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The Evolution Of Credit Bidding

Law360, New York (February 17, 2010) -- Credit bidding has gained prominence during the current restructuring cycle, in no small part due to depressed asset values and more active secondary markets for trading debt.

No longer is it simply a tactic used by distressed debt investors employing the much maligned "loan-to-own" strategy, either. Major financial institutions such as Wachovia and Credit Suisse — not to mention the United States Treasury — have recently employed credit bids to acquire assets out of bankruptcy.

While some of this activity (see, e.g., General Motors Corp.) is no doubt attributable to the unprecedented crisis from which the national and global economies may be emerging, much of it is the product of market forces. Now credit bidding is mainstream.

The increased frequency of credit bidding has resulted in scrutiny of its legal underpinnings and limits, highlighting the tension between maximizing asset values for a bankruptcy estate and protecting secured creditors' property rights.

Within the last several months, two significant bankruptcy disputes with credit bidding at their center have reached United States Courts of Appeal, signaling that bankruptcy professionals and their clients would be well advised to familiarize themselves with the nuances of credit bidding.

What Is Credit Bidding?

Credit bidding is the use of debt as currency in a bid to purchase assets. Imagine a lender that is owed $10 and holds a security interest in all of the borrower's assets. The borrower decides to sell those assets.

In the absence of higher bids, the lender offers to buy the assets for five dollars. When the borrower accepts the offer, the lender takes title to the assets and deems five of the borrower's $10 obligation satisfied.

That scenario, or some variation of it, is playing out more and more often in bankruptcy courts. Section 363(k) of the Bankruptcy Code expressly authorizes credit bidding by a secured creditor at a sale of the creditor's collateral. For secured lenders, the right to credit bid is an essential component of their property interest in their collateral.

Like the right to elect, pursuant to Section 1111(b), to treat a claim as fully secured, even when the underlying collateral is worth less than the obligation it secures, the right to credit bid is one way of ensuring that the lender has the opportunity to obtain the benefit of its bargain with the borrower.

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Notably, the lender can bid the full value of its claim, not simply the value of the collateral, and set that amount as the floor for other bids. To the extent that there are cash bids that exceed the amount of the credit bid, the lender reaps the benefit by being paid in full (assuming the full amount of the claim was bid).

To the extent no higher bids are made, the lender obtains title to its collateral. Both outcomes are roughly consistent with the bargain to which the lender agreed in its credit documents: in exchange for lending money it would receive payments or collateral.

The Bankruptcy Code recognizes those economic expectations not only in Section 363(k) but also in the context of plans of reorganization. Section 1129(b)(2(A)(ii) arguably provides that in order to "cram down" a class of secured creditors, a plan calling for the sale of the creditors' collateral must also permit the creditors to credit bid their claims as part of the sale.

In other words, a minimum prerequisite for being "fair and equitable" to a secured creditor is allowing the creditor the opportunity to credit bid when its collateral is being sold.

Credit bidding in bankruptcy is not always welcome. Creditors committees or debtors typically would prefer cash bids, and for that reason may propose a sale process that discourages or even prohibits credit bids. Accepting a credit bid can mean that only one creditor obtains a recovery through an asset sale, as the sale would generate little or no cash to fund distributions to other creditors.

For a secured creditor, the decision to credit bid can have significant consequences that implicate more than its recovery in a particular case. First and foremost, it has to be prepared to win.

The right to credit bid is toothless if the creditor has no way to subsequently realize on the value of the assets, either by selling them or operating them. Most traditional lenders, of course, especially banks, shy away from owning their borrowers.

For them, a credit bid may be a remedy of last resort, to be exercised only in "defensive" situations where other bids for the assets are at such depressed values that the creditor thinks it could extract more on its own.

Other secured creditors (e.g., distressed debt funds, private equity firms) may be more comfortable with owning assets, and may in fact have purchased the debt they bid precisely for that reason. Some lenders may provide debtor-in-possession financing in contemplation of using the debt to acquire the collateral.

Syndicated loans give rise to unique considerations in the credit bidding context. Holders of syndicated debt that want to credit bid need to be sure that the credit documents give them the right to do so.

Conversely, holders that do not want to credit bid should determine at an early stage whether they could be forced by the terms of their credit documents to be dragged along in a credit bid.

Insofar as syndicated lenders typically vest significant authority in an agent, who may only need the direction of a majority of lenders to act, a minority holder can find itself tied to the fate of a credit bid involuntarily.

Clearly, credit bidding can alter the dynamics of a distressed situation. Two recent case decisions also show how increased judicial scrutiny of credit bidding rights can influence those dynamics.

In Re Pacific Lumber Co.

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The Fifth Circuit Court of Appeals made news by endorsing a plan of reorganization that provided for the sale of debtors' assets without affording secured creditors the right to credit bid for those assets. In re Pacific Lumber, 584 F.3d 229 (5th Cir. 2009).

The debtors in Pacific Lumber were engaged in growing, harvesting and processing timber in California. One of their creditors and one of their competitors jointly proposed a plan of reorganization pursuant to which the debtors' assets would be transferred to new entities controlled by the plan proponents.

Among those assets was a large tract of timberland that had been pledged as collateral in connection with the issuance of certain notes. The plan provided that the noteholders would be paid an amount equal to the value of the collateral, which, as determined by the bankruptcy court, was materially less than the amount of their claims. They would receive an unsecured deficiency claim for the balance.

The noteholders objected to their treatment because, contrary to Section 1129(b)(2)(A)(ii), the plan did not give them the opportunity to credit bid their claims in connection with the sale. As a result, according to the noteholders, the plan was not fair and equitable and could not be confirmed.

In response, the plan proponents argued that Section 1129 requires only that the plan either give the noteholders the right to credit bid their claim or furnish them with the "indubitable equivalent" of their claims, in keeping with Section 1129(b)(2)(A)(iii).

To the surprise of many observers, the Fifth Circuit agreed with the plan proponents, holding that the language of Section 1129(b)(2)(A) unambiguously requires the satisfaction of only one of its three subsections, and that it was not error for the bankruptcy court to find that payments in an amount equal to the judicially determined value of the noteholders' collateral represented the "indubitable equivalent" of their claims, even though the value of the claims was much higher.

Prior to Pacific Lumber, it was taken for granted by many practitioners that any plan that contemplated an asset sale had to provide secured creditors the opportunity to credit bid their collateral.

That conclusion was based in no small part on the reason for mandating credit bidding outside of the plan context, which was to ensure that the secured creditor at least had the opportunity to use the entire value of its claim to set the price for the assets.

Otherwise, the creditor could be deprived of the basic benefit of its bargain, as a successful bid by a third party in a lesser amount would give the creditor neither the collateral nor payment in full of its claim.

In Pacific Lumber, that fear materialized. The noteholders were forced to accept payments in an amount far less than the amount of their claims, and lost their collateral.

Whatever the merits of the Fifth Circuit's statutory construction, the Pacific Lumber decision has upset the expectations of many secured lenders, and is a particularly unwelcome development for undersecured creditors.

In Re Philadelphia Newspapers LLC

A Pennsylvania court followed the Fifth Circuit's lead by approving, over the objection of secured creditors, sale procedures proposed in connection with a plan that did not permit credit bidding. In re Philadelphia Newspapers LLC, 418 B.R. 548 (E.D. Pa. 2009).

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In Philadelphia Newspapers, the debtors proposed a plan that contemplated the sale of all of their assets to a stalking horse purchaser for an amount far less than the amount of the claims secured by the assets.

The bidding procedures proposed by the debtors explicitly provided that credit bidding would not be permitted because the sale was to be conducted as part of a plan, and not pursuant to Section 363.

The debtors' secured lenders objected to the bidding procedures on the basis that Section 1129(b)(2)(A)(ii) guaranteed their right to credit bid, whether or not the sale was conducted under the aegis of Section 363 or Section 1129. The bankruptcy court agreed with them, and refused to approve the procedures.

On appeal, however, the district court, like the Fifth Circuit in Pacific Lumber, examined Section 1129 and found that it plainly means that the right to credit bid is one possible alternative set forth in Section 1129(b)(2)(A); it is not mandatory as long as one of the other conditions is satisfied.

That decision was immediately appealed to the Third Circuit, which heard oral argument in December 2009 but has not yet issued a decision.

Whether or not the Third Circuit affirms the district court and adopts the more restrictive view of credit bidding rights under Section 1129, there are important distinctions between Pacific Lumber and Philadelphia Newspapers that could diminish the latter's impact.

Perhaps most significant are their procedural postures. Unlike Pacific Lumber, the Philadelphia Newspapers court was not determining whether the secured creditors' treatment under the plan constituted the "indubitable equivalent" of their claims. It was only deciding whether bidding procedures should be approved.

For that reason, the court was careful to say that approving the bidding procedures was not tantamount to a finding that the plan was "fair and equitable" within the meaning of Section 1129(b), and that the lenders were free to argue at confirmation that the auction did not generate sufficient proceeds to furnish them with the "indubitable equivalent" of their claims.

The opinion stands only for the proposition that Section 1129(b)(2)(A)(ii) does not require credit bidding in every sale conducted pursuant to a plan.

Conclusion

Pacific Lumber and Philadelphia Newspapers are significant because they erode the rights (or perceived rights) of secured creditors to use credit bidding to preserve their economic interests and exercise additional leverage in plan negotiations.

Substantive merits aside, however, the decisions are providing needed guidance and, hopefully, some measure of predictability in what is a relatively new frontier of bankruptcy law.

Given the recurrence of asset sales as defining events in bankruptcy, and the stagnancy of credit markets, credit bidding likely will continue to be a useful tool both for traditional lenders seeking to recover principal and interest, and entities using debt to acquire companies.

A more developed body of case law governing credit bids should ultimately lead to more informed and efficient use of the tactic.

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