

The Nuts And Bolts Of Credit Bidding: A Primer For Traditional Lenders And Distressed Debt Investors

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What is credit bidding? Distilled to its most basic level, Section 363(k) of the Bankruptcy Code gives a secured creditor the right to use up to the full amount of the debt owed to the secured creditor by the debtor as currency in a bankruptcy auction sale of the collateral securing the debt owed to the secured creditor. For example, a creditor who is owed \$1 million secured by a valid and perfected lien on an asset offered for sale by a debtor in bankruptcy can credit bid up to \$1 million dollars as purchase price for such asset. Originally, Congress adopted Section 363(k) as a means for a secured creditor to protect its interests by preventing a bankruptcy sale of its collateral free and clear of its lien for a price that the secured creditor considered inadequate. In such a scenario, the secured creditor can credit bid its debt and either attempt to drive up the other bids or win the auction and take back its collateral in exchange for releasing the amount of its debt equal to the winning bid. Today, credit bidding has evolved into a formi-



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dable offensive weapon available to private equity, hedge funds and other investors in distressed debt who frequently are able to acquire secured debt from existing creditors at a discount and then credit bid the full amount of that debt to acquire the collateral. In this article, we will examine the basic mechanics of credit bidding and potential challenges that a secured creditor may face in achieving a successful credit bid.

Who Can Credit Bid?

Section 363(k) does not apply to unsecured claims. Only a creditor holding an allowed claim secured by a valid, perfected lien can credit bid for its collateral. A holder of an undisputed secured claim may credit bid if its claim is deemed allowed under Section 502 of the Bankruptcy Code. A claim is deemed allowed if proof of such claim has been filed and there is no pending objection to

such proof of claim or if the debtor listed the claim in the schedules filed with the Bankruptcy Court as non-contingent, undisputed and liquidated. If there is a bona fide dispute as to the validity, extent or priority of the secured creditor's lien or the amount of its allowed claim, the Bankruptcy Court may condition the creditor's ability to credit bid on the creditor's agreement to pay the purchase price in cash if the claim is ultimately disallowed.

What Assets May Be Subject To A Credit Bid?

Credit bids can be applied only to the secured creditor's collateral, which raises issues when a secured creditor wants to credit bid for a basket of assets that consists both of its collateral and other property. These other assets may include property encumbered by senior liens of other creditors, property of non-debtor subsidiaries or assets that cannot be attached by liens, such as government licenses. In such circumstances, the credit bidder may be able to allocate value between its collateral and the assets not subject to its lien, and provide separate consideration in addition to the credit bid for the assets that are not subject to the bidder's lien. Allocating value to specific assets can be challenging.

What Is The Maximum Amount Of A Credit Bid?

Although there was a divergence of opinion whether only the secured portion (based on the value of the collateral) or the full amount of the claim can be credit bid, the prevailing view today is that a secured creditor can credit bid up to the full face amount of its claim. A creditor who credit bids its secured claim at a sale

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under Section 363(k) can also include in its bid interest and costs to the extent permitted under the governing loan documents.

What Is The Effect Of Priority Of The Lien That Forms The Basis For A Credit Bid?

First lien lenders can credit bid their debt on the assets subject to their first lien. Second lien or junior lenders can also credit bid their debt, as long as they pay in cash the full amount of the claims of lenders in front of them first (including interest and fees under applicable loan documents).

Under What Circumstances Can The Court Deny A Credit Bid For "Cause"?

Section 363(k) of the Bankruptcy Code provides that the court can deny a credit bid for cause. The term "cause" is not defined in Section 363, but it is intended to be a flexible concept enabling a court to fashion an appropriate remedy on a case-by-case basis. Further, the language of Section 363(k) does not prohibit a bankruptcy court from placing conditions upon a secured creditor's ability to credit bid. Typically, "cause" to deny a credit bid may be found where (i) there is a bona fide dispute as to the extent, validity or priority of the creditor's lien in the property for which it seeks to credit bid; (ii) there is a bona fide dispute as to the allowed amount of the creditor's claim; (iii) when determining the status of a creditor's security interest or lien in the property would substantially extend the sale process and diminish the value of the property being sold; or (iv) where the secured creditor fails to follow the bidding procedures established by the Bankruptcy Court.

Frequently, unsecured creditors who, as a result of the credit bid would not receive any recovery, attempt to foil the credit bid by challenging the validity or priority of the secured creditor's lien. Some courts have criticized credit bidding by dominant creditors as unfair and likely to chill other bidding because a dominant creditor can submit a credit bid over and above the reasonable value of the assets. If a pure credit bid, without any other consideration, is successful, then the bankruptcy estate receives no

money for the assets sold, making it difficult or impossible for administrative expenses incurred during the bankruptcy case and other priority claims to be paid. If a sale based on a credit bid is likely to leave the debtor administratively insolvent, the Bankruptcy Court may be inclined not to approve the sale based on a credit bid without any cash component necessary to maintain the estate solvent.

What Is The Effect Of An Asset Sale Being Part Of A Plan Of Reorganization?

Some courts have held that the Bankruptcy Code does not afford a secured creditor an absolute right to credit bid when the sale of the debtor's assets is part of a plan of reorganization as opposed to a stand-alone Section 363 sale. In those instances, to protect their collateral from being sold at depressed value, holders of secured debt still have the ability to bid in cash for their collateral at an auction, with the expectation that they will receive most of the cash used in the bid back on account of their allowed secured claims.

Who Has The Right To Credit Bid In A Syndicated Loan Facility?

In a simple credit bid scenario a single lender holds both the claim and the lien securing the claim. In syndicated loan transactions, each member of the syndicate holds a separate claim against the debtor, but the lien securing those claims is usually held by a collateral or administrative agent for the benefit of all members of the syndicate. This does not mean, however, that only the agent can present a credit bid. Each lender, as a holder of a claim, can present a credit bid in the amount of the claim that it holds.

A number of recent Bankruptcy Court decisions have confirmed that, although the right to credit bid belongs to the individual lender, the collateral agent, under appropriate circumstances, can make a credit bid in the full amount of the outstanding loan on behalf of the entire syndicate. The courts in those cases have focused on the governing loan documents and concluded that when the loan documents give the agent the right to exercise remedies upon default with the consent of the majority of lenders, the agent can credit bid the full amount of

the syndicated facility pursuant to the direction of the majority over an objection of minority lenders.

This leads to the question of what treatment must be afforded to those members of the syndicate who oppose the credit bid. The answer again lies in the governing loan documents. In most syndicated loan transactions, lenders agree to share recoveries on their claims on a *pro rata* basis. One way to satisfy this requirement could be for the lender or group of lenders who made a successful credit bid to provide a cash paydown to the non-credit bidding lenders that would yield the same net paydown for all members of the syndicate. The feasibility of a credit bid can be significantly diminished, however, if the non-credit bidding lenders are required to be paid cash by the credit bidding lender or lenders to ensure equal treatment from the net paydown perspective of the entire group. The cash out option may not be the only way to satisfy the equal treatment requirement. Depending on the language of the "drag along" provisions of the governing loan documents, the non-credit bidding lenders may be compelled to accept equity *pari passu* with the credit bidding lenders in the new entity created to take title to the assets subject to the credit bid. The claims of non-credit bidding lenders against the agent and the credit bidding lenders relating to the credit bid and enforcement of the equal treatment provisions are typically not determined by the Bankruptcy Court because they do not involve the debtor or the bankruptcy estate. Such claims are usually reserved for potential litigation in state or other federal courts.

Conclusion

With the reduction of capital sources during the recent economic downturn, expedited Section 363 sales have become an important alternative to traditional chapter 11 reorganizations. As a result, credit bidding has been elevated to the forefront of defensive strategies for traditional lenders and offensive strategies of the private fund community focused on distressed investment. Both of these constituencies should be aware of the advantages and pitfalls of credit bidding in order to maximize the value of their investments.