To Bid or Not to Bid?: Recent Developments and Gamesmanship in Credit Bidding in Chapter 11 Cases and Implications for Secured (and Unsecured) Bond Trustees

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Sometimes indenture trustees represent secured bonds. Sometimes unsecured bonds. The general rule that it is usually better to be secured (or "asset rich") than unsecured ("asset poor" or "out of the money") has rarely been as pronounced as in the last several years of tight credit and plummeting asset values. And seldom in recent memory has there been as much gamesmanship between secured and unsecured debt -- often putting indenture trustees in the middle.

This article will focus on perhaps the most dramatic and publicly debated recent such intercreditor tranche warfare development -- the recent case law limiting the right of secured creditors (including secured bond trustees) to exercise in certain circumstances their right to credit bid for their collateral. Putting this development in context, however, it may be worth a minute to consider certain of the more global trends which indenture trustees and other creditors may have experienced in representing different warring tranches of debt in the last several years, and which reflect, the authors believe, the tight credit/low value environment which so precipitously sprang upon the marketplace.

Recent Secured and Unsecured Debt Trends in a Low Value/Tight Credit Economy

From a totally unscientific, impressionistic perceptive, the authors have noticed -- or imagined -- the following trends in the world of distressed debt and bond defaults going into bankruptcy, which they believe reflect, in significant part, the recent tight credit/low value environment:

1. There have been many more pre-packaged or pre-negotiated plans as debtors and secured/senior debt wish to avoid free fall bankruptcies and get favorable results for themselves.

2. Previously, pre-packaged plans generally would get something for all classes of creditors down to the unsecureds. Recently, as values have fallen, secured/senior debt has seemed to try to take advantage of low values to freeze out lower levels of debt and take any future upside for themselves.

3. If secured debt cannot get a consensual deal together, particularly with the debtor and its management, they may try to take advantage of low values to credit bid their secured debt. As discussed further below, some debtors have pushed back on such credit bid rights.

4. Low values have also lead to a proliferation of fraudulent conveyance actions against banks and other parties to LBOs done when values were higher (up to mid-2008).[1]

5. There has been a proliferation of rights offerings and other financings by hedge and other funds to finance plans to secure for themselves ownership of more advantageously priced companies.

Underpinnings of Credit Bidding

With access to credit having been at historically tight (although potentially loosening) levels, bankrupt issuers have had a tougher time accessing sufficient amounts of capital to finance or structure consensual reorganizations. This has led to an increase in the number of situations where an issuer decides, or the secured lender insists, that its only real option is to sell its assets to the highest bidder. Secured lenders generally have a large say in whether, how, and what price their collateral is sold, even when that sale is taking place in the bankruptcy context. At the same time, the economic downturn in general, and low asset valuations in particular, have made this a particularly challenging time to realize what a secured creditor may believe to be sufficient value or the true, long term value of those assets. As a result, a recent trend has been for secured creditors dealing with issuers or borrowers in default to use their right to bid the amount of their debt in an asset sale, thus capturing the assets at a potentially low value with the hope of holding on and benefiting from rising values over the next several months or years. This right to credit bid has been viewed as sacrosanct and inviolable by secured lenders.

In the year or two before the Supreme Court's decision in *Radlax Gateway Hotel, LLC v. Amalgamated Bank*, 2012 U.S. LEXIS 3944, affirmed credit bidding rights to secured lenders and indenture trustees for secured bonds in the chapter 11 plan or section 363 context, three court opinions -- one out of a bankruptcy court and two out of the courts of appeals -- addressed and brought into question the absolute right of a secured creditor to credit bid its debt in the context of an asset sale in a plan. The opinions have implications for indenture trustees for secured bond deals backed by collateral. Indeed, one of the opinions addresses the scenario where less than all

[1] A fraudulent conveyance is a transfer –

(i) designed to hinder, delay or defraud other existing creditors; or

(ii) for less than reasonably equivalent value when the company is or causing the company to become insolvent, undercapitalized, etc…

For example, in *In re Tousa, Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009), a Florida bankruptcy Court ruled that (i) $500 million in liens upon secured loans issued to the debtor less than 6 months before the bankruptcy filing could be avoided, and (ii) $420 million in payments to prior Lenders from that loan could be disgorged, as a fraudulent transfer under § 548(a)(1)(B) of the Bankruptcy Code, upon the finding that the lenders should have known the debtor was insolvent at the time the loan was made. Additionally, the debtor and its subsidiaries did not receive reasonably equivalent value for the liens placed on their assets and were left with an unreasonably small capital. The decision, by avoiding liens on property and disgorging payments, as well as disgorging as a preference $207 million in tax refund proceeds, allows unsecured creditors -- including bondholders -- to share in a recovery on unencumbered assets.

of the secured bondholders attempted to credit bid just their secured bond debt in such a sale, but were blocked by the court from doing so based on, among other things, the court's interpretation of the indenture as stating that only the indenture trustee could so credit bid.

This article will provide a short background on the right of a secured creditor to credit bid under the Bankruptcy Code, address the recent credit bidding case law, and discuss the potential implications for indenture trustees.

Background on Credit Bidding Under the Bankruptcy Code. Section 363(k) of the Bankruptcy Code provides:

> At a sale under subsection (b) of this section [permitting sales of property outside the ordinary course of business] 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.

11 U.S.C. §363(k). Thus, the Bankruptcy Code permits the holder of a claim secured by the debtor's property to use up to the full amount of its secured claim in its bid. For example, suppose a debtor desires to sell its assets in a chapter 11 case and further suppose that a secured lender (a) has a valid and enforceable security interest in all of those assets and (b) is owed $10 million by the debtor. At an auction for the sale of those assets, if the secured lender is the successful bidder, and its successful bid is $15 million, the secured lender would only need to come up with $5 million in cash, using its $10 million claim for the balance of the amount owed. At the end of the day, the secured lender's $10 million claim would be considered satisfied in full and it would own the assets, so long as it paid $5 million in cash to the debtor's bankruptcy estate. On the other hand, if the assets are not worth or do not attract $10 million, the secured lender can bid any amount up to the $10 million, with any unused secured claim amount being retained as an unsecured deficiency claim (which may or may not have some value). While a relatively straight-forward concept, recent cases have involved twists on this situation, and have had unanticipated consequences for secured lenders and bondholders.

Pre-*Radlax* Case Law Limiting Credit Bidding

Pacific Lumber and Philadelphia Newspapers. Two pre-*Radlax* court of appeals decisions addressed – and ultimately rejected – the absolute rights of secured lenders to credit bid in the context of an asset sale through a chapter 11 plan, as opposed to the more traditional way of selling assets through section 363(b) of the Bankruptcy Code. As a result, those courts had to consider whether the section 1129, which addresses the requirements for chapter 11 plan confirmation, were met and whether a provision requiring that dissenting secured debt holders get at least the "indubitable equivalent" of their secured claim could circumvent or be an alternative to a provision which required the allowance of credit bidding in a sale under plan.

In *In re Pacific Lumber Co.*,[2] an indenture trustee for bonds secured by certain of the debtor's redwood forest assets (working closely with bondholders) objected to confirmation of a chapter 11 plan that provided for a sale of those assets and the payment to the secured bondholders of an amount of cash equal to the court's valuation of those assets. The objection was overruled, and the indenture trustee sought, and was granted, an expedited appeal to the Fifth Circuit Court of Appeals. After dismissing challenges that the appeal was moot because the plan had been substantially consummated, the court recognized that the plan must meet the Bankruptcy Code's "fair and equitable" standard with respect to the bondholders because the bondholders as a class had voted to reject the plan. With respect to secured creditors such as the bondholders, this meant that section 1129(b)(2)(A) of the Bankruptcy Code had to be satisfied. That section provides that, in order to be confirmed with respect to a dissenting class of secured creditors, the plan must provide (i) that the bondholders retain their lien on the assets and have the right to receive deferred cash payments having a present value equal to the value of the collateral, (ii) that the property be sold free and clear of the liens, with the liens attaching to the proceeds, so long as the secured creditor has the right to credit bid pursuant to section 363(k), or (iii) for the realization by the secured creditor of the "indubitable equivalent" of its claims.[3]

The indenture trustee argued that, because clause (ii) alone dealt with the sale of collateral under a plan and that that section permits the secured creditor to credit bid for the collateral, clause (ii) ought to control, and any sale -- such as the sale here -- accomplished without giving the secured creditor the ability to credit bid ought to be found not to comply with section 1129(b)(ii)(A). In particular, the indenture trustee argued that the debtor could not argue that the bondholders had received the "indubitable equivalent" of their claim under clause (iii) because the more specific and applicable provision (clause (ii), which specifically deals with sales) ought to govern over the more general provision (clause (iii)).

The court rejected the indenture trustee's arguments. As an initial matter, the court held that section 1129(b)(2)(A) is written in the disjunctive, so that a plan may comply with clause (i), (ii), or (iii). As a result, the proponent of the plan could proceed under the "indubitable equivalent" prong of section 1129(b)(2)(A). With respect to that prong, the court held that "whatever uncertainties exist about indubitable equivalent, paying off secured creditors in cash can hardly be improper if the plan accurately reflected the value of the [bondholders'] collateral."[4] The court then proceeded to reject various arguments from the indenture trustee that the bankruptcy court's valuation of the bondholders' collateral was flawed, and upheld confirmation of the plan.[5]

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[2] 584 F.3d 229 (5th Cir. 2009).

[3] *Id*. at 245.

[4] *Id*. at 247.

[5] The bondholders' collateral was only one of many assets being sold under the plan, which did not separately value the various assets, thus necessitating a valuation of the bondholders' collateral by the bankruptcy court.

While not a bond case, in the even more recent *In re Philadelphia Newspapers, LLC*,[6] the Third Circuit Court of Appeals reached the same conclusion as the Fifth Circuit in *Pacific Lumber*, but with greater attendant public notoriety and furor among secured lenders, making the decision something of a cause célèbre. In *Philadelphia Newspapers*, the debtor filed in the bankruptcy court a motion seeking approval of certain bid procedures for a sale of its assets pursuant to a chapter 11 plan. The procedures specifically sought to preclude the debtors' secured lenders from credit bidding at the auction. The bankruptcy court held that this was impermissible, and an appeal was taken. The district court disagreed with the bankruptcy court's reasoning, and ruled that the Bankruptcy Code provided a way around the entitlement for secured lenders to credit bid at an auction sale pursuant to a chapter 11 plan. The secured lenders appealed to the Third Circuit, which affirmed the district court's ruling

The Third Circuit held that the plain meaning of section 1129(b)(2)(A) permits a debtor to conduct an asset sale under subsection (iii) without allowing the secured lender to credit bid.[7] As in *Pacific Lumber*, the court first noted that section 1129(b)(2)(A) is written in the disjunctive, meaning that a plan that complied with any of the subsections, as opposed to all of the subsections, was sufficient. Further, as in *Pacific Lumber*, the court rejected the secured lenders' argument that the requirements of the specific provision of section 1129(b)(2)(A) dealing with sales free and clear of liens (clause (ii)) ought to trump the more general "indubitable equivalent" provision (clause (iii)), although the minority dissent by a judge who previously had been an experienced bankruptcy lawyer found that argument legally and practically persuasive. The court recognized that, in a different context, the Supreme Court had held that a specific enumeration followed by a broader "catchall" provision does not require the application of the more specific provision.[8] The court further rejected arguments that the "indubitable equivalent" language of section 1129(b)(2)(A)(iii) is ambiguously broad and that the plain meaning of section 1129(b)(2)(A) is inconsistent with Congressional intent.[9]

Two other recent cases address a related issue in a way, however, that is particularly relevant for indenture trustees for secured bond deals - assuming the ability to credit bid on behalf of secured bonds, can the bondholders bid in their own claims on their own behalf or must any such bid be by the trustee on behalf of all bondholders?

Trustee vs. Bondholder Credit Bidding

Electroglas. In an unpublished but widely discussed opinion from the Delaware bankruptcy court in the *Electroglas* case, involving secured bond debt, the court addressed the

[6] 599 F.3d. 298 (3rd Cir. 2010).

[7] *Id*. at 304.

[8] *Id*. at 307 (*citing Variety Corp. v. Howe*, 516 U.S. 489, 511-12 (1996)).

[9] *Id*. at 310-318.

issue of "whether and to what extent Noteholders may credit bid."[10] After holding that the court had jurisdiction to determine this issue because of its affect on the liquidation of the bankruptcy estate, the court denied the right of noteholders to credit bid at a sale of the debtor's assets, largely based on the language of the indenture itself and the respective roles of the indenture trustee vis-à-vis bondholders. First, the indenture specifically provided "that no noteholder may take an action that does not treat all noteholders equally and accrue to noteholders a common benefit."[11] The court further noted three other instances of language in the indenture and related agreements calling for such equality of treatment. Allowing a group of noteholders to credit bid just their notes, the court held, would create an inequality of treatment between the credit bidding noteholders and those that did not credit bid their notes.[12]

Having foreclosed the ability of the noteholders to credit bid some of the notes, the court addressed the issue of who has the right to credit bid on behalf of all of the notes. Again, the court relied on the so-called no-action clause of the indenture (which appears in virtually all corporate indentures), which prohibited noteholders from instituting "any suit, action or proceeding in equity or at law upon or under or with respect to this Indenture" unless first making a written demand on the indenture trustee and meeting other procedural requirements, including offering adequate indemnity.[13] This section of the indenture, the court noted, "makes clear that Noteholders may not step into the shoes of the Trustee and simply credit bid the Notes themselves, as doing so would constitute an action with respect to the Indenture."[14] Further, the Court found that the noteholders may not force the trustee to bid their credit on their behalf because the indenture, as interpreted by the court, provided that "a majority of noteholders are allowed to tell the Trustee what to do procedurally, but not substantively," and credit bidding the notes would be a substantive action.[15] While the noteholders could "request[] that the Trustee take a certain substantive action . . . such as credit bidding," and "may even have a cause of action against the Trustee" should it refuse, "a group of noteholders may not effectively go over the head of the Trustee" and credit bid their own notes.[16] While noting that section 363(k) of the Bankruptcy Code explicitly allows a creditor to bid its credit at an asset sale "unless the court for cause orders otherwise…," the court found cause in denying the right to credit bid due to the "confusion as to rights" that would occur.[17]

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[10] *In re Electroglas, Inc., et al.* (Case No. 09-12416 (PJW)), slip op. at 1 (Bankr. D. Del., September 23, 2009).

[11] *Id*. at 2.

[12] *Id*.

[13] *Id*. at 3.

[14] *Id*. at 3-4.

[15] *Id*. at 5.

[16] *Id*. at 5-6.

[17] In an even more recent opinion, *In re Lehigh Coal and Navigation Company*, 2010 WL 2025211 (Bankr. M.D. Pa., April 2, 2010), a Pennsylvania bankruptcy court addressed a similar issue, but arguably reached a

Implications for Indenture Trustees

Regardless of some of the reasoning of the *Electroglas* decision (which could be refined), it probably should not be too surprising that a court would not condone credit bidding by some secured bondholders (less than all bondholders) for their sole benefit, the result of which would be to leave the non-credit bidding bondholders unsecured and condemned to receive a significantly lower recovery than the credit bidding bondholders. The conclusion in *Electroglas* could potentially increase pressure on a group, perhaps even a minority of bondholders desiring a credit bid, to convince the indenture trustee to exercise its credit bid rights. Following the general trend mentioned at the beginning of this article, such pressure likely would be even greater in an environment where secured bondholders feel that any given sale process is unlikely at the current time to result in full value for the assets.

Electroglas thus brought to the fore again questions that indenture trustees have dealt with for years in the context of foreclosure proceedings and which are equally as applicable in the context of a credit bid in a bankruptcy case, including whether and how an indenture trustee should exercise such remedies as foreclosure and credit bidding and possibly take control of collateral (which trustees have historically been very reluctant to do). For example:

- What direction and indemnity is required from bondholders? What percentage of holders giving direction is required? Can the trustee just say no?

- Should the indenture trustee take title to the assets or should it form a separate corporate entity to do so? Normally the preferred answer for trustees is to put any assets in a separate entity, both so value can be distributed evenly to bondholders and so the trustee bank does not expose itself to undue pre-existing or future environmental and other liabilities.

- If it forms a separate entity, how should that entity be organized? How would the value of the assets be transferred to bondholders? Should bondholders get a beneficial or equity interest? How does the trustee ensure that bondholders are treated fairly and equally?

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different conclusion in a situation which did not seem to involve a secured bond trustee. There, the court was asked to approve bid procedures for an asset sale. An agent for a secured lending group, along with an investor in that lending group, argued that the stalking horse bidder, which was another investor in the lending group, should not be allowed to credit bid its debt in the asset sale. Relying on *Electroglas*, the non-stalking horse investor argued that the stalking horse investor ought not be allowed to credit bid because the "investment agreement" to which they were parties provided that "certain benefits would be shared *pro rata*." *Id.* at *1. Noting that the *Electroglas* court was concerned primarily with the confusion that could result if a noteholder should act separate from the group, the court held that (i) there was no evidence introduced to suggest that there would be "the least confusion should [the stalking horse] be the successful bidder" and (ii) the issue in *Electroglas* arose at the time of the hearing on the sale, not preliminary to the actual sale hearing, as was the case here. The court thus permitted the stalking horse bidder to credit bid. (The court did not provide a great deal of detail about the precise relationship among the agent and the investors or the "investment agreement" that apparently defined that relationship).

- Could successor or continuing liability for environmental or other tort claims related to the property attach to the indenture trustee as a holder in the chain of title?

Credit Bidding Options for Indenture Trustees and Bondholders

While there are multiple possible structures to get at the above issues, the authors recently were involved in a credit bid structured as follows. In this case, the indenture trustee and bondholders were secured by a *second* lien on substantially all of the debtors' assets. Thus, the credit bid had to include a cash component in an amount sufficient, at least, to pay off the *first* lien lenders.

(i) the majority holders of the bonds would form (a) the entity to act as the bidder as a limited liability company and (b) a "Holdco", also a limited liability company, which would own 100% of the membership interests in the bidder;

(ii) the majority holders would initially own 100% of the membership interests in Holdco in the form of "Class A Interests";

(iii) the majority holders would direct the Indenture Trustee to, *inter alia*, designate the bidder as the entity that could exercise the credit bid, both in any proposed asset purchase agreement and at the auction;

(iv) if the bidder were to be the successful bidder at the auction, the majority holders would provide financing to the bidder contemporaneously with the closing of a sale of the Debtors' assets to the bidder in an amount sufficient to fund the cash component of the bid (including on account of the Senior Claims) and to fund the bidder's anticipated working capital needs. This acquisition financing would obligate Holdco and the bidder to pay fees and expenses of the majority holders providing the financing, including professional fees and expenses as well as an upfront commitment fee for making the financing;

(v) if the bidder were to be the successful bidder at the auction and a sale of the Debtors' assets to the bidder were to close, Holdco would distribute to the Indenture Trustee as consideration for the Assignment and for the proceeds of the exercise of the credit bid, 100% of the "Class B Interests" in Holdco, which the Indenture Trustee will then distribute on a *pro rata* basis to all holders of the bonds as of a record date to be determined; and

(vi) following distribution of the Class B Interests by the Indenture Trustee, the Class A Interests would be extinguished.

Conclusion

The limits to financing available to distressed issuers and borrowers, combined with low collateral values, has increased secured creditor gamesmanship generally, including particularly the number of situations where credit bidding is seen an attractive (or at least less undesirable) option for secured lenders. For indenture trustees, the cases discussed above again raised questions related not only to the substantive right of a secured bond trustee to credit bid, but also to the trustee/bondholder relationship memorialized in the indenture.