

WHAT SECURED CREDITORS NEED TO KNOW ABOUT CREDIT BIDDING IN CHAPTER 11 BANKRUPTCY¹

By: **Jamie L. Harris (Copyright © 2010)**

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As part of a Chapter 11 reorganization or liquidation, a debtor can choose to sell its assets free and clear of liens pursuant to Section 363 of the Bankruptcy Code, commonly referred to as "363 Sales." As 363 Sales continue to be prevalent in Chapter 11 cases, secured creditors must play an active role in such sales. With a 363 Sale, the rights of secured creditors are sufficiently protected since the lien is transferred and attaches to the proceeds of the sale. Secured creditors should ensure that such protective language is included in any order approving the sale of its collateral. The goal of any secured creditor whose collateral is subject to a potential sale in Chapter 11 bankruptcy is the preservation of the lien/collateral and maximizing the value of the collateral and the claim securing the collateral.

Secured creditors are afforded another important protection in connection with 363 Sales pursuant to Section 363(k) of the Bankruptcy Code--the right to credit bid. Under certain circumstances, it may be preferable for the secured creditor to acquire the collateral in exchange for cancellation of its debt, rather than having the debt repaid. In particular, credit bidding is a valuable tool where the secured creditor is confident that it can achieve a greater return of value on the collateral than the debtor can through an auction process. Secured creditors should evaluate and monitor the debtor's efforts to market their collateral and provide the debtor input on auction/sale procedures to ensure the process will maximize the value of the collateral. Such efforts will help inform the secured creditor as to the necessity of credit bidding.

Credit Bidding allows a secured creditor to bid up to the full amount of its claim to acquire the collateral to which its lien attaches in exchange for cancellation of the indebtedness in the amount of its bid. Credit bidding serves an important function to ensure that collateral is not sold for less than the amount of the debt securing the collateral or less than the secured creditor thinks it may be worth. A secured creditor can credit bid the full amount of its claim at sale, even if the full amount of its claim exceeds the value of the collateral². A credit bid does not need to include any payment of value to the debtor. A credit bid can also be mixed, including cash or other additional value beyond the amount of secured debt to be cancelled. If the amount of the debt forgiveness is larger than the cash amount bid by a third party, the debt forgiveness can be deemed the "highest and best bid" and hence the successful bid in an auction held pursuant to

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² See *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Systems Corporation)*, 432 F.3d 448 (3rd Cir. 2006).

Section 363. It is important to note that the winning bidder or holder of the "highest and best bid" is not always the highest cash bidder. The Bankruptcy Court will evaluate the full value of the bid to the debtor, its creditors, its equity holders, its employees and other parties in interest in determining which bid is truly the "highest and best bid."

A debtor can choose to sell its assets pursuant to an auction or private sale pursuant to Section 363 or the debtor can sell its assets pursuant to a plan of reorganization or liquidation. In the recent highly-publicized (and controversial) Third Circuit decision in *In re Philadelphia Newspapers, LLC, et al.*, 599 F.3d 298 (3rd. Cir. 2010), the Court held that a debtor could conduct a sale of its assets under a plan of reorganization without allowing secured creditors to credit bid. This decision followed a decision by the U.S. Court of Appeals for the Fifth Circuit in *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009), which upheld confirmation of a plan of reorganization that denied a group of secured noteholders their asserted right to credit bid at a private judicial sale of the secured noteholders' collateral. Until these cases, it was generally recognized that asset sales through plans would also provide for credit bidding like 363 sales conducted outside of a plan. It will be interesting to see if these rulings lead to an increase in asset sales pursuant to plans in an effort to circumvent the rights of lenders to credit bid. In light of this decision, secured creditors should have the debtor stipulate in writing to the preservation of the right of the lender to credit bid if the debtor intends to sell its collateral pursuant to a plan. Whether collateral is sold pursuant to a 363 Sale or plan, secured creditors need to actively monitor and evaluate the debtor's efforts to market the collateral in order to determine how valuable a tool credit bidding will be in the process.

For more information about secured creditor rights and bankruptcy sales, please contact Jamie L. Harris at jharris@dlgfir.com or any of the other attorneys at DelCotto Law Group.