# Educational Materials

**Thursday October 9, 2014 3:00 PM - 4:00 PM**

## The Commercial Law League of America
## Frank W. Koger Memorial Education Program:

Current Developments in Hot and Emerging Areas of Bankruptcy
Bankruptcy and the Markets – The Uneasy Relationship Between Debtors, Traders and Judges

**The National Conference of Bankruptcy Judges**

**The Commercial Law League of America**
**Frank W. Koger Memorial Education Program**

**Chicago, Illinois**

**Thursday, October 9, 2014**

**3:00 p.m. to 5:15 p.m.**

# *Bankruptcy and the Markets – The Uneasy Relationship Between Debtors, Traders and Judges*

**<u>Panelists</u>:**


Hon. Jeffery A. Deller
United States Bankruptcy Court for the Western District of Pennsylvania
Pittsburgh, Pennsylvania

David L. Eaton
Kirkland & Ellis LLP
Chicago, Illiniois

Debra Grassgreen
Pachulski Stang Ziehl & Jones, LLC
San Francisco, California

Jeffrey N. Rich
Rich Michaelson Magaliff Moser, LLP
New York, New York

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*A series of decisions over the past year indicate a potential emerging trend in which bankruptcy courts are increasing the scrutiny of claims trading transactions. This program will examine key issues impacting secondary market purchases of claims including whether a purchase of a claim in order to control the underlying chapter 11 process should justify designating the vote of the purchase as invalid, whether a claim purchaser takes the claims subject to the same infirmities as the original claim holder, whether a transfer of a claim could result in reclassification, and how claims purchased from insiders are treated.*

## I. <u>Strategic Claim Purchases.</u>

What happens to the claimant who strategically purchases one or more claims to control the bankruptcy process, including plan confirmation? The claimant's vote may be designated "not in good faith" under section 1126(e) of the Bankruptcy Code and disregarded in connection with plan confirmation; or the claimant's proposed plan may be rejected as not in good faith under section 1129(a)(3) of the Bankruptcy Code.

**A. Bad Faith: *Dish Network Corp. v. DBSD North America, Inc.(In re DBSD North America, Inc.),*** 634 F. 3d 79 (2d Cir. 2011) (affirming vote designation where competitor purchased all secured debt and substantial unsecured debt for the purpose of blocking a proposed plan and acquiring debtor's spectrum rights).

In *DBSD,* the Second Circuit affirmed the designation of a creditor-purchaser's vote against confirmation as having been submitted in bad faith under 1126(e). The facts were somewhat unique because the purchaser admitted that it bought the claims in order to obtain a blocking position and control the bankruptcy process. *Id.* at 87 ("As DISH admitted, it bought the First Lien Debt not just to acquire a 'market piece of paper' but also to 'be in a position to take advantage of [its claim] if things didn't go well in a restructuring."). The creditor, DISH, owned an interest in a competing company and purchased the claims "with an eye toward DBSD's spectrum rights." *Id.* DISH purchased the debt at face value for $40 million (i.e., overpaid), consisting of the entire class of claims, after a plan had been proposed. The court concluded that the claim purchase was a strategic effort to acquire the debtor's spectrum rights, rather than making a traditional sale bid for the debtor's assets. *Id.* at 104.

The *DBSD* court was careful to distinguish between the "ulterior motives" that support a designation of bad faith, and business interests that may be not be the same as the debtor. The findings of bad faith – i.e., the ulterior motive – were based on facts including (1) an admission of its strategy, (2) that the purchaser was not a prepetition creditor, (3) it overpaid for the claims, (4) it purchased the claims after the debtor proposed a plan, and (5) it purposefully bought a blocking position in a class of claims. *Id.* at 104-05. The court emphasized that designation of a vote under 1126(e) is fact-intensive and left to the discretion of the bankruptcy judge. Whether a pre-existing creditor can vote its interest strategically was expressly not decided; the court limited its ruling to a prohibition against *obtaining* a blocking position for the purpose of a strategic vote. *Id*. at 105.

**B. Not Bad Faith: *In re LightSquared Inc., et al.,*** 513 B.R. 56 (Bankr. S.D.N.Y. 2014) (vote designation denied where purchaser was direct competitor of debtor and purchased prior to plan proposal, which was otherwise unconfirmable; but inequitable purchaser conduct supported claim subordination).

The *LightSquared* case reviewed all of the facts and legal tenets of *In re DBSD* and denied vote designation on the basis that the plan was unconfirmable. *See id.* at 91-92 ("Where a creditor votes to reject a plan for an admixture of reasons, some of which can be characterized as being consistent with the interests of a creditor acting to protect its legitimate interests, its vote cannot be designated... Here, while it is not subject to credible dispute that SPSO has non-creditor interests, its vote to reject this demonstrably unconfirmable plan cannot be designated, especially when to do so would arguably render the protections of section 1129(b) inapplicable."). The lesson is that a debtor cannot seek a bad faith vote designation against a creditor where the plan treatment is defective and the creditor has been treated unfairly.

Similarly, in *In re Lichtin/Wade, LLC*, 2012 WL 6576416 (Bankr. E.D.N.C. Dec. 17, 2012), the court denied to designate a purchaser's vote in bad faith where the purchaser was motivated to improve its plan treatment, not take control. The critical distinction from *DBSD* was that the claim purchaser presented credible evidence of its underwriting process to support its motive to maximize its investment, and argued that if it wanted to control the debtor's assets consisting of real property it could have sought relief from stay to foreclose. *Id.* at *6-7. Moreover, the debtor failed to meet the "heavy burden" of proving bad faith. *Id.* at *8.

Courts may also be reluctant to deem a "strategic" purchaser's vote to be in bad faith where the proposed plan is consistent with a viable reorganization. In *Trikeenan Tileworks,* 2011

WL 2898955 (Bankr. D.N.H. July 14, 2011), the court considered two competing plans, including one by a claim-purchaser, Butler, who effectively pursued a hostile takeover. Butler sought to buy the Debtors' business both before and during the bankruptcy. *Id.* at *3. Butler's plan was based on a cash infusion to the Debtors, consolidation of certain operations, updating equipment, and implementing new personnel. *Id.* at *2. The Debtors argued that the Butler plan was not submitted in good because it was a strategic purchase by a competitor, seeking to take over the Debtor. *Id.* at *6-8. The court disagreed on the grounds that the competing plan of reorganization "coincides with the goals of chapter 11" by restructuring the business, infusing capital, and providing a dividend to unsecured creditors. *Id.* at *7. Most significantly, the Butler plan had significant creditor support, while the Debtors' plan was deemed to violate the absolute priority rule. *Id.* The fact that the purchaser may have been a competitor who strategically purchased the claim was not *per se* bad faith provided the content of the plan was consistent with the goals of a reorganization. *Id.* The fact that the reorganization was not a liquidation and was supported by other creditors was likely critical.

**C. Key factors that affect designation.** Based on the foregoing cases, key factors that affect the designation of a purchaser's vote to be in bad faith include the purchaser's motivation, the timing of the claim purchase if a plan has already been proposed, the valuation and purchase price of the claim, the purchaser's status as a competitor, and whether other creditors support a plan proposed by the purchaser. A strategic claim purchaser that meets one or more of these criteria should be wary that its strategy may fail and it will not necessarily defeat a debtor's proposed reorganization plan.

## II. Purchased Claims Subject to Prior Infirmities.

How good is the purchased claim? Another question faced by a claim purchaser is whether the purchased claim is subject to disallowance under section 502(d) of the Bankruptcy Code based on avoidance claims that lie against the original claimant. Most commentators agree that a purchased claim will be subject to prior infirmities and, therefore, disallowed if the original claimant received avoidable transfers.

**A. *Enron Corp.* versus *KB Toys Inc.*** In *Enron Corp. v. Springfield Assoc., LLC, et al. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007), the court reviewed whether a purchased claim should be equitably subordinated or disallowed based on allegations that the original claimant received and failed to repay an avoidable transfer. The court drew an elaborate distinction between claim transfers by sale versus assignment, concluding that an assigned claim is subject to "personal disabilities" of the original claimant whereas a purchased claim is potentially free and clear. *Id.* at 443-446. The case was remanded to determine whether the claim was transferred by way of sale or by way of "pure assignment." *Id.* at 446. If the latter, the transferor received the claim with all of the faults (and avoidability) held by the transferor. The *Enron* court went on to note numerous issues and defenses that could be raised by the transferor if its claim were subject to potential disallowance. *Id.*

The *Enron* case was heavily criticized by *In re KB Toys Inc.,* 736 F. 3d 247 (3d Cir. 2013), which held that a trade claim is subject to disallowance under section 502(d) of the Bankruptcy Code based on avoidable transfers made to the original claimant. The *KB Toys* court specifically rejected *Enron* and held that section 502(d) disabilities travel with the claim, not the claimant, such that it makes no difference whether a transferor received the claim by sale or assignment. The two courts held fundamentally different views of whether the plain language of the statute focuses on the claim or the claimant. *See id.* at 252. The policy rationale for disallowing the transferred claims under 502(d) was in part to prevent "claim washing." *Id.* ("To allow the sale to wash the claim entirely of the cloud would deprive the trustee of one of the tools the Bankruptcy Code gives trustees to collect assets…").

The policy against "claim washing" was particularly applicable to the facts of *KB Toys* because all nine of the claims at issue were purchased from trade claimants who (1) were listed on the debtor's Statement of Financial Affairs as having received preferential transfers, and (2) went out of business and were deemed judgment proof. *Id.* at 250. On its face, the decision is limited to the transfer of trade claims (*id.* at 251), but the policy against "claim washing" can easily be applied to other types of claims. *Enron* also considered the policy against claim washing, but held that it was outweighed by the countervailing public policy of protecting bona fide purchasers who obtain a claim for value. *See In re Enron Corp.,* 379 B.R. at 448 ("[T]he burden and risk is better carried by creditors as a whole in favor of the bona fide purchaser in the context of a sale…").

**B. Purchaser Considerations.**

The reasoning of *Enron* does not appear to have been adopted by any significant decisions. Consistent with the *KB Toys* decision, a claim purchaser should expect that its claim is subject to possible disallowance based on avoidable transfers made to the original claimant. To this end, a purchaser should perform satisfactor due diligence, including a thorough review of the debtor's statement of financial affairs, to confirm that the transferor is not subject to avoidance claims. In addition, a claim purchaser should seek indemnification from the transferor based on any disallowance of the claim under 502(d).

## III. Reclassification of Purchased Claims.

**A. The Code Provision:** Section 1122 of the Bankruptcy Code Provides, in pertinent part, as follows:

> (a) Except as provided in subsection (b) of this section, a plan may place a claim or interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.

**B. The Recent Cases**

**1. *In re The Capital Centre, LLC***, 2013 WL 4510248 (Bankr. E.D.N.C. August 22, 2013) (separate classification in proposed plan for purchased claims not supported by "legitimate purpose").

The facts in *Capital Centre* are relatively simple. When the Debtor could not obtain the requisite vote of the class of unsecured creditors in order to satisfy the confirmation requirement imposed by 1129(a)(10) that there be one accepting class of impaired creditors, the Debtor broke down the unsecured creditors into two classes, one of which was based on the claimant being the purchaser of an unsecured claim (Class 4A) as opposed to the original claimant and the other of which were the remaining unsecured creditors (Class 5). The Class 4A creditor was to be paid over a ten year period as opposed to the Class 5 creditors which would be paid in full over a shorter period of time. The Court found that there was no legitimate purpose to justify this separate classification.

The Debtor sought to distinguish between the two classes of unsecured creditors on the basis that (i) it intended to do future business with the Class 5 creditors and (ii) the class 4A claim had been purchased in an effort to take control of the debtor's property and prevent confirmation of the debtor's plan which was opposed to the best interests of the debtors remaining unsecured creditors. Despite the Debtor's protestations, however, the Court found that the Debtor had no intention of dealing with the creditors in Class 5, and that there was therefore an absence of contradictory interests. The Court also found that "the treatment under the two proposed classes has not been fashioned to recognize the particular distinctive interests of their members". Accordingly, the Court concluded the purpose of the separate classification was improper class gerrymandering.

Courts have permitted separate classification of claims where the separate classification of claims of one group would materially enhance the reorganization process. *See, e.g., In re U.S. Truck Co.,* 800 F.2d 581, 587 (6th Cir. 1986) (allowing separate classification of union claim where union vote was likely to be influenced by non-economic factors dissimilar to those of other unsecured creditors); *In re Atlanta West VI,* 91 B.R. 620, 626 (Bankr. N.D. Ga. 1988) (permitting separate classification of claim of creditor that agreed to provide infusion of cash into the reorganized entity).

Observation and Query: There is very little case law in this area of the law, and each case of separate classification must be decided on the basis of its own facts and circumstances. In *Capital Centre*, the Court found that the goal of taking over the Debtor was not, by itself, sufficient to separately classify the purchased claim. No argument was apparently made by the debtor to designate the claim. Whether such an argument would have been successful is unclear, but the extant case law suggests that where separate classification would materially aid the reorganization process – or prevent the impairment of the reorganization process – courts are more inclined to permit reclassification.

**2. *CWCapital Asset Management, LLC v. Burcam Capital II, LLC (In re Burcam Capital II, LLC),*** 2014 WL 2864678 (E.D.N.C. June 24, 2014) (reversing lower court decision that allowed separate classification of purchased claims on the grounds that trade claims would be paid earlier; evidence of plan modification after purchaser's no vote demonstrated "obvious gerrymandering").

Again, the facts of this case are simple. The Debtor's original plan had two classes of unsecured creditors; general unsecured claims ("Class 5 Claims") and small unsecured claims. The secured creditor purchased a sufficient number of Class 5 Claims and cast enough rejection ballots to deny the Debtor a class of claimants voting in favor of the Plan. The Debtor thereafter sought to modify the Plan to create a third class of unsecured creditors consisting of the rejecting unsecured creditors with the obvious intention of separating the consenting from the non-consenting creditors and permitting a cram-down scenario.

The court noted that while separate classification of similar claims it is not *per se* prohibited, it may only be undertaken for reasons independent of the Debtor's motivation to secure the vote of an impaired assenting class. The usual legitimate business justification for separate classification of unsecured claims is the need to pay trade creditors on a separate timetable than other unsecured creditors in order to secure their goodwill and supply relationships. In this case, by contrast, there was no evidence in the record that the separate classification was motivated by anything other than a naked desire to place the dissenting creditors into a separate class to permit confirmation of the plan, and the appellate court viewed this as a clear case of the sort of gerrymandering prohibited by section 1122.

<u>Observation and Queries:</u> In *CWCapital*, the class of trade creditors was extremely small in comparison to the secured claims and most of the trade creditors didn't vote on the Plan. One can therefor imagine that the result may have been different if the trade creditors' votes or the claim disparity was substantially less. In short, a more favorable evidentiary record might have provided a legitimate business justification for separate classification, and thus plan confirmation.

The Fourth Circuit requires a debtor to provide documentary or other evidence that separate classification will enhance the chance for an effective reorganization. Is paying one class of unsecured creditors more quickly because they may be helpful to the debtor's continuing business a sufficient business justification for separate classification? Based on inferences drawn from the existing case law, the answer would appear to be "yes."

Another question might be is whether the purchase of claims, in itself, is sufficient justification for separate classification? Again, based on inferences drawn from the existing case law, the answer appears to be "no," at least not in the absence of some extra rationale for providing inferior treatment to the disadvantaged class.

**3.** ***In re LightSquared Inc., et al.,*** *supra,* 513 B.R. 56 (Bankr. S.D.N.Y. 2014) (separate classification of purchaser justified by status as competitor capable of pursuing "non-creditor interests" in the reorganized debtor; plan confirmation denied on other grounds).

In *LightSquared*, the claims purchaser was placed in a separate class as a result of its status as a competitor of the Debtor and having various adverse non creditor interests that would presumably affect its vote on the debtor's plan. Over the creditor's objection, the Court held that separate classification was warranted when a creditor is a competitor of the Debtor. The Court stated that the nature of the claim and the identity of the claimant may be relevant classification analysis where it would be in the creditor's interests to see that the Debtor not be successful in its efforts to reorganize so that the creditor could further its own objectives of acquiring certain assets of the Debtor.

## IV. <u>Transfer of Insider Status. Does the insider status of a claimant transfer to the purchaser?</u>

**A.** **<u>The Code Provision</u>:** The definition of an "insider" can be found in Section 101(31) of the Code.

**B.** **<u>The Recent Cases</u>**

1. ***Village at Lakeridge, LLC v. U.S. Bank Nat'l Ass'n, et al. (In re Village at Lakeridge, LLC),*** 2013 WL 1397447 (9th Cir. BAP 2013) (reversing decision that purchaser of claim automatically acquired original claimant's status as statutory insider).

Here, a third party purchased the claim of the sole member of the Debtor LLC. The claims purchaser was not otherwise a statutory insider of the debtor under the provisions of code section 101(31)(B). The bankruptcy court concluded the claims purchaser was not a non-statutory insider based on the purchaser's lack of control over the Debtor's affairs despite a personal relationship with a member of the board of managers. The bankruptcy court's determination was affirmed on appeal.

The appellate court went on to discuss whether in acquiring an insider's claim the claims purchaser automatically became a statutory consider and concluded in the negative. The appellate court stated that insider status must be determined on a case-by-case basis and existing case law in and outside of the Ninth Circuit is consistent with that approach.

<u>Observation and Query</u>: While the decision of the Ninth Circuit BAP seems to make sense, how do you reconcile the apparent inconsistency with the recent case law with respect to purchased claims being subject to disallowance under section 502(d) of the Bankruptcy Code based on avoidance claims that lie against the original claimant? *See Enron Corp. v. Springfield Assoc., LLC, et al. (In re Enron Corp.), supra,* 379 B.R. 425 (S.D.N.Y. 2007) (drawing distinction between claim transfers by sale vs. assignment, with assigned claim subject to "personal disabilities" of original claimant and purchased claims potentially free and clear); *In re KB Toys Inc.*, *supra*, 736 F. 3d 247 (3d Cir. 2013) (rejecting Enron, trade claim is subject to disallowance under 502(d) based on avoidable transfers to original claimant).

Should a claims purchaser be allowed to cleanse the claim of a clear insider simply by taking an assignment of the claim, or is the Third Circuit's analysis in *KB Toys* that 502(d) status travels with the claim correct?

## V. <u>Latest Developments in Credit Bidding</u>

*Distressed debt deals have evolved tremendously in the last couple of decades. Originally, the vast majority of deals were relatively simple trades in senior secured debt and trade claims where traders, often commercial banks or funds that dabbled in the category, were simply looking to buy low and sell high. Today, it is common for private equity and hedge funds devoted* *to the practice to purchase distressed debt in or near default, with a view to exercising remedies that include avenues to gain control or outright ownership of the borrower.*

*Foreclosure, credit bidding and/or controlling a large important class of votes for a Chapter 11 Plan are typical end games in loan to own deals, but as the practice has become more sophisticated, so have the objections and issues that complicate the successful execution of the strategy. Here, we'll address the latest developments in credit bidding to purchase assets in a bankruptcy case.*

## A. What is credit bidding?

- Two principal provisions of the Bankruptcy Code allow a debtor to sell its assets.
    - Section 363 sets forth the requirements for asset sales outside of a chapter 11 plan.
    - Section 1123 sets forth the requirements for asset sales pursuant to a chapter 11 plan.
- The Bankruptcy Code permits secured lenders to "credit bid" their debt to purchase assets pursuant to asset sales undertaken via section 363(b) of the Bankruptcy Code or under a chapter 11 plan.
- Investors often seek to acquire secured claims at a discount in order to use the claims as transaction currency in distressed transactions.
- Setting aside transaction costs, a winning credit bid should exactly match the results that would obtain if the secured creditor bid entirely with cash.
- It should be noted that credit bidding is not limited to bankruptcy.
    - State law will also typically authorize or permit credit bidding either through in-court (*e.g.*, receivership or judicial foreclosure) or out-of-court processes (*e.g.*, strict foreclosure under Article 9 of the Uniform Commercial Code).

## B. Limiting Credit Bidding "For Cause"

- However, a lender's right to credit bid is not unlimited under the Bankruptcy Code.
- This right may be limited "for cause."
    - Two recent bankruptcy court decisions remind us that the landscape for credit bid transactions in chapter 11 is not without risks.
    - Specifically, in *In re Fisker Automotive Holdings, Inc.*, No. 13-13087 (KG) (Bankr. D. Del.), and *In re Free Lance-Star Publishing Co.*, No. 14-30315 (KRH) (Bankr. E.D. Va.), bankruptcy courts limited credit bidding "for cause," preventing creditors from credit bidding the full value of their claims.

- Much has been said and written about whether these decisions changed the landscape as to whether credit bidding is still an effective strategy.

## C. Credit Bidding: Overview

- Under section 363(b) of the Bankruptcy Code, a debtor is allowed to sell, lease, or use assets outside of the ordinary course of business with prior bankruptcy court approval.

- Section 363(k) of the Bankruptcy Code provides that, in any sale under section 363(b) "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."

- Well-established law provides that a buyer can only credit bid for assets subject to the buyer's perfected liens.

- A debtor may also cause assets to be sold under a plan. *See* 11 U.S.C. § 1129(a)(5)(D).

  - A credit bid may also be used in a "plan sale." *See* 11 U.S.C. § 1129(b)(2)(A)(ii).

## D. Example of Credit Bid Transaction

- Secured lender has $1 million secured claim against debtor with collateral worth $500K.

- Third party stalking horse bids $600,000 in cash for the debtor's assets.

- Generally, applicable law permits the secured lender to "credit bid" the full $1 million of its debt, regardless of the fact that the collateral may only be worth $600,000.

### 1. Issues Related to Credit Bidding:

  - Whether the secured lender should bid its entire $1 million claim or only incrementally in amounts above $600K.

    - Potential benefits in retaining unsecured deficiency claim include:

      - potential "currency" for a settlement with unsecured creditors; and

      - the possibility of bidding for other accretive assets in debtor's estate.

  - Whether the secured lender's credit bid may chill cash bids by other potential acquirers.

  - Whether sufficient lenders of record will direct the agent to credit bid (*e.g.*, whether a holder of 51% of debt can effectively force a group of lenders to credit bid). *Cf. In re GSC Group, Inc.,* No. 10-14653 (Bankr. S.D.N.Y.). Generally, the enforcement provisions of the applicable credit agreement will control the level of "required lenders" necessary to direct a credit bid.

#### 2. <u>"Cause" for limiting credit bids is typically found where:</u>

- liens are **subject to challenge or bona fide dispute;**
- credit bidding was intended to cover a mix of assets subject to their perfected or unperfected liens (*i.e.*, "**mixed collateral**"); or
- the credit bidder acted in **bad faith**.

- Significantly, the Third Circuit noted in *dicta* in *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 316 n.14 (3d Cir. 2010) that credit bidding could also be limited "to **foster a competitive bidding environment**."
  - *Philadelphia Newspapers* was subsequently overruled on other grounds by the United States Supreme Court in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012).

### E. *Fisker*: Key Facts

- In late 2013, the Department of Energy (the "<u>DOE</u>") sold its interest in a $168 million loan made to Fisker—which was at least nominally secured by all of Fisker's assets—to Hybrid Tech Holdings, LLC ("<u>Hybrid</u>").
- The DOE sold its interests via a public auction conducted by the DOE's third-party advisors.
- Hybrid then negotiated a transaction with Fisker to purchase substantially all of Fisker's assets for consideration that included an $8 million self-priming DIP facility, a $75 million credit bid, waiver of Hybrid's DIP facility claims, and $1 million in cash to wind down the bankruptcy cases.
- Hybrid's deal required a late-November bankruptcy filing, a January 3 sale, and no subsequent marketing.
- Hybrid's deal also included assumption of certain substantial liabilities related to, among other things, a shuttered 3.2 million square-foot production facility in Wilmington, Delaware.
  - However, days before the sale hearing, Hybrid announced that it would **<u>not</u>** assume those facility liabilities.
  - Prominent Delaware politicians and various municipal and state taxing bodies subsequently opposed the sale with both public statements and filings in the bankruptcy court.

- An alternative bidder, Wanxiang America Corp. ("Wanxiang"), emerged but conditioned participation in an auction on Hybrid's credit bid being limited.

- The Creditors' Committee supported a cap of Hybrid's credit bid in light of, among other things, the presence of an apparently ready and willing alternative bidder.

### F. *Fisker*: Bankruptcy Court Opinion Capping Credit Bid

- The parties stipulated that the only bases for consideration on whether Hybrid's credit bid could be "capped" would be:

  - facilitating an auction; and

  - the so-called "mixed collateral" issues—*i.e.*, the value of (and consideration for) assets that might not be subject to a perfected lien.

- After extensive oral argument, the bankruptcy court ordered Fisker to conduct an auction for its assets and capped Hybrid's credit bid at $25 million.

- The bankruptcy court cited disputes regarding whether Hybrid could credit bid for "mixed collateral" over which it might not hold valid liens.

  - The bankruptcy court, which had also signaled support for an auction during prior hearings, stated that Hybrid's ability to credit bid $168 million and Hybrid's "hurried" proposed sale timetable would "freeze" competitive bidding.

- Significantly, the bankruptcy court's ruling did **not** limit Hybrid's secured claim or address creditor recoveries or allocations.

### G. *Fisker*: Appellate Ruling

- Hybrid subsequently sought certification to immediately appeal the credit bid ruling by motion to the U.S. District Court for the District of Delaware (the intermediate appellate court immediately above the bankruptcy court). *See In re Fisker Automotive Holdings, Inc.*, 2014 WL 576370 (D. Del. Feb. 12, 2014).

- In applying the standard applicable to such procedural requests, the District Court held that there was **no** "substantial grounds for a difference of opinion" as to whether a credit bid could be limited to facilitate an auction.

### H. *Free Lance-Star*: Key Facts

- Free Lance-Star Publishing Co. ("FLS") is a newspaper, radio, and communications company located in Fredericksburg, Virginia.

- In 2007, FLS borrowed approximately $50.8 million from Branch Banking and Trust ("BB&T") to finance the construction of a commercial printing plant.

    - The BB&T collateral package specifically excluded FLS's "Tower Assets," which consisted of real property utilized in FLS's radio broadcasting operations.

    - BB&T did not file mortgages to perfect liens on the Tower Assets.

- In June 2013, BB&T transferred its interest in the FLS loan to DSP Acquisition, LLC ("DSP"), an entity affiliated with Sandton Capital Partners.

- In July 2013, DSP informed FLS that DSP wanted the company to file for chapter 11 and to sell substantially all of its assets to DSP pursuant to section 363 of the Bankruptcy Code.

    - During restructuring discussions, DSP unilaterally recorded mortgages on various Tower Assets without either authority from, or notice to, FLS.

    - These restructuring discussions collapsed and in January 2014, FLS filed for chapter 11 and sought both a sale process and avoidance of certain of DSP's asserted liens.

### I. *Free Lance-Star*: Credit Bid Capped

- In March 2014, the bankruptcy court ruled that DSP did not have a valid perfected lien in certain assets, and limited DSP's credit bid to $13.9 million (from $38 million) due to the inclusion of mixed collateral in its proposed credit bid.

- The *Free Lance-Star* opinion, however, is also notable because, unlike in *Fisker*, the bankruptcy court considered the creditor's pre- and post-petition conduct.

- Specifically, the *Free Lance-Star* court held that DSP had actively "engaged in inequitable conduct" by:

    - **failing to disclose** to the court its subsequent attempts to encumber FLS's assets during a cash-collateral hearing;

    - **pressuring FLS to seek an expedited sale hearing** six weeks after filing for bankruptcy; and

    - engaging in an "**overly zealous loan-to-own strategy**."

### J. *Free Lance-Star*: Appellate Ruling

- Like in *Fisker*, DSP subsequently sought certification to immediately appeal the credit bid ruling by motion to the U.S. District Court for the Eastern District of Virginia (the intermediate appellate court immediately above the bankruptcy court).

- This appeal did not delay the proposed auction.

- Relying on the *Fisker* appeal opinion, the District Court, applying the standard applicable to such procedural requests, held that there was **<u>no</u>** "substantial grounds for a difference of opinion" as to whether a credit bid could be limited to facilitate an auction.

- The District Court also noted that DSP had "not even addressed the presence of" exceptional circumstances justifying an immediate appeal, a striking omission in light of "the Bankruptcy Court's finding that DSP engaged in inequitable conduct."

## K. Takeaways

### 1. <u>Limiting Credit Bidding to Foster "Competitive" Bidding</u>

- Citing *Philadelphia Newspapers* (as well as *Fisker* and *Free Lance-Star*), creditors' committees and other parties in interest likely will seek to limit credit bidding to promote a "competitive bidding environment."

- However, both *Fisker* and *Free Lance-Star* suggest that something in addition to the need to promote competitive bidding is required to cap credit bidding "for cause."

  - For example, *Fisker* and *Free Lance-Star* also involved mixed-collateral disputes (discussed in detail below).

- *Fisker* and *Free Lance-Star* may also be limited to their respective facts.

### 2. <u>Mixed Collateral</u>

- As noted above, competition problems, coupled with mixed-collateral disputes (*i.e.*, where assets may be subject to disputes regarding the perfection and validity of a creditor's liens), may lead a bankruptcy court to cap credit bidding for cause.

- A debtor has tremendous flexibility to craft bid procedures designed to promote a more competitive bidding environment.

- However, the mixed-collateral issues often present greater challenges.

  - There are few "easy fixes" for mixed-collateral disputes, which are often litigated in chapter 11 plans. *See, e.g., Hawker Beechcraft*, *Rural/Metro*, *Cengage Learning*, and *Sbarro*.

  - Mixed collateral may comprise certain of a debtor's most valuable assets.

## L. Executing Credit Bids After *Fisker* and *Lance-Star*

- Sellers, lenders, and buyers should focus on a number of issues with respect to executing credit bids in light of recent developments:

- carefully identifying **<u>assets that will be encumbered</u>** when entering into loan agreements and **<u>identifying</u>** assets where there may be **<u>unperfected or questionable liens</u>**;

- **<u>sponsoring a chapter 11 plan</u>** that seeks to **<u>equitize debt</u>**, thereby:

  - appearing as a "white hat" that deserves protection against undervaluation of collateral, rather than a "loan-to-own" buyer;

  - addressing valuation issues at plan confirmation; and

  - providing for a transaction that addresses both sources <u>and</u> uses of value.

- crafting auction procedures to permit bidding on the asset pools in question within the overall auction (*e.g.*, permitting bidders to separately bid on foreign intellectual property);

- developing **<u>reasonable sale and restructuring timelines</u>**;

- considering local **<u>political dynamics</u>** related to potentially sensitive acquired assets;

- obtaining **<u>third-party valuation</u>** with respect to unencumbered or arguably encumbered assets; and

- seeking a **<u>section 506(c) and marshaling waivers</u>** to protect recourse to unencumbered collateral.