HANDCUFFED AT THE AUCTION:
Bankruptcy Court Limits Credit Bids for Some Distressed Investors

By: Joshua D. Bradley

Two recent opinions, one issued by the United States Bankruptcy Court for the District of Delaware in *In re Fisker Automotive Holdings, Inc.*, 2014 WL 210593 (Bankr. D.Del 2014) ("Fisker"), and an unreported decision issued by the United States Bankruptcy Court for the Eastern District of Virginia in *In re: The Free Lance-Star Publishing Co. of Fredricksburg, VA* Case no. 14-30315 ("Lance-Star"), have unsettling implications for distressed debt investors. In each of these opinions, the courts capped the amount that the respective secured creditors could credit bid during a Bankruptcy Code Section 363 Sale (a "363 Sale").

As a general rule, when a secured creditor's collateral is sold at a 363 Sale, the Bankruptcy Code allows the creditor to bid by simply giving the debtor credit against what it owes for the amount bid. Requiring the creditor to pay the debtor the amount of its bid in cash only to have the debtor give the money back to the secured creditor serves no purpose and other creditors are not affected if the collateral can't be sold for more than the debtor owes the secured creditor.

Distressed debt investors have used the right to credit bid as part of a "loan to own" strategy. Such strategy typically involves an investor: (1) purchasing distressed debt secured by substantially all of a debtor's assets at a discount; (2) pressuring the debtor to file for bankruptcy and to immediately sell its assets in a 363 Sale; and (3) outbidding other bidders at the sale by credit bidding up to the loan balance to acquire the debtor's assets. Typically, the agreement between the original lender and the distressed debt investor provides that the amount that the investor paid is confidential.

Both *Fisker* and *Lance-Star* involved situations where investors purchased loans secured by substantially all of the respective debtors' assets for less than the outstanding loan balances. In *Fisker*, the secured creditor purchased a secured claim of approximately $168.5 million for $25 million and in *Lance-Star* the secured creditor purchased a secured claim of approximately $50 million for an undisclosed amount.

In *Fisker*, the Court limited the amount that the secured creditor could credit bid to $25 million, being the purchase price paid for the secured claim, rather than the amount the debtor owed. In *Lance-Star*, the Court limited the secured creditor's right to credit bid to $13.9 million.

Neither court limited the right to credit bid simply because the claim had been bought at a discount. The *Fisker* Court reasoned that if it did not limit the creditor's bid, there would be no bidding at all and also noted that the secured creditor did not appear to have a properly perfected lien on all of the debtor's assets. A critical factor in this determination also appears to be that a capable third party bidder existed. In *Lance-Star*, the Court limited the secured creditor's right to credit bid based upon: (1) the fact that the secured creditor's liens did not extend to all of the debtors' assets; (2) the secured creditor's "overly zealous loan-to-own strategy"; and (3) the "negative impact" the secured creditor's actions had on chilling bidding from third parties (i.e. by suggesting that it was the only party that could possibly purchase the assets).

Nevertheless, in the face of two opinions limiting the right of distressed debt investors to credit bid under certain circumstances, debtors and creditors' committees are likely take the position that the price paid for secured claims is relevant and discoverable information in the context of assessing a 363 sale. Moreover, these opinions signal a willingness of Bankruptcy Courts to modify the right to credit bid, at least where the party asserting that right is not the original lender. Therefore distressed debt investors risk having their right

to credit bid diluted or even outright denied. Distressed debt investors truly may not get what they pay for as they could end up with fewer rights than their predecessor, despite "legally" standing in their shoes.

The decisions do provide some guidance for minimizing the risk. First, both courts were very concerned that the "overly zealous" actions by the secured creditors, which were evidenced by accelerated time frames for the respective 363 sales and a lack of sufficient marketing, could discourage competitive bidding. Secondly, the security interests at issue in both cases were either infirm or not entirely perfected. In order to protect against similar results, a prudent investor could: (1) when deciding whether to buy a loan, confirm in the due diligence process that the lender truly does have perfected liens on all assets and determine whether the lender has done anything that might be regarded as overly zealous; and (2) be careful not to take positions that could be seen as discouraging third parties from participating in 363 sales after buying the loan. While these steps may not entirely protect a distressed debt investor's position, they will certainly allow it to more easily anticipate pratfalls along the way.

For any of your other creditors' rights needs, please contact an attorney in our creditors' rights group:

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