed collateral and unencumbered collateral that is being sold, and there may be concerns or allegations regarding the extent and/or validity of the secured creditor's liens on various collateral. Courts have generally dealt with credit bids involving the sale of mixed assets by permitting the secured creditor to credit bid up to the full amount of the secured claim with respect to the secured collateral, but requiring that the secured creditor provide other consideration for collateral that is ultimately determined to be unencumbered. In some

⁸ *In re Fisker Automotive Holdings, Inc. et al.*, Case No. 14-CV-99 (GMS) (D. Del. Feb. 7, 2014) [Docket No. 34].

⁹ Just recently, the Bankruptcy Court in the *Florida Gaming Centers* bankruptcy proceeding held that a secured creditor's credit bid could not include components of the creditor's claim that had been disallowed in a separate adversary proceeding and referred the parties to mediation to determine the amount the secured creditor would be allowed to credit bid. *In re Florida Gaming Centers, Inc. et al.*, Case No. 13-29597 (RAM) (Bankr. Ct. S.D. Fla. Feb. 5, 2014) [Docket No. 305].

⁶ The collateral in dispute consisted primarily of (i) foreign intellectual property, (ii) approximately six vehicles in the U.S. and (iii) certain vehicles located in other countries.

⁷ *In re Fisker Automotive*, Case No. 13-13087 KG) (Bankr. D. Del. Jan. 17, 2014) at 10.

cases, where the value of the unencumbered collateral was unclear or where there was a legitimate dispute over whether the secured creditor was fully perfected, courts have ordered the secured creditor to indemnify the estate, post a letter of credit or guaranty, and/or pay a portion of the purchase price in cash if it was ultimately determined to be unsecured.

Fisker Automotive is the first case that we are aware of which held that the desire to foster an active auction or the voicing of a mere concern regarding the extent and validity of a secured creditor's liens, without more, was sufficient to constitute cause to limit a secured creditor's right to credit bid. Furthermore, capping the credit bid at an amount equal to the purchase price for acquiring the secured claim appears to contradict the fundamental principle that the price paid by a creditor for a claim has no bearing on the amount of the creditor's claim in bankruptcy. The holding in *Fisker Automotive* substantially lowers the bar for challenging what was once thought to be a basic right of secured creditors—the right to credit bid—and raises concerns for secured creditors and purchasers of secured claims in the secondary market.

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